

## **Do managers have a role to play in sustaining the institutions of capitalism?**

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### Abstract

In a capitalist system based on free markets, do managers have responsibilities to the system itself? If they do, should these responsibilities shape their behavior when they engage in the political processes that structure the institutions of capitalism? The prevailing view—perhaps most eloquently argued by Milton Friedman—is that the first duty of managers is to maximize shareholder value and thus that they should take every opportunity (within the bounds of the law) to structure market institutions so as to increase profitability. We argue here that this shareholder-return view of political engagement may apply in cases where the political process is sufficiently “thick,” in that sufficiently detailed information about the issues is widely available and the public interest is well-represented. However, we draw on a series of detailed examples in the context of the determination of corporate accounting standards to argue that when the political process of determining the institutions of capitalism is “thin,” in that managers find themselves with specialized technical knowledge unavailable to outsiders and with little political resistance from the general interest, then managers have a responsibility to market institutions themselves, even if this entails acting at the expense of corporate profits. We make this argument on grounds that this behavior is both in managers’ long-run self-interest and, expanding on Friedman’s core contention, that it is managers’ moral duty.

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On May 23, 2012, at a meeting in Norwalk, Connecticut, the trustees of the Financial Accounting Foundation, the quasi-public authority charged with overseeing America's accounting-standards infrastructure, approved the establishment of the Private Company Council (PCC). The PCC was empowered to create accounting rules for private companies—that is, companies not listed on regulated stock exchanges in the United States.<sup>1</sup> Henceforth, private companies would be governed by different accounting standards—created by a different rulemaking body—than public companies.

This was an extraordinary move. Prior to the establishment of the PCC, those private companies that had issued financial reports had generally used the same accounting rules that were required of public companies. In the course of lobbying for the PCC, private companies and their intermediaries had expressed frustration with the rising costs of complying with these rules and the difficulty of influencing the political process that determines them. But inconvenient rules and a difficult political terrain are hardly reasons to create a new rulemaking body. Accounting rules are at the heart of modern market capitalism, shaping incentives and performance evaluations and the resource allocation decisions that drive economic activity, and there is no compelling evidence in the recent research literature that would suggest that having separate accounting standards for public and private companies would increase overall economic efficiency.<sup>2</sup> Is this a case of firms inappropriately shaping the rules of capitalism for their own benefit?

Of course it is too soon to tell whether the creation of the PCC will impose net costs on the economy. But there is a real risk that imposing separate accounting rules on private and public companies could create confusion and increase costs, particularly for the small, unsophisticated investors who benefit most from widespread transparency. But even larger, more sophisticated players may be hurt, given that there is considerable evidence in the accounting research literature suggesting that changes in even the mere form of accounts can impose real costs on markets.<sup>3</sup>

Despite its potential implications, the establishment of the PCC went unnoticed by most Americans, and—as far as we can tell on the basis of public records—only one member of Congress was even cursorily involved in its creation. The process of determining accounting rules is hardly one that receives much attention from the general public, politicians, and the media, and the process surrounding the creation of the PCC was both highly technical and highly specialized. Corporate managers (including auditors and finance executives), by virtue of their resources and experience and the fact that the

development of the PCC took place largely outside the public eye, appear to have had a remarkable ability to affect its resolution.

Here we ask whether this is a good thing—and in particular whether it is consistent with the role of corporate managers in capitalism.

*“Thin” and “thick” political processes and the responsibilities of corporate managers*

The idea that firms might attempt to influence the rules of the game in their own interest is not a new one, as the long literature in the field of so-called “regulatory capture” suggests.<sup>4</sup> For example, in the United States, where data on corporate political contributions and lobbying expenditures are relatively more accessible, a number of studies suggest that firms engage in the political process in an attempt to improve their profitability.<sup>5</sup> Internationally too, there is some limited evidence of similar self-serving corporate political behavior.<sup>6</sup>

We argue here that, in general, self-interested profit-seeking corporate political activity may not be a cause for concern if the political process is sufficiently “thick”—that is, if diverse interests and viewpoints are sufficiently well-represented that the public interest in the operation of well-functioning markets is actively addressed. If firms face active and involved competitors—or other powerful interest groups such as labor unions, pensioners, or organized consumers—as they attempt to shape legislative or regulatory outcomes, it seems plausible that in many cases the kinds of lively conversations that result will lead to the development of institutions that can support an approximation to free and fair competition.

Indeed, the research literature generally supports this view—suggesting that while firms and their managers are often active in the political processes that determine market institutions, they are not usually able to shape political outcomes entirely to their own interest.<sup>7</sup> However, we argue that when managers have access to critical information that is *not* available to others who might have an interest in shaping these institutions and when they face very limited opposition—that is, in “thin” political processes—there is a real risk that private sector engagement with the political process will fundamentally distort the institutions of capitalism, and managers may have responsibilities to the system itself. These responsibilities flow from exactly the moral commitments that underpin managers’ commitment to shareholder-value maximization.

In developing this argument, we explore the broad question of the responsibilities that managers have when they engage in political activity. In whose interests should managers act in those cases that involve highly technical issues about which they have unique information and for which there is no well-defined opposition? When is it legitimate, for example, for managers to distort the rules that define accounting profit in order to increase their own profitability? More generally, how should we think about corporate managerial engagement in sustaining the institutions of market capitalism, particularly when managers have a near monopoly on the necessary substantive expertise and experience little political opposition from the general interest?

