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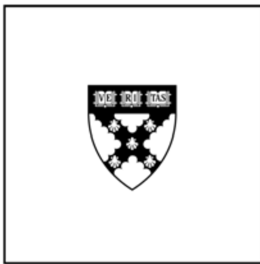

Managers and Market Capitalism

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Managers and Market 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 are engaging in the political process in an attempt to 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 maintain here that this shareholder-return view of political engagement applies in cases where the political process is sufficiently 'thick,' in that diverse views are well-represented and sufficiently detailed information about the issues is widely available. 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 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. We provide a framework for future research to explore and develop these arguments.

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1. Introