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THE COMPANY AS A BUSINESS INSTITUTION

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## THE COMPANY AS A BUSINESS INSTITUTION

Last year, two editors working for *The Economist*, John Micklethwait and Adrian Wooldridge, published a short and fascinating book on the world's dominant vehicle for doing business, the company.<sup>1</sup> It was entitled *The Company: A Short History of a Revolutionary Idea*. In the *Times Literary Supplement*, a reviewer wrote:

The company has always been one of the great mysteries of capitalism: liberals and socialists have never known quite what to think about it. The company is collectivist and co-operative, based on hierarchy, bureaucracy and planning rather than individualism, competition and exchange. Companies appear as little islands of socialism in the market sea.<sup>2</sup>

I think the reviewer slightly overstates his point. Economists have explained the collectivist nature of the company, and the authors of *The Company* cite that explanation. But the reviewer is, I think, correct to note that there is no generally agreed way of evaluating the modern company. Of all the institutions of economic freedom, it is the most controversial and contentious. The other main institutions – free markets, competition, and private property – are widely accepted as necessary conditions for economic growth and reasonably high living standards. But even though the company has evolved as the most efficient way of organising the matching of supply of and demand for goods and services, it has never been exactly popular, especially when it takes on giant or multinational proportions.

Several question marks hang over the modern company. Do the managers really deserve big bonuses in exchange for their purported managerial talent (or lack of it, in the case of some failed ones), or have they just found a way of ripping off their customers, shareholders, and employees? Do big profits really indicate success in meeting customers' preferences, or are they a sign of hidden monopolistic power? Is it acceptable for companies to seek only to maximise share value, or should they be willing to sacrifice share value in the interests of their employees, the communities in which they operate, their suppliers, and the environment? And so on.

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<sup>1</sup> John Micklethwait and Adrian Wooldridge (2003), *The Company: A Short History of a Revolutionary Idea*, Weidenfeld and Nicolson, London.

<sup>2</sup> Andrew Gamble, 'Little Islands', *Times Literary Supplement*, 16 January 2004.

Even Adam Smith had his doubts. Writing about joint-stock companies with limited liability, he accepted that they could mobilise much more capital than what he called 'private copartneries'. But he went on:

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own ... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.<sup>3</sup>

With hindsight, we can be more confident today of the benefits of limited liability, but Smith's observation about the tensions arising from the separation between management and ownership remains highly pertinent. The so-called principal-agent problem – that of better aligning the interests of agents with those of their principals – is a central concern of what today is called 'corporate governance'. Developments since Smith's time, such as the growth of efficient share markets, the emergence of professional investment analysts, executive remuneration policies tied to company performance, and the role of takeovers have done much to discipline poorly performing companies and mitigate problems arising from the separation of ownership and control.

Micklethwait and Wooldridge have quite a lot to say about these issues in their brief history of the institution. But they try to put them into perspective by urging us to recognise the fundamental truth that the company has been a great success and shows every sign of continuing to be so. They bring a much-needed breath of fresh air to the subject. Their celebratory approach is set out in their Introduction:

Hegel predicted that the basic unit of modern society would be the state, Marx that it would be the commune, Lenin and Hitler that it would be the political party. Before that, a succession of saints and sages claimed the same for the parish church, the feudal manor, and the monarchy. The big contention of this small book is that they have all been proved wrong. The most important organization in the world is the company: the basis of the prosperity of the West and the best hope for the future of the rest of the world. Indeed, for most of us, the company's only real rival for our time and energy is the one that is taken for granted – the family (pp 2–3).

In saying this, Micklethwait and Wooldridge in no way seek to minimise the role and legitimacy of other forms of business organisation. Cooperatives,

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<sup>3</sup> Adam Smith (1776), *The Wealth of Nations*, Vol I, p 18.

mutuals, partnerships, owner-operators and other entities all thrive in a wide range of industries. In farming, for example, the owner-operator model remains dominant. If such vehicles for doing business survive in open competition with others, they are demonstrably efficient, although all organisations need to review their structures as market conditions, technology and other factors change. The only point Micklethwait and Wooldridge are making is that, numerically and by weight of economic activity, the company is the principal vehicle for doing business in most parts of the world today.