One influential answer to these questions is that as long as they are careful to obey the law, managers should act solely to maximize shareholder returns. Milton Friedman's assertion that "the social responsibility of business is to increase its profits" is perhaps the most well-known summary of this idea.<sup>8</sup> Friedman's assertion is commonly interpreted as suggesting that if managers can shape the rules of the game to increase their own profits then they should certainly do so.

Here we qualify this interpretation. We begin by showing that Friedman's argument—and the focus on shareholder responsibility that is so central to our current conversation about managerial responsibility—is essentially a statement about a manager's *moral* responsibility. Put differently, Milton Friedman's clarion call to focus corporate managers on shareholder responsibility is deeply grounded in a long tradition of argument in economics *and ethics*. We revisit this tradition to suggest that it rests on three key commitments: to maximize aggregate welfare, to secure individual economic and political freedom, and to minimize the problem of agency. We reason that Friedman's suggestion that all three commitments can be best met by maximizing shareholder returns is entirely appropriate in a world in which market competition is "free and fair"—but that when there is a risk that corporate political involvement will make markets significantly less free and fair, these commitments themselves imply that managers have an agency responsibility for the institutions of the market.

Specifically, we suggest that when markets are fully competitive and the political process is sufficiently "thick," such that one can be reasonably certain that the institutions constraining the market are designed in the presence of adequate information and a wide range of diverse interests, then a single-minded focus on shareholder returns is indeed consistent with these moral commitments. However, we draw on a range of examples from the development of accounting rules to argue that a simple focus on shareholder

returns is morally untenable when political processes are “thin.” In these kinds of settings—which, besides accounting rulemaking, can include the determination of banking regulations, insurance and actuarial standards, and auditing rules—expertise relevant to developing the rules of the game (the institutions that support market capitalism) is largely concentrated in the hands of business. Here, we argue, the managers of these businesses are agents not only of their shareholders but also of the system that sustains market capitalism. Importantly, this conclusion follows from the same moral logic that legitimizes the pursuit of shareholder returns in competitive markets. In thin political processes, we argue that managers have a duty to act in a way that advances the interests of the system as a whole. We suggest that this responsibility could mean acting at the expense of corporate profits—and hence of shareholders—and we close this article by exploring how this responsibility could be enforced in practice.

### *The fundamental moral commitments of capitalism*

The idea that managers should act as agents for their shareholders and that their foremost duty is to maximize shareholder returns is deeply embedded in today’s conversation about managerial responsibility. Indeed, it is perhaps the singular normative principle embodied in contemporary economics. It is also believed to be enshrined in U.S. corporate law and in the law of almost all other jurisdictions with some form of a market economy. Further, a host of private institutions such as auditing and supervision by a non-executive board of directors have emerged to enforce it in practice.<sup>9</sup>

The injunction to maximize shareholder returns rests on three central moral principles.<sup>10</sup>

First, as Friedman and many of his colleagues suggested, under a number of well-defined conditions, including free competition, non-constant returns to scale, the absence of collusion, and the mitigation of information asymmetries, maximizing shareholder returns maximizes public welfare.<sup>11</sup> Intuitively, if all firms aggressively pursue the creation of shareholder value, competition will drive all of them to be both efficient and innovative whilst also preventing any single firm from becoming dominant. Thus, although every firm will attempt to achieve monopolistic profits, competition between them will lead many firms to become increasingly efficient, innovative, and responsive to consumer needs. It will also prevent any one firm from actually becoming a monopolist for any extended period of time.

Technically, this idea is laid out in what is known as the “welfare theorems.”<sup>12</sup> These theorems establish two powerful results. First, they show that any outcome that results from a multitude of profit-seeking firms competing with each other will efficiently allocate, in the aggregate, scarce resources across all of the diverse preferences in a population. In other words, outcomes from competitive markets are efficient for society at large. Second, recognizing that there might be different notions of “efficient” allocations across a population (driven by differences in human preferences over what constitute fair distributions), they establish that any predetermined efficient allocation (or distributional outcome) can be accomplished through profit-seeking firms competing in properly designed markets.<sup>13</sup> The first compelling moral justification for the maximization of shareholder returns is thus utilitarian—or a reflection of the belief that, all else being equal, we should act in such a way that we maximize the welfare of the greatest number of people possible.

The second moral argument behind the injunction to maximize shareholder returns—one made often by Milton Friedman and others writing on the ethics of capitalism, including Friedrich Hayek—rests on the normative primacy of individual freedoms.<sup>14</sup> This is the belief that personal, individual freedom is—or should be—the primary goal of society and that an individual’s ability to make decisions about the disposition of her resources and time should be one of society’s highest goals. This idea is deeply rooted in the post-Enlightenment, classical-liberal tradition of the eighteenth and nineteenth centuries. In writing about the moral core of capitalism in the aftermath of World War II, Friedman and Hayek drew from this tradition as a way to articulate an intellectual counterpoint to the Soviet Union’s philosophy of centralized economic control.

