Capitalism: Still on Trial

BY NORMAN BARRY

It was not enough to defeat communism and cause all socialists to rethink their anti-capitalist strategy. Still the private-property market system is under sustained attack from the left. But this time the opposition has a more profitable approach. The aim is no longer to socialize everything, but to subject capitalism to a prolonged ethical assault.

This approach is a bit more subtle and is immune from the empirical refutations that destroyed old-fashioned socialism. But the effect of the new critique could be as deadly as the familiar anti-capitalist nostrums. And it cannot be denied that capitalists themselves have been the main source of the new critique. Because of the business scandals of recent years, the opposition has been aided by the behavior of personnel in the business system. As I shall demonstrate, the problems of business today relate to some familiar quirks of the capitalist system, and naturally the critics have got it all wrong.

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There are some easy targets. Unrestrained capitalism, it is said, produces unadulterated greed, and its problems can only be alleviated by yet more government regulation and more restraints on entrepreneurship, the creative driving force of business. And, of course, parallels are already being drawn between today's malfeasance and the infamous "decade of greed," the 1980s. But although both eras involve the same business problems, the mechanics of business change and behavior are rather different.

One of the greatest achievements of capitalism was the invention of the limited-liability, or joint-stock, company; its easily exchangeable shares and legal personality led to that flexibility which is the envy of markets that have not developed it. There are indeed two types (at least) of capitalism: the Anglo-American system, which emerged from the common law of contract, and the European system, which is the product of code law.

The Anglo-American theory of the corporation, despite legislative and judicial depredations, endures.[1] The managers of a corporation have a fiduciary (strict) duty to advance the interests of the owners, the stockholders. In the European model of capitalism, other groups, known as stakeholders, are thought to have a significant role in decision-making in the corporation. This is best exemplified in the German company, which has the two-board management system in which trade unions and others, often politicians and public figures, can be decisive. The statute that created the limited-liability company in 1870 decreed this. Though not eliminated, owners' rights are reduced. That is why takeovers are rare.

But the Anglo-American corporation, despite its many virtues, has been afflicted by one problem since its beginnings. It was first identified by Adam Smith and is known as the "agency" problem. The owners are the *principals*, the managers the *agents*.[2] The question is: how do we get the agents to observe their fiduciary

Contributing editor Norman Barry (norman.barry@buckingham.ac.uk) is professor of social and political theory at the University of Buckingham in the U.K. He is the author of An Introduction to Modern Political Theory *and* Business Ethics.

duties and not run off with company assets, shirk on the job, and pursue their self-interest. They do have considerable discretion, especially in America under the "business judgment" rule, by which courts are prepared to accept almost anything done by managers as being in the interests of the company. Smith thought that the only viable form of business enterprise was the owner-managed firm.

If we compare the 1980s with the early years of the 21st century, we see the same problem but with widely different answers. It is a serious mistake of the critics of capitalism to bundle the two eras under the common name—greed. They are very different.

The 1980s saw a really significant shift in wealth and power from the managers to the owners. This was a response to the earlier accumulation of wealth and power by corporate executives. True, takeovers took place in the earlier period, but they were not designed to advance stockholder value. Rather they were to increase the wealth and power of the managers. This led to the creation of unwieldy conglomerates that held back American economic progress. Clever entrepreneurs like T. Boone Pickens and adroit financiers such as Michael Milken broke them up. Companies were captured by raiders, only this time to advance stockholder value. They were often taken private; management was slimmed down; and the companies were brought back to market to yield even more profits. The personnel involved in this were despised and their methods excoriated, yet the whole experience underlay the remarkable American prosperity at the end of the twentieth century. This was the result of the spontaneous evolution of capitalism.

Victims of Managerial Power

The very opposite happened at the beginning of this century. Stockholders had become the victims of a new era of managerial power. And, in comparison to the much-despised 1980s, which were characterized by rather high levels of probity, there was massive cheating by executives. They deceived the stockholders at every turn and rigged the stock market, and that much-prized value, transparency, which should be the main feature of good corporate governance, descended into a mystifying opaqueness. It was difficult for stockholders to know what was going on until it was too late.