Their history of the company emphasises three points. First, "the company's past is often more dramatic than its present" (p 8). For all the talk of modern buccaneering entrepreneurs and triumphant multinational corporate power, company life today is a rather tame affair when compared with earlier times, when entrepreneurs risked their lives on voyages to remote parts of the world and competition sometimes took the form of literally destroying your rivals. Second (and connected with the first point), companies have become more honest and more socially responsible. In the past, companies were involved in the slave and opium trades, and some readily used violence against their employees. Today, the number of private sector companies in a country is quite a reliable guide to its degree of political freedom. Third, the modern limited liability company is one of the West's great comparative advantages: a point that was better understood in the nineteenth century than today. One reason is, as Adam Smith observed, that it increased the amount of capital available for investment. Another is that investors could move their capital out of a company reasonably quickly, thus both imposing a discipline on companies and enabling investors to respond quickly to emerging economic opportunities. Micklethwait and Wooldridge argue that it was the company that enabled the West to outstrip the once superior civilisations of China and the Islamic world; and they note that Japan, by far the most successful economy in Asia, is the only one in that continent to have embraced companies early on.

They conclude their Introduction with the observation that, although the influence of companies as a whole has never been greater than it is today, when most people in the West work for them, the clout of the individual company has declined. Certainly it is much less than that of some giant companies that sprang up in the United States a century ago. And not only does the increasing number of companies enhance competition between them, but small companies are growing even faster than big ones, and even bringing into question the rationale of companies.

The authors cite the famous 1937 article, 'The Nature of the Firm', by Ronald Coase which resolves the paradox noted by the reviewer in the *Times Literary Supplement* about companies as "islands of socialism in the market sea". The company exists because it minimises the transaction costs of coordinating economic activity. The alternative – individual transactions between buyers and sellers at every stage in the process of production – would impose ruinous transaction costs. But the authors recognise that the structure of the company itself imposes what they call 'hierarchy costs' – "the costs of central managers ignoring dispersed information" (p 10). Much of the present upheaval in the company world can be explained by the fall in transaction costs as a result of technological change and lower barriers to entry, and the consequent opportunities to save on hierarchy costs. Especially in the global economy, rapidly changing circumstances quickly affect the balance between transaction and hierarchy costs, ensuring that companies have to be flexible and innovative in order to survive and that the company will continue to evolve into new shapes and forms.

The authors trace the history of the company from as early as 3000 BC. Early civilisations set up organisations for conducting trade, but they tended to be *ad hoc* and temporary. However, the Romans did make a breakthrough in the development of company law by providing for an association of people to have a collective legal identity separate from those of its members. After the fall of Rome, China and the Islamic world became the centres of civilisation, but for various cultural, legal and policy reasons – such as China's decision in 1424 to cease maritime exploration – they did

not develop institutions to match the Western company, which began to take its modern form in medieval Europe. Sophisticated banking evolved in Italy, and guilds in northern Europe. Building on Roman law, jurists began to recognise 'corporate persons', which could be "towns, universities, and religious communities as well as guilds of merchants and tradesmen" (p 22). Then in the sixteenth and seventeenth centuries emerged the 'chartered companies', whereby government and merchants collaborated in extracting wealth from the new regions opened up by the fifteenth-century explorers and later colonised by European powers. The companies were granted monopolies on trade with territories for a fixed period. The most famous of them, Britain's East India Company, lasted until 1874, 274 years after it was set up. Occasionally they became virtual governments of the regions they operated in, employing not only administrators but also military forces.