Broadly, this freedom-based argument for the shareholder-value paradigm can be understood as deriving from the libertarian conception of freedom. Freedom, in this context, is “immunity from encroachment” or the ability to make decisions free from the interference of others.<sup>15</sup> Milton Friedman suggested that the ability of individuals to choose their field of employment is a particularly compelling example of this kind of freedom. Others have suggested that political freedom may in turn rest on the maintenance of economic freedom, since when the state controls the economy the space for political dissent is greatly limited.<sup>16</sup>

The third moral principle on which Friedman based his argument for a focus on shareholder value is the notion that managers should act as trustworthy agents for

investors. This is both because maximizing shareholder returns is in itself the appropriate moral stance for the firm, for the arguments we have outlined above and because acting as a trustworthy agent for a principal is a moral commitment in its own right, rooted in the widely shared idea that it is a moral imperative to keep one's word and not to misuse funds with which one has been entrusted.

Together these three arguments make a powerful case for shareholder-value maximization and are the moral force behind Milton Friedman's famous summary as to what constitutes the "social responsibility of business." From this perspective, failing to maximize shareholder returns not only constitutes a betrayal of one's responsibility to shareholders but also threatens to reduce overall welfare and—by compromising the efficiency of the system—to reduce individual economic and political freedom.

Of course, as we suggested above, these arguments are premised on a model of capitalism that assumes that competition is "free and fair." More technically, they rest on a number of critical conditions such as the integrity of contracts, the existence of free entry, prices that incorporate all relevant information, active competition amongst firms, the absence of collusion, and the mitigation of information asymmetries. If competition is not free and fair—if, for example, the state sells the monopoly for the importation of key commodities to the highest bidder, or if success in the marketplace is driven not by the excellence of a product and by the efficiency with which it is made but by pervasive corruption—then, while individual firms may be extremely profitable, the market as a whole will not maximize welfare and individual freedoms may be significantly curtailed. "Crony capitalism" cannot be morally justified, even if it is in the interest of the shareholders of those firms who end up on top.

In practice, few markets ever completely meet all the conditions that define perfectly free markets, but in the developed world, at least, most of these conditions are materially approximated by a host of private and public institutions. For example, in the U.S., the integrity of contracts and the prohibition of collusion are accomplished in part through the efforts of courts and the justice system and partly through the work of private institutions such as auditors. Similarly buyers and sellers of securities often have close to common information both because of accounting rules (known as GAAP) and through the efforts of various private and public intermediaries such as financial analysts, the press, and the Securities and Exchange Commission (SEC).

Indeed, in many cases, profit-seeking firms will themselves create the conditions that legitimize profit seeking. Financial analysts and information intermediaries of all kinds arise to mitigate the problem of information asymmetry, for example, and in some circumstances private arbitration arises to enforce contractual integrity. However, in general, public institutions such as the law and GAAP—institutions determined through the political process—are also critical to achieving the conditions under which profit-seeking is ethically legitimate. It is this observation—and the increasing ability of firms to shape these rules in their own interests in the contexts of “thin” political processes—that in our view suggests that the fundamental moral commitments of capitalism imply that managers may now have a responsibility to the market system itself as well as to their shareholders.

### *Understanding thin political processes*

A thin political process has three characteristics.<sup>17</sup> First, it includes a group or constituency that has a concentrated economic interest in the outcome. This group is otherwise known as a “special interest.” Second, this special-interest group also possesses experience-based subject-matter expertise that is directly relevant to the issue at hand. That is, the special interest’s experience is largely “tacit,” so that it cannot be easily duplicated or communicated. Third, there is little political participation from the general interest in the political process, or from other special interests that might ensure that the general interest is well represented. Often this occurs because the issue at hand is not particularly salient or particularly visible.

Under these kinds of conditions, special interests may be able to operate with relatively little opposition or control. They may thus be able to distort the political process in such a way that they can structure the institutions of capitalism in their own interest. In so doing, they reduce the degree to which competition is “free and fair,” thus effectively subverting the conditions that make the pursuit of shareholder value morally legitimate in the first place.

The creation of the Private Company Council—the separate GAAP rulemaking body for private companies described in the introduction to this article—is a particularly compelling example of a thin political process in action. In this case, a handful of private companies and their auditors and other intermediaries, frustrated both by the direction of at-large GAAP and by their inability to influence it were able to create for themselves an

altogether new rulemaking body. This feat was accomplished by virtue of their experience running private companies, their uniquely relevant insights into whether separate GAAP for private companies was warranted, and their facing little public interest or opposition in the debate over the PCC's creation.

Of course, it is reasonable to ask: where were the intermediaries that could be expected to represent the public interest—academics, the press, or even politicians—during the process of the PCC's creation? We suspect that one reason that the academics were missing was because they lacked the day-to-day experience that would have enabled them to credibly opine as to whether the application of public-company standards (GAAP) placed an undue burden on private companies. Moreover, the fact that the nature of accounting standards is not a hot button issue amongst the general public meant that neither politicians nor the media—the kind of countervailing parties who can often be relied on to represent the general interest—had any significant incentive to get involved. Politicians don't usually run for election on the basis of their ability to represent citizen interests in accounting rulemaking, and the press rarely devotes its attention to the nuances of proposed changes in GAAP since coverage of accounting rules rarely drives readership.