Of course, the market eventually wreaked its revenge, and big companies all but collapsed under a sea of debt. The market does eventually punish wrongdoers, but a lot of people lose serious money on the way. A crucial feature here was the decline in effectiveness of the auditors and accountants. Supposedly independent of management, they are charged with the duty of providing stockholders with essential information about the company. But they were also engaged in lucrative consultancy work for the company. This obviously gave them an incentive not to reveal vital information. It would obviously have a deleterious effect on the price of the stock.

None of this had much to do with today's morality. Indeed, the people involved in scandals had high moral profiles. They gave money to charity (though that was often company money), practiced affirmative action in the workplace, and generally followed the dictates of conventional business ethics. But what the aberrant companies did in the last five years was to breach those conventions of good business practice that had grown up independently of statute and departments of moral philosophy at Ivy League universities.

Enron Collapses

Enron collapsed with massive debts in December 2001.[3] It was a hugely successful energy-trading company, though it began as a small gas firm. Its problems arose because it had embarked on highly ambitious schemes and engaged in complex derivative trading and various offshore ventures. It had managed to conceal its difficulties from the public and investors, and was still getting good reports from the press right up to its demise, although the credit-rating agencies always thought it a risky company.

The virtue of Anglo-American capitalism is that Enron-type disasters are avoided, or their worst effects mitigated, through constant stockholder pressure, either through "voice" (harassing management at annual general meetings) or "exit" (selling their stock to a raider). These are checking devices that have emerged spontaneously to solve the agency problem. But to be effective they require transparency on the part of companies.

In the Enron case, stockholders were deceived about the true state of the company. This was done in a number of ways, the most important being the creation of Special Purpose Entities (SPEs). These are a kind of partnership within the firm, and they have the advantage, for someone anxious to conceal the truth, that their figures do not appear in the company's books. SPEs are not illegal. However, they are certainly imprudent, and in Enron's case their existence enabled the managers to evade the responsibility of telling the truth to investors.

Enron executives were distinguished by the fact that the bulk of their income came from stock options. This gave them an incentive to keep the price of the stock artificially high. Their auditors, the now-ruined Arthur Andersen company, helped them in this. The auditors were not defenders of the stockholders' assets, but were conspiring with the managers.

Neither federal nor state law was any help to the stockholders. The federal Williams Act of 1968 made it difficult for outside stockholders to organize tender offers and threaten management with surprise bids. Equally significant was the fact that all 50 states had passed their own anti-takeover laws in response to the boom of the '80s. This was largely at the behest of incumbent managers worried about their jobs. These laws were designed to protect the allegedly defenseless employees and investors. They did precisely the opposite, entrenching management instead.

Perhaps one of the most questionable acts of the Enron executives was to persuade workers to keep on buying stock in the company when the executives knew it was in desperate trouble. They were unloading shares at what was then a high price. One, CEO Kenneth Lay, has been charged with insider dealing (and other federal criminal offenses), a law of which I have written critically in the past: but this was not the real error in the case. It has been cogently suggested that Lay had good reasons for selling his Enron stock and that his sale was not merely a preemptive response to a future fall in its price.[4] But the appropriate remedy here for any wrongdoing should have been civil action. Enron executives were in breach of their fiduciary duties to the firm and its investors (especially the workers). However, the Justice Department has become adept at turning civil wrongs into serious criminal offenses. It is clear that that the action against Lay is more political than legal, and the long delay in bringing him to trial suggests this. Like other "white collar criminals" in the past, he has been so publicly vilified that a jury is unlikely to be impartial. Of course, the government wanted someone to blame. And the workers, through their representatives, were remiss in not demanding more information. No doubt they were misled into thinking that regulation would save them.

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The WorldCom Case

The scandal at WorldCom, whose bankruptcy in 2002 matched that of Enron, revealed similar features of business malpractice. This was a small telecommunications company that became a world leader, largely through some spectacular takeovers. But it had suffered from bad investment decisions and some extraordinary extravagance by employees. Its founder and former chief executive, Bernard Ebbers, was said to have "borrowed" up to $408 million from the company. All the time information was withheld from the market so that investors could not make informed choices. An example was the company's representing as working profit $2 billion put aside for bad debts. These malfeasances had been going on since 1999, when Arthur Andersen was the auditor, and were only revealed by the replacement firm, KPMG.