In the eighteenth century it was a chartered company whose conduct inadvertently halted the evolution of the company for a century. In 1711 the British government founded the South Sea Company, giving it a monopoly of trade with Spanish America. Pushed out of that business by war between Britain and Spain, in 1719 the company turned to the market for public debt, and in 1720 it took over the entire national debt. The rapid rise in its stock price stimulated a flood of proposals for new companies competing with the South Sea Company for capital. In June 1720 the British parliament passed the Bubble Act, which made it very difficult to found a new joint-stock company. The puncture of the bubble later that year made the legislation unnecessary, but it remained on the statute book for a century, symbolising the new-found public distrust of joint-stock companies – a distrust that perhaps lingers to this day. Yet Micklethwait and Wooldridge are inclined to defend the chartered corporations against charges like Adam Smith's (namely, that they were less efficient than owner-managed companies), arguing that individual traders could never have commanded the information and trust that were necessary for commerce with regions on the other side of the earth.

Corporate instability did not come to an end until Britain's Companies Act of 1862, which hugely favoured the growth of the joint-stock, limited liability company at the expense of the partnership. Pressure for change had come from some spectacular technical developments in the early and mid-nineteenth century, like railways, the telegraph, and steam-powered shipping. In 1844 the British minister and future prime minister, William Gladstone, legislated to do away with the need for companies to obtain special charters and to allow them to be incorporated simply by registration. But his Companies Act didn't include automatic limited liability. Indeed, at the time many liberals followed Adam Smith in viewing limited liability as a form of harmful subsidy. Even today, some critics of the company can be found who oppose limited liability on the grounds that it enables businesses to exploit their creditors, suppliers and customers by making them carry much of the risk of enterprise.

However, there were strong advocates of extending limited liability. Among them were John Stuart Mill, the liberal philosopher, and Richard Cobden, an erstwhile leader of the Anti-Corn Law League, who argued that limited liability would enable the poor to set up businesses. (It probably did not escape Cobden's attention that the opponents of limited liability included most established manufacturers: what a valuable barrier to entry the restrictions on limited liability must have been for them!) But it was Robert Lowe who made the decisive liberal case for limited liability and went on to frame the legislation that made it automatic (except for banks and insurance companies). As Lowe put it, "If people are willing to contract on terms of relieving the party embarking his capital from loss beyond a certain amount, there is nothing in natural justice to prevent it" (p 56).

As the number of new companies began to increase at an accelerating rate, their legal status was clarified and consolidated in the Companies Act of 1862. This Act brought together what Micklethwait and Wooldridge call "the three big ideas behind the modern company" (p 5): that it could be an artificial person; that it could issue tradeable shares to any number of investors; and that those investors could enjoy limited liability. The authors of *The Company* claim that this Act was one of the great (though generally

underrated) innovations of the nineteenth century: it was widely copied by other countries, and set the company on its way to becoming "the most important organization in the world". This became evident with the subsequent rise of big business in Britain, Germany, Japan, and above all America, where the growth of the railways required the companies that built them to develop the internal management, accounting and information systems that are characteristic of the modern company.

it was in the American manufacturing sector that the potential of the company to assume gigantic proportions was mainly realised. Entrepreneurs like Andrew Carnegie and Henry Ford became owners of corporations whose size was driven by the enormous economies of scale which they were able to exploit through close and complete central control of the manufacturing process. The speed and scale of the growth of such companies promoted the corresponding expansion of industrial trade unionism and also the beginnings of a new kind of business regulation. In 1890, popular fear of and doubt about the corporation led to the Sherman Antitrust Act, which formally outlawed private monopoly. In 1906, the US federal government launched an antitrust lawsuit against Standard Oil, which was broken up five years later on the orders of the Supreme Court. Such regulation has always been controversial, and some modern scholars have argued that the market power of the so-called 'robber barons' was a myth, but it's worth reminding ourselves that individual companies were much more dominant at that time than before or since. As Micklethwait and Wooldridge write about the transformation of Carnegie Steel, then the world's largest manufacturer, into the still bigger US Steel:

[I]n 1901, after a brief conversation on a golf course, [Carnegie] sold the company to J P Morgan and Elbert Gary for \$480 million. They then combined it with another two hundred or so smaller firms and offered the United States Steel Corporation to the public at a valuation of \$1.4 billion. A similar deal done today, expressed as the same proportion of GNP, would approach half a trillion dollars ... The company's value was equivalent to two-thirds of all the money then in circulation in the United States (p 74).