Within a thin political process, therefore, there is a real risk that a dominant special interest can enjoy unchecked influence. Two additional examples drawn from the study of the political process that determines accounting rules illustrate this point further. The first example relates to the development of “goodwill” accounting standards. The second relates to recent changes in standards for the audit of companies' financial reports. We focus on accounting issues for two reasons. In the first place, it is widely accepted that their existence—and their fairness—is critical to the development of an efficient market-capitalist system and hence to the legitimacy of capitalism. Indeed, in their efforts to embrace market capitalism over the last twenty years, nearly all the formerly centrally planned economies have put in place some form of internationally acceptable accounting standards.<sup>18</sup> In the second place, we focus on the development of accounting standards as “a case in point” because there is compelling evidence that in several cases the process has been highly influenced by private interests in a way that has immediate implications for the degree to which the rules of the game affect the kind of free and fair competition that is central to the moral justification of shareholder-value maximization. We argue that in each of these cases, corporate managers' self-serving pursuit of profits has likely undermined the operations of the market system as a whole.

In the U.S., for example, the standards for accounting for mergers and acquisitions (M&A) appear to have been shaped—at least in part—by the lobbying of some of the investment banks. The principal issue in accounting for M&A is how to treat the “goodwill” that is created in most acquisitions. Goodwill is the difference between the acquisition price and the current value of the acquired firm’s identifiable net assets. In principle, this premium reflects the future revenues the acquirer hopes to realize from the acquisition, including, for example, the synergies likely to be realized by combining the two firms. Ideally, as these revenues are recognized in the acquirer’s financial reports, the corresponding costs—including the goodwill—should also be recognized. After all, recognizing the costs associated with generating a given set of revenues is a common-sense way of defining profits and thus of evaluating a firm’s performance. But recognizing the costs associated with acquiring goodwill drags down an acquirer’s earnings, making them look less profitable. Acquirers, anticipating such effects, may be less likely to pay high premiums in an acquisition (or less likely to pursue the acquisition itself), which in turn may make the investment banks, who are paid on the basis of M&A volume and price, less profitable.

In this context, it is interesting to note that when the accounting rules for M&A were being reevaluated in the late 1990s and early 2000s, several of the nation’s largest investment banks lobbied heavily and successfully against the requirement to recognize the costs associated with acquiring goodwill. Instead, in private meetings with the accounting rule-makers, they advocated for the idea that the managers of acquiring firms should be allowed to determine for themselves (with input from their bankers and other intermediaries) when, if ever, those costs should be recognized in the income statement. Not surprisingly, after these rules were put in effect, managers appear to have become more opportunistic in their recognition of these costs. For example, the costs are generally avoided when they might negatively affect an incumbent CEO’s bonus. This suggests that the ability to evaluate the performance and success of corporate M&A—a multi-trillion dollar industry annually—may have been compromised through a subtle manipulation of the accounting rules. Moreover, in the face of this decreased accountability, there is some evidence to suggest that stock markets predicted more overpayment in acquisitions after the rules were put in effect. One plausible sign of this is that the stocks of acquiring firms experienced greater price declines upon announcing an acquisition in the period after the rule change than before. Thus, in the case of M&A, it appears that lobbying by certain investment banks may have created an accounting

regime that made investment banks and firms engaged in M&A better off at the expense of the efficiency of the market system as a whole.<sup>19</sup>

Another example of special-interest capture relating to accounting issues is the recent changes in audit procedures around fair-value accounting. The international audit industry is an oligopoly dominated by four large players – Deloitte, EY, KPMG, and PwC. In the United States, these players appear to have progressively lobbied for rules that reduce the level of professional judgment required of them. In the context of a number of accounting issues that rely on considerable management discretion—such as generating current value (or “fair value”) estimates for highly uncertain and illiquid assets such as goodwill—the large audit firms have lobbied for—and appear to have succeeded in creating—a set of check-the-box procedures that when followed mitigate their liability. For instance, the auditing standard that addresses auditors’ responsibilities on fair-value estimates—known as SAS 101—suggests that auditors cannot be “responsible for predicting future conditions” implicit in making fair-value estimates because these estimates are “inherently imprecise.” Instead, the standard provides a checklist of activities for auditors to perform and thus meet their legal obligations to market participants. These procedures allow the large auditors to benefit from the scale economies inherent in their size while simultaneously socializing the risks they create.<sup>20</sup>

In all three cases discussed above (the creation of the PCC, goodwill accounting, and auditing rules on fair values), the relevant standards were developed in the context of thin political processes. In each case, the participating special interests possessed an experience-based advantage that could not be easily mitigated, and ordinary investors and the general public—those who were most likely to be affected by these kinds of distortions—were not actively lobbying against them. This is both because neither ordinary investors nor the general public had the expertise necessary to participate in the relevant political process and because the effects on the public welfare appear to have been too diffuse to motivate any single individual to take action.

In theory, investment managers, who act for ordinary investors in capital markets, could mitigate these kinds of lobbying efforts. But the evidence suggests that investment managers are themselves among the special interests seeking self-serving accounting rules. Over the last twenty years, as the financial services sector in the U.S. economy has grown, the proportion of regulators with a financial services background represented on the U.S. accounting standards body—the Financial Accounting Standards Board (FASB)—has increased. Before 1993, the FASB included no representatives from

investment management (or, for that matter, from investment banking). By 2007, members from the financial-services industry (defined to include both investment management and investment banking) made up more than a quarter of the board. This shift appears to have been associated with an increased incidence of accounting-standards proposals that benefit the financial services sector, particularly in ways that make the sector's performance look more favorable than it actually is.<sup>21</sup> Given accounting's role in evaluating and compensating managers, these kinds of standards can result in the misappraisal of the performance of financial services executives and thus in pay levels that are not justified by underlying economic realities.<sup>22</sup>

Collectively, this evidence is consistent with the hypothesis that, at least in the case of accounting standards, corporate special interests sometimes obtain results that increase their own profits but that may be actively distorting the market, imposing welfare losses on society more broadly. This is consistent with the idea that private sector lobbying in thin political processes can significantly distort the nature of competition. But, as we suggested above, if markets are not "free and fair," then the moral logic that underpins the maximization of shareholder value as a moral duty for firms does not hold. What does this imply for the responsibilities of managers? We turn to this question in the following section.