Another great scandal that shocked the Anglo-American corporate world was the affair at Tyco International. This did not involve the complexities of corporate finance that Enron featured. It was more a case of straight theft from the firm. But it illustrates the familiar agency problem. Its chief executive, Dennis Kozlowski, and the chief financial accountant, Mark Schwartz, treated the company like a personal cash cow. Kozlowski is said to have spent $1 million of company money on his wife's birthday celebration and, equally notoriously, $6,000 on a shower curtain for his home. The pair eventually faced a 32-count indictment, including charges of grand larceny. A mistrial was eventually ordered because of witness tampering, but the defense argument that the expenditure had board approval and that there was no criminal intent may prevail, bizarre though that seems.

The lesson drawn by some business observers is that stockholders should be more active in the running of publicly quoted companies. But that is a little misleading, for traditionally the ultimate exercise of ownership rights, selling out to a raider, had been sufficient to keep management in line. In normal circumstances it is not in the rational self-interest for small owners to be involved in management. However, the aforementioned federal and state laws restricting takeovers have blunted that weapon; so a new form of stockholder activism might be required. And here there is clearly a role for big equity owners to take an interest in the company. They can see more clearly the effect of management on the value of their stock. Already this is happening. The huge public-sector pension organization, the California Public Employees Retirement System (CalPERS) is active in corporate governance and the practice is spreading throughout the Anglo-American capitalist world. After all, managers of pension funds have fiduciary duties to their members.

David Hume

Limits of Morality

But in all these issues it is important to understand the nature and limits of morality. Moral philosophers have been far too anxious to stress supererogatory duties, that is, those that are worthy but not compelling, and have underplayed the basic rules by which we all live. The latter may not be glamorous, but successful business would be impossible without their observance.

The eighteenth-century Scottish philosopher David Hume was acutely aware of the dangers of a strident morality. He said that ethics has no basis in reason and was entirely a function of the passions. But this did not make him an *immoraliste*, for he believed that human experience shows how strict *conventions* (the basic and uncomplicated rules of morality) come to be adopted, especially for law, property, and economics.[5] By playing "repeat games" we overcome the absence of trust in human affairs so that self-interested utility-maximizers advance their own goals by cooperating. He was worried that morality had a tendency to become an "enthusiasm" detached from human experience. He would regard modern business ethics as one such enthusiasm. All the recent business scandals have involved clear breaches of fiduciary duties. We don't need a new moral philosophy to tell us that corporate theft and lying to stockholders are wrong. We only need to understand conventions.

European Capitalism

Just as the Europeans were preening themselves on their virtue in the light of American business scandals, they were suddenly shocked by the revelation that Parmalat, the huge Italian company, was facing bankruptcy with losses of 14.5 billion euros. This was in the Enron and WorldCom class for corporate chicanery.

Part of the original European claim for financial probity was that companies there were not primarily vehicles for the enrichment of greedy stockholders. European companies are "stakeholder driven" organizations in which a variety of groups essential to the business have a share in its governance. Owners (stockholders) are simply one of them. The influence of stockholders is further reduced because most investment capital is raised by bank loans rather than share issues. Since banks are also considerable equity holders, unlike in the United States or the United Kingdom, this gives them excessive influence in company policy. The banks are important figures on the supervisory boards of German companies, enabling them to put together coalitions of interests to resist the sanitizing effects of corporate raiders. Banks also act for minority stockholders. Since the restless search for stockholder value has not been a feature of German business, the significance of ownership is less than in the Anglo-American corporation.

However, as Italian experience reveals, the stakeholder system, so far from "democratizing" the corporation and making it responsive to demands of groups other than stockholders, has entrenched the management of a small group of self-interested insiders. True, Italian companies are quoted on the stock exchange, but they are effectively controlled by families. The Agnelli family's reluctance to cede control of Fiat, which has slid near bankruptcy, is the classic example. Italians have not developed the Anglo-American style of corporate governance because they have not developed a notion of trust (or reliance on Humean conventions). The anonymity of large-scale capital markets, as opposed to the intimacy of family ties, is alien to them. Italy is the heartland of "crony capitalism."