Probably most of the anti-capitalist folklore whose most recent incarnation is the anti-globalisation movement stems from this period of the so-called trusts. Yet in the history of the company it was a surprisingly short-lived episode. By contrast, the next phase of the history of the company –

managerial capitalism – lasted for 60 years, and ended only about 30 years ago.

The sheer size of the big American corporations had inevitably made them too big for their owners to manage personally. So began in the first two decades of the twentieth century the famous 'separation of ownership from control' as the managers took over. The pioneer of this revolution was Alfred Sloan. In reorganising the ailing General Motors in the 1920s, he founded a new corporate model. Deciding that the company was too big to be run by a central authority, he treated its various units as autonomous divisions. In the so-called multi-divisional company, one line of production could be emphasised at the expense of the others in response to changing demand. In recessions, it could survive by switching to cheaper products, and in this way ameliorate the economic cycle. For this to work, management had to become a profession. For most of the twentieth century, the company was dominated by 'the company man', the professional manager whose yardstick of success was not so much profit as market share. As Sloan put it, "I do not regard size as a problem. To me it is only a problem of management" (p 105).

Micklethwait and Wooldridge survey some of the vast body of literature – sociological as well as economic – that managerial capitalism spawned. One strand of thinking claimed that managerialism had obliterated the distinction between capitalism and socialism. James Burnham's *The Managerial Revolution*, first published in 1941, held that the managers constituted a new ruling class in both the West and the Soviet Union: ownership, whether by shareholders in the West or by the state in the USSR, was no longer the source of power. This thesis reached its apogee with John Kenneth Galbraith's *The New Industrial State*, which appeared in 1967. According to Galbraith, the United States was run by an oligopoly of big corporations whose managers in effect planned the entire economy in the name of stability, in more or less amicable cooperation with the trade unions. In striking similarity to their Soviet counterparts, they provided their workers with lifetime career paths and pensions, and even with company-run entertainment and holidays. Implicit if not explicit in this account was

the downgrading of market forces, since macroeconomic policy could maintain high levels of demand and companies could manage demand for their products through devices like advertising.

It's hard to recall just how dominant this way of thinking was, so alien does it seem now. J K Galbraith visited New Zealand in the late 1960s: economists like Bryan Philpott and others associated with the 'indicative planning' vogue of the time fawned over him. But, in retrospect, we can see that Galbraith's joining the debate was a leading indicator of trouble. Galbraith is one of those academics who have the knack of being wrong but fashionable, so that even their mistakes turn out to be good career moves. Only a few years after *The New Industrial State* was published, the first OPEC oil price shock, coinciding as it did with a sudden drop in productivity growth in the United States, revealed how sclerotic many Western economies had become. The development of new forms of transport and communication helped spawn a new breed of entrepreneurs who, tuned to market forces, started to challenge and eclipse the big corporations; the most well-known and most symbolic example is the decline of IBM and the rise of Microsoft. Japanese exporting companies organised on different lines from their Western counterparts seized terrifyingly big slices of market share from them. As the centrality of the marketplace was rediscovered, deregulation and privatisation brought new power to shareholders, including those aggregated in pension funds, who started demanding competitive returns on their investments. The main response has been what Micklethwait and Wooldridge call "the unbundling of the company", that is, concentration by companies on their 'core competencies' as they shed the rest. Although big companies continue to grow, small companies grow faster, and now supply most of the new jobs. The result has been a net shift away from corporate bigness to a degree that is not widely realised, least of all by the anti-globalisation movement. According to Micklethwait and Wooldridge:

In 1974, America's one hundred biggest industrial companies accounted for 35.8 percent of the country's gross domestic product; by 1998, that figure had fallen to 17.3 percent. Their share of the nation's workforce and its corporate assets also roughly halved ... by 2000, roughly half the biggest one hundred industrial firms in 1974 had disappeared through take-overs or bankruptcy (pp 125–6).