### *Responsibilities of managers in thin political processes*

It seems unlikely that it is only accounting rules that are determined in a thin political market. Rulemaking for auditing standards, actuarial standards, and capital requirements for banks similarly appear to take place in the context of thin political processes. In each instance, self-interested players have access to highly technical information that is not easily available to others, and each is sufficiently abstruse that there is very little countervailing participation from the media, the press, or institutions representing small investors or "the general public." Moreover, each of these areas is central to the construction of the conditions that enable free and fair competition. For instance, auditing standards are critical to ensuring the integrity of audits, which in turn mitigates information asymmetries, collusion, and the managerial agency problem vis-à-vis shareholders and creditors. Similarly, actuarial standards are critical to the integrity of valuation estimates in insurance and beyond, without which the market's role in the efficient allocation of scarce resources across competing ventures is likely to be

compromised. Adequate capital standards for banks may impose costs on the financial sector but lower the risks to the system as a whole.

How, then, should we think about managers' and firms' "social responsibility" in the context of thin political processes? Given that they enable firms to distort the structure of capitalism in ways that violate the underlying assumptions that legitimate the pursuit of shareholder value, surely the social responsibility of business in thin political processes can no longer be simply "to increase profits." Instead, we argue here that the underlying moral commitments of capitalism imply that in the context of thin political processes managers have the responsibility to support—and perhaps to actively advance—the conditions that enable free and fair capitalism. Put differently, we suggest that in some circumstances managers have not only the responsibility to act as agents for their investors but also the responsibility to act as agents for "the system" as a whole.

This is a controversial idea. A long literature acknowledges that many political processes will necessarily be imperfect, not least because private firms will attempt to capture them, but, in general, this literature argues that this capture is an unavoidable consequence of market capitalism.<sup>23</sup> Mostly, this literature assumes that any incompleteness in political processes will, in the long run, be overcome by competitive forces—that is, thin political processes will eventually "thicken." Sometimes this does indeed happen. For instance, bank regulation and, in particular, the regulation of banks' securitized, off-balance sheet liabilities was very likely a thin political process prior to the Financial Crisis of 2008–09. Since then, as off-balance sheet liabilities have attracted more attention, while a lot of the key expertise continues to remain in the hands of the banks, intermediaries acting on behalf of the general public, including politicians and the media, have become more focused on the issue. Thus, in this context, the ability of bank managers to structure the rules of the game in their own interest has likely been at least somewhat curtailed. But this process can take a long time and, as the examples we outlined above suggest, society can be subject to large costs in the meantime.

One response to this problem, one offered particularly by economists of the Chicago School, is deregulation.<sup>24</sup> For example, Milton Friedman, in considering the problem of natural monopolies, asserted that the costs imposed on society of an unregulated natural monopolist are likely to be less than those imposed by regulation that attempts to correct the problem.<sup>25</sup> This is an argument that sidesteps the problem of thin political processes by proposing that market forces alone be allowed to determine the nature of regulations such as accounting rulemaking. But there is little evidence that such

radical deregulation will in fact be less costly than even a moderately functioning political process. After all, the largely unregulated capital markets of the United States in the 1920s are often believed to have played an important role in creating the conditions that eventually led to the Great Stock Market Crash of 1929.<sup>26</sup> Moreover, such a policy of total deregulation is unlikely to be practically feasible today.

Here we suggest that if we are to remain true to the spirit of Friedman's dictum on the "social responsibility of business" and to accept a responsibility for the normative ideals that legitimize market capitalism (e.g., individual freedom and aggregate efficiency), the acceptance of regulatory capture, or the simple hope for deep and active "thick" political processes, or the yearn for a deregulatory nirvana are not always satisfactory responses. We suggest, in contrast, that in those cases in which the political process is likely to be thin, that corporate managers have an active duty to advance the interests of the system as a whole (even over the interests of their firm) and that as a society we should invest in developing institutions and norms that enforce this duty.

The argument for this proposition comes from the very considerations of ethics and duty that underpinned Milton Friedman's contention that managers should focus on increasing corporate profits. As we suggested above, Friedman's articulation of a "social responsibility" for the private sector is based on the logic that it is through the fulfillment of this social responsibility that capitalism can deliver on its normative ideals, including individual freedoms and aggregate efficiency. Put differently, the injunction that managers should consider themselves first and foremost the agents of shareholders reflects first and foremost a set of ethical principles about the right ends of the firm in a capitalist system.

We argue that since in thin political processes advancing the interests of shareholders usually subverts the conditions that enable capitalism to meet its normative goals, in these cases managers should consider themselves first and foremost agents of society, with the objective to approximate the conditions under which capitalism can flourish—that is, the conditions that underlie free and fair competition.