If crony capitalism is bad for business, as it unquestionably is, then the Parmalat case took it to new heights of venality.[6] Despite the absence of a love interest, a diva, and a dagger, it was worthy of a Verdi opera. Parmalat was originally a successful company specializing in dairy products. But gradually it lost interest in milk and cheese and acquired *worldwide* holdings in a variety of unrelated products.

Parmalat was able to carry on without restraint because of the absence of any checking mechanisms, least of all from stockholders, in the company. It was effectively controlled by one family, the Tanzi, and the dominant figure was Castilio Tanzi. He ruled the company like a medieval tyrant, and corporate governance was abysmal. Extensive bank loans were raised and companies bought at inflated prices. And unlike in American takeovers, the companies were not turned into viable business enterprises, but became the personal property of the Tanzi family. When disaster struck, Parmalat was an incomprehensible, impenetrable, and debt-ridden colossus with no discernible business strategy.

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Stakeholders Silent

And what did the legendary stakeholders do about all this? Precisely nothing, except blame one another. The crisis could have been averted if investors and bankers had taken action. As it turned out, they were silent and inactive and lost large amounts of money. There were culpable individuals involved, but the whole culture was rotten. In Italian business the importance of family control is so strong that the checking bodies are reluctant to stand up to them. That had not been too serious in the past, but the successful spread of globalization requires a notion of trust that extends beyond family members. And indeed, Parmalat's problems emerged when it became a globalized company.

Only in Germany are there signs of stockholder activism. Although the country had established a full-fledged market system under Ludwig Erhard in the 1950s, it had never adopted Anglo-American business techniques. Firms were always run by stakeholders, especially bankers, and stockholders had little influence. The apogee of German stakeholderism was reached in 2001 with the defeat of the hostile bid for Krupp by Thyssen. It was turned into a tame merger.

But the successful bid for Mannesmann by Vodafone in 2002 was a significant blow for Anglo-American capitalism.[7] The case had a curious aftermath. Mannesmann executives awarded themselves massive (American-style) "golden parachutes." This angered stockholders and caused great controversy in German business. The executives were eventually charged with criminal offences, and although they were acquitted, the whole saga marked a turning point in German business. There are other cases pending, and German stockholders are now demanding, vociferously, an Anglo-American-style of business with a new emphasis on stockholder value.

Despite their obvious differences, recent events in American and European business reveal a remarkable similarity: the shift in wealth and power to company executives. In America the investors were the losers, and in Europe other stakeholders suffered as well. In the 1980s the threat of a takeover kept agents (company executives) in line. Sadly, that has been seriously weakened through legislation, and in Europe it has always been moribund. But the natural, self-correcting mechanisms of the market are the only secure devices against fraud and the exploitation of the owners by managers.[8]

1. See Norman Barry, "The Theory of the Corporation," in *Ideas on Liberty*, March 2003, pp. 22–26, www.fee.org/~web/0303iolpdf/feat5.pdf

2. See Adolph A. Berle and Gardner C. Means, *The Modern Corporation and Private Property* (New York, Macmillan, 1932) for a critique of capitalism from this perspective.

3. See William A. Niskanen, *A Preliminary Perspective on the Major Policy Lessons from the Collapse of Enron*, Cato Institute, July 2002.

4. William L. Anderson and Candice E. Jackson, "Is Ken Lay a Criminal?" Ludwig von Mises Institute Daily Article, August 16, 2004, www.mises.org/fullstory.aspx?control=1589 Mises.org.

5. See Norman Barry, "Political Morality as Convention," *Social Philosophy and Policy*, vol. 21, 2004, pp. 266–92.

6. See *Financial Times*, April 13, 2004.

7. Norman Barry, "The Logic and Morality of Takeovers," *Ideas on Liberty*, July 2000, pp. 33–37.

8. The Sarbanes-Oxley Act of 2002 got some things right. For example, auditors must rotate every five years, and they cannot be consultants. But it also imposed heavy compliance costs on companies. However, companies could have done these things themselves, and were doing so, without the heavy regulatory burdens.