Although the authors of *The Company* don't develop the idea, the managerial capitalism of the early and mid-twentieth century faded away because the 'hierarchy costs' of the company – the costs of central managers ignoring dispersed information – had grown inefficiently large, leaving established companies vulnerable when new, market-friendly technologies started lowering the transaction costs whose avoidance provided the entire rationale of the company. As well, new technology has made it possible to customise products to such a degree that the economies of scale on which the famous companies of a century ago grew to such size and prominence no longer exist. The management fads of recent decades – downsizing, total quality management, re-engineering – can be viewed as attempts to economise on hierarchy costs by tapping into the knowledge dispersed among a company's entire workforce. It's generally accepted nowadays that companies that succeed in the modern era of consumer capitalism avoid big bureaucracies and encourage the flow of ideas and information throughout the organisation. At the same time, to remain competitive, companies are having to shed or reduce the quasi-welfare-state functions that Galbraith and others identified as characteristic of the modern corporation, like the promise of lifelong employment and secure pensions.

In their concluding chapter on 'The Future of the Company', Micklethwait and Woodridge offer three possibilities. The first is the one presented by the anti-globalisation movement: a few giant corporations are silently taking over the world but, unlike the nation states they are displacing, they are unaccountable and have no sense of responsibility. The authors reject this outcome for reasons we have already seen: the market share of the biggest companies is declining, not growing, and this is true even for companies producing the most advanced products like computers and long-distance telephony. Moreover, talk of companies being bigger than many countries is based on false comparisons; in terms of net output, hardly any countries are smaller than the largest companies.

The second possibility envisages that transaction costs decline to the point where they fall below the hierarchy costs of companies, and thus render

companies uneconomic. That is to say, it would be cheaper for each stage of the production process to be negotiated separately on the open market than to bring them under a central organisation. Evidence for this possibility exists in the form of increasing contracting-out of services by organisations and growing numbers of independent freelance contractors, for whom the Internet might have been specially designed. Indeed, the Internet is the site of the world's biggest market in terms of participants. Ebay is no more than a website, but on it many millions of people buy and sell all manner of products; it is the nearest real-world approach yet to the textbook model of 'perfect competition' in which information flows virtually instantaneously and at zero marginal cost. Nevertheless, Micklethwait and Wooldridge don't see the company becoming extinct; too many of them have core competencies, usually cultural ones, that can't easily be marketised, and there are enough market failures around to justify companies' preferences for attempting to do some things internally. Even companies that set up internal markets are still companies.

The third possibility flows from the second: that the company will be displaced as the basic building block of the modern economy by the network. The idea derives from the 'borderless' firms of Silicon Valley rather than the interlocking firms of Japan's *keiretsu*. But the authors of *The Company* point out that these networks are still based on companies, which, unlike networks, have legal personalities that can be held accountable.

The authors conclude that the trend is nevertheless towards lower transaction costs and networks:

The erosion of Coasean transaction costs will make it ever easier for small companies – or just collections of entrepreneurs – to challenge the dominance of big companies; and ever more tempting for entrepreneurs to enter into loose relationships with other entrepreneurs rather than to form long-lasting corporations (p 177).

Yet they wisely hedge their bets by bringing in that most unpredictable factor: politics. Recall the 'question marks' that I said at the start of this speech hang over the company. The three possibilities sketched above are all driven by economic factors. But the operation of these factors is bound

to be affected by regulation. While markets have been largely deregulated, companies are in fact being subjected to new kinds of regulation – and not just ‘social’ regulation, but also, and especially in the case of the privatised utilities, ‘economic’ regulation designed to prevent the abuse of monopoly power. Yet Micklethwait and Wooldridge still expect the Anglo-Saxon model of the company, with its focus on shareholder value, to gain ground, not only because its success has been proven but also because it is so flexible and adaptable to changing circumstances.