This agency to the system in thin political processes is not, as it may at first appear, at odds with a manager's position in (and legal obligation to) a firm. Firms are, after all, legally the creations of states. The first corporate charters (for corporations as we would recognize them today) were granted in the England with the express understanding that the corporations would create benefits for the English Crown.<sup>27</sup> To

this date, in the United States and beyond, corporations receive a number of legal rights in the expectation that they will play a productive role in society. Moreover, contrary to popular misconception, there is no explicit legal requirement that corporate managers must solely pursue profits, as even conservative U.S. Supreme Court justice Samuel Alito noted in the court's prominent *Hobby Lobby* ruling: "While it is certainly true that a central objective of for-profit corporations is to make money, modern corporate law does not require for-profit corporations to pursue profit at the expense of everything else, and many do not do so."<sup>28</sup>

Indeed, we suspect that a strategy that sacrifices easy profits in favor of supporting healthy institutions might, in the long run, be beneficial to firms. After all, the gradual but systematic subversion of the central institutions of free and fair capitalism that can occur through narrow profit-seeking behavior in the context of thin political processes may eventually threaten capitalism's legitimacy and thus the very existence of a market society.<sup>29</sup> The emergence of activist anti-establishment groups such as Occupy Wall Street and the Tea Party since the Financial Crisis of 2008–09 is a reminder that the legitimacy of market capitalism is not immune to ideological attacks, even in the United States. Given these risks, it may be very much consistent with their own self-interest for firms and their managers to assume some responsibility for the market capitalist system.

To summarize, our arguments above suggest that there are two major duties of corporations and their managers. The first is to increase profits within the bounds of the law. The second is to play an active role in maintaining the conditions that sustain capitalism when operating in thin political processes. When there is no active, informed opposition to check the consequences of self-interested profit-seeking and when the firm has an informational advantage over the public that cannot be easily remedied—as in the setting of accounting standards—then the firm and its managers, acting as an agent of the state that chartered it, has a duty to advance the interests of the capitalist system as a whole. This duty might at times require subverting the profit interests of the firm itself.

*How do we get there?*

These arguments raise a number of practical issues. First, we have emphasized that a manager's responsibility to the system is relevant when the political process that structures market institutions is "thin." We have attempted to provide some illustration of what such thin political processes look like and to contrast thin political processes with

those where the general interests or, at least, powerful competing special interests are represented. But, this description is very much a preliminary account and just a starting point for a more exhaustive identification of thin political processes. If one is to define a general duty along the lines we suggest, it will be critical to develop greater clarity around how thin political processes can be identified. Thus, we see the development of practices that distinguish political processes where managers have a heightened agency responsibility to the system from those where they do not as an important area for innovation.

Moreover for this responsibility to be widely accepted there must be greater recognition of the challenges presented by thin political processes. This article is a first step, but the development of a sustained conversation on the subject is critical. Drawing on our role as teachers, we believe there is significant scope for curricular innovation in management programs exploring the leadership choices available to managers in thin political processes. Within MBA programs, courses on strategy and political economy, in particular, are ripe areas for new materials that allow prospective managers the opportunity to explore the idea of multiple (competing) agency relationships in a comprehensive intellectual framework. For example, it will be useful to develop case studies of managerial decisions in the presence of dual principals (i.e., shareholders and the market-capitalist system), and to explore the costs and benefits of alternative courses of action in such situations. These early-career learning experiences can have a formative impact on prospective managers, eventually shaping their responses to thin political processes when they are in positions to effect outcomes.

Senior business executives currently positioned to influence the outcome of thin political processes must also be involved in any attempt to change behaviors in these settings. Of course, it is naïve to imagine that businesses will significantly change their approach to lobbying simply upon reflecting on their responsibilities to the system. Indeed, more concrete enforcement efforts will be necessary to trigger any real change, and we turn to these efforts shortly. But it is also important to recognize that ethical custom plays an important role in shaping both how managers view themselves and how they are viewed by society. Corporate managers often frame their profit-seeking activities as morally virtuous, citing the works of Milton Friedman and the like. Consider, for example, former Goldman Sachs executive director Fabrice Tourre, famous for his role in inventing “exotic” financial products sold to “widows and orphans” in the run up to the 2008–09 Financial Crisis. Tourre, who was subsequently found liable by the SEC for

defrauding investors, wrote defensively at the time of his misdeeds, “the real purpose of my job is to make capital markets more efficient... so there is a humble, noble and ethical reason for my job.”<sup>30</sup>

As this statement suggests, even when it implies stretching logic to absurd extremes, the human tendency to rationalize evokes a desperate grasp for ethical justification. Thus, there is some merit to making clear the ethical limits of profit-seeking behavior. A richer and more informed understanding of the conditions under which a single-minded focus on profit seeking is no longer consistent with the underlying ethical basis for capitalism might, at the very least, dispel any veneer of legitimacy that special interests might seek for engaging in thin political processes in an attempt to shape institutions to their own advantage.

Another implication of our arguments is that it is important to monitor and enforce responsibility to the system. As we have learnt from many years of research on the manager-shareholder agency relationship, there is no reason to believe that the interests of the individual manager are necessarily (naturally) aligned with those of the shareholder.<sup>31</sup> Thus, much of the thrust of agency-related scholarship and practice has been to identify and design mechanisms that align the interests of the manager with those of the shareholder. This alignment is accomplished partly by the law (such as through the law of fiduciaries), partly by the discipline imposed by actors such as boards and analysts, and partly through a reliance on mechanisms such as options, restricted stock, accounting-based bonus incentives, and performance metrics such as the balanced scorecard.

All these mechanisms flow from and are legitimized by the social consensus in capitalist societies that the larger goals of efficiency and freedom are best served by holding managers to account as agents of shareholders. Just as the explicit recognition of the agency relationship between managers and shareholders led to an enormous body of scholarly work and practical innovation in mechanisms to align managers with shareholders, so too must the notion of managerial agency to the system spur similar developments.

The emerging field of corporate accountability reporting is a promising step in this direction. For example, just as metrics for incenting and evaluating performance in the manager-shareholder relationship are engineered to account for the manager’s information advantage over shareholders, so we need metrics and systems that reduce the

information asymmetries inherent in thin political processes. Institutions such as the Global Reporting Initiative, the Sustainability Accounting Standards Board, and The Prince of Wales' Accounting for Sustainability Project are promising first steps in this direction. Over time, and with the development of theory and practice in this area, we expect more sophisticated reporting systems to emerge that can help assess the extent to which corporations and their managers do indeed assume their responsibility for sustaining the conditions for market capitalism.<sup>32</sup>

It might also be fruitful to encourage innovation in institutions that promote and enforce business standards that address managerial agency for the market system. For example, we see as promising the development of standards and professional codes for business lobbying (especially in cases of technocratic regulations that are outside the public eye). Also encouraging is the development of governance standards for boards of directors so that they are informed and empowered to advise and reward CEOs on this particular aspect of senior management's responsibilities. Some emerging examples in this regard are the International Council on Mining and Metals, which aims to bring together key players in mining and metallurgy to build and enforce standards for environmental and social sustainability, and the Bank Governance Leadership Network, which brings together bank directors, executives, and regulators in moderated sessions that aim to rebuild trust among key constituencies in the financial sector in the aftermath of the 2008–09 Financial Crisis.

### *Conclusion*

This brief article raises questions about the role of managers in sustaining the conditions under which market capitalism can achieve its normative objectives. We note that in many cases the opportunity to sustain the institutions that enable free and fair competition is a significant profit opportunity and that in cases where the political process is sufficiently "thick" corporate engagement focused on advancing the firm's interests can play an important role in developing effective institutions. In fact, this thickness—or presence of diverse, competing, informed views in the political process—is the condition under which Milton Friedman's famous moral assertion that the business of business is to increase profits remains valid. By contrast, in those cases in which the provision of an institution is via a scarcely attended political process where some firms possess significant experience-based information advantages, managers of those firms have a duty to act in the interests of the market system as a whole. We have argued that if

managers do not behave in this way, the ethical and political legitimacy of market capitalism is likely to be compromised.

We acknowledge that our attempt to raise these arguments is only a first step, designed as much to sketch a strategy for more systematic study of the issues and to provoke discussion and debate as to be conclusive. Moreover, our economics-based approach complements the related works of those approaching these questions from law, psychology, and sociology. We see these questions as fundamentally important: finding a way to reconcile economic models of the role of the corporation and of business activity with the reality of events such as the Financial Crisis and the prevalence of capture in thin political processes is, we argue, one of the most important challenges of our time.

### *Endnotes*

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<sup>1</sup> For more details on the process of establishing the PCC see Ramanna, K., and Viceira, L., “The Private Company Council,” Harvard Business School Case Study No. 113-045 (2012).

<sup>2</sup> See, e.g., Bradshaw, M., et al., “Financial Reporting Policy Committee of the American Accounting Association’s Financial Accounting and Reporting Section: Accounting Standard Setting for Private Companies,” *Accounting Horizons* (March 2014): 175-192.

<sup>3</sup> Changes in the form of accounts can impose costs on markets for two reasons. First, because individuals—even sophisticated market players such as equity analysts—tend to become fixated on a few summary accounting numbers (e.g., net income or net assets) and on the relation of these numbers to stock prices without deconstructing the many nuances driving the summary numbers. Second, because numerous contracts (e.g., executive compensation contracts and debt contracts) are written on accounting numbers and these contracts are slow to adjust to changes in the forms of accounts. See, e.g., Lee, C., “Market efficiency and accounting research: a discussion of ‘Capital market research in accounting’ by S.P. Kothari,” *Journal of Accounting and Economics* (September 2001): 233-253; Armstrong, C., Guay, W., and Weber, J., “The role of information and financial reporting in corporate governance and debt contracting,” *Journal of Accounting and Economics* (December 2010): 179-234.

<sup>4</sup> For a recent look at regulatory capture, see, e.g., Carpenter, D., and Moss, D., *Preventing Regulatory Capture* (New York: Cambridge University Press, 2014).

<sup>5</sup> See, e.g., Hillman, A., Keim, G., and Schuler, D., “Corporate Political Activity: A Review and Research Agenda,” *Journal of Management* (November 2004): 837-857; Stratmann, T., “Some Talk: Money in Politics. A (Partial) Review of the Literature,” *Journal of Management* (July 2005): 135-156.

<sup>6</sup> See, e.g., Faccio, M., “Politically Connected Firms,” *The American Economic Review* (March 2006): 369-386.