Nevertheless, the writers admit the damage to the company's reputation done by scandals like those of Enron and WorldCom. Beyond that, they allude to a problem of what could be called ‘unrequited loyalty’: companies are widely felt to demand a lot from their employees – for example, long hours of work – and yet to make them redundant readily when the bottom line so demands. As well, they recognise that popular doubts and fears about multinational corporations may rest on deep sentiments that cannot be argued out of existence by demonstrations of the benefits of globalisation. As they say, "There is something worrying about the idea that your job is dependent on the decisions of managers who live in faraway places" (p 172). They end up warning that there have to be limits to regulation: “[B]oth government and companies have prospered when the line between them has been fairly thick” (p 183). The company must assuredly obey the law, but it must be left alone to generate wealth.

So *The Company* ends, rather unexpectedly, on an uncertain note. The authors return to the point they make at the end of their Introduction about the declining influence of individual companies. But now they sound downbeat rather than triumphalist: “[W]hile the company in general has never seemed more vibrant, individual companies have never seemed more fragile and insubstantial” (p 183). Have they then made good their original claim that the company is the most important organisation in the world, rivalled only by the family in its claim on our time and energy? They make a good case, but there is surely more to be said.

There is one big and obvious difference between the company and the family: each of us belongs to one family, but very rarely does a single company command an individual's allegiance in the same way. For a start, we can't choose our families, but we freely choose to work for or to quit a company. Only in the era of managerial capitalism did a significant number of people identify with a company to a degree that approached their closeness to their families. But many people who work for companies still assume or expect a kind of mutual loyalty, a sentiment that is really a throwback to an earlier era when companies inherited the loyalty of a deferential workforce that had only recently been emancipated from patron-client, feudal relationships (a mentality unfortunately prolonged by managerial capitalism). Contemporary demands for regulation to enforce 'corporate responsibility' are similarly reactionary; modern companies have to deal fairly and clean up their own mess, but they surely have no special obligation to provide welfare for those in need that goes beyond the obligation we all have to do that. Indeed, if companies are as competitive as we want them to be, they will have no spare margin of resources to devote at their discretion to good causes. Where giving does not benefit the company, that role should be left to shareholders unless they have given their consent to purely charitable activities.

Micklethwait and Wooldridge cite the forces reducing the transaction costs that explain why companies exist, and recognise that these forces are changing the structure, orientation and longevity of the company. If these forces gather pace, as they presumably will, people will learn to withhold loyalty from the companies they work for but to remain loyal to their own professionalism. That is to say, relationships within the company will become increasingly negotiable and contractual, and will survive only so long as they serve the interest of both parties. All this is unavoidable if both companies and their employees are to remain competitive. As such, even if the company remains a central building-block of the modern economy, it will not *seem* so important, or to so many people, as it once did.

As noted, Micklethwait and Wooldridge insist that the company is here to stay. "Despite the seductive charm of frictionless capitalism", they write,

"most people seem to like being in companies" (p 11). No doubt, but the forces that the authors themselves cite could well eventually change the share of people who work for companies. As we've seen, they envisage that falling transaction costs will create more opportunities for, as they put it, "entrepreneurs to enter into loose relationships with other entrepreneurs rather than to form long-lasting corporations". As a result, working for a company is likely increasingly to appear as just one type of contractual relationship among the several that individuals may enter into.

And while the company may be the most important 'organisation' in the world, it rests on an institution which is even more basic and which genuinely does rival the family in importance, namely, private property. Without property, there could be no companies, but neither could there be any other way of doing business that creates wealth for all the parties involved. Respect for private property, including the property rights of shareholders, under the rule of law and in markets open to competition, remains the foundation on which the wealth of nations is built, as Adam Smith argued more than two centuries ago.