<sup>7</sup> See, e.g., Ansolabehere, S., de Figueiredo, J., and Snyder, J., “Why is There so Little Money in U.S. Politics?,” *Journal of Economic Perspectives* (Winter 2003): 105-130.

<sup>8</sup> Friedman, M., “The Social Responsibility of Business is to Increase its Profits,” *The New York Times Magazine*, September 13, 1970.

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<sup>9</sup> See, e.g., Jensen, M., and Meckling, W., “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” *Journal of Financial Economics* (July 1976): 305-360.

<sup>10</sup> A very large literature in philosophy and ethics explores the ethical basis for capitalism. See, e.g., Applbaum, A., *Ethics for adversaries: The morality of roles in public and professional life* (Princeton, NJ: Princeton University Press, 1999); Heath, J., and Potter, A., *The rebel sell: How the counterculture became consumer culture* (Capstone, 2005). Here we focus on what we perceive to be “the theory in use” by the vast majorities of economists and managers. We take no position on whether it is philosophically correct.

<sup>11</sup> For an early articulation of this model see, e.g., Stigler, G., *The Theory of Price*, (London, U.K.: Macmillan, 1952).

<sup>12</sup> For early mathematical articulations of the welfare theorems see, e.g., Arrow, K., “An Extension of the Basic Theorems of Classical Welfare Economics,” *Proceedings of the Second Berkeley Symposium on Mathematical Statistics and Probability*, J. Neyman (ed.), (Berkeley, CA: University of California Press, 1951), 507-532; Debreu, G., “The Coefficient of Resource Utilization,” *Econometrica* (May 1951): 273-292.

<sup>13</sup> On this point also see Coase, R., “The Problem of Social Cost,” *Journal of Law and Economics* (October 1960): 1-44.

<sup>14</sup> See, e.g., Friedman, M., *Capitalism and Freedom* (Chicago, IL: The University of Chicago Press, 2002); Hayek, F., *The Road to Serfdom* (London, U.K.: Routledge, 1951).

<sup>15</sup> Sen, A., “Markets and Freedom: Achievements and Limitations of the Market Mechanism in Promoting Individual Freedoms,” *Oxford Economic Papers* (October 1993): 519-541.

<sup>16</sup> See, e.g., Friedman, B., *The Moral Consequences of Economic Growth* (New York: Alfred A. Knopf, 2005).

<sup>17</sup> For a fuller exposition of thin political markets see Chapter 8 of Ramanna, K., *Political Standards: Accounting for Legitimacy*, (Chicago, IL: The University of Chicago Press, forthcoming).

<sup>18</sup> See, e.g., Ball, R., “International Financial Reporting Standards (IFRS): Pros and cons for investors,” *Accounting and Business Research* (2006): 5-27.

<sup>19</sup> For a detailed discussion of the evidence (and important qualifiers) on the issue of accounting rules for M&A, see Chapter 3 of Ramanna, K., *Political Standards: Accounting for Legitimacy* (Chicago, IL: The University of Chicago Press, forthcoming).

<sup>20</sup> For further details on this point, see Chapter 4 of Ramanna, K., *Political Standards: Accounting for Legitimacy* (Chicago, IL: The University of Chicago Press, forthcoming).

<sup>21</sup> For further details on this point, see Chapter 5 of Ramanna, K., *Political Standards: Accounting for Legitimacy* (Chicago, IL: The University of Chicago Press, forthcoming).

<sup>22</sup> See, e.g., Desai, M., “The Incentive Bubble,” *Harvard Business Review*, (March 2012).

<sup>23</sup> A seminal article in this literature is Stigler, G., “The Theory of Economic Regulation,” *The Bell Journal of Economics and Management Science* (Spring 1971): 3-21.

<sup>24</sup> See, e.g., Stigler, G., *Chicago Studies in Political Economy* (Chicago, IL: The University of Chicago Press, 1988).

<sup>25</sup> Friedman, M., *Capitalism and Freedom* (Chicago, IL: The University of Chicago Press, 2002).

<sup>26</sup> See, e.g., Hawkins, D., “The Development of Modern Financial Reporting Practices among American Manufacturing Corporations,” *The Business History Review* (1963): 135–168; Seligman, J., *The Transformation of Wall Street 3<sup>rd</sup> ed.* (New York: Aspen Publishers, 2003).

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<sup>27</sup> See, e.g., Micklethwait, J., and Wooldridge A., *The Company: A Short History of a Revolutionary Idea* (New York, NY: Modern Library, 2005).

<sup>28</sup> *Burwell v. Hobby Lobby Stores, Inc.*, 2014 WL 2921709 - Supreme Court 2014.

<sup>29</sup> See, e.g., Bower, J., Leonard, H., and Paine, L., *Capitalism at Risk* (Boston, MA: Harvard Business Review Press, 2011).

<sup>30</sup> See, e.g., Eder, S., and Wutkowski, K., “Goldman’s ‘Fabulous’ Fab’s conflicted love letters,” *Reuters*, April 25, 2010.

<sup>31</sup> See, e.g., Fama, E., and Jensen, M., “Separation of Ownership and Control,” *Journal of Law and Economics* (June 1983): 301-325.

<sup>32</sup> See, e.g., Eccles, R., and Rogers, J., “The SEC and Capital Markets in the 21st Century: Evolving Accounting Infrastructure for Today’s World,” *Brookings Initiative on 21<sup>st</sup> Century Capitalism* (2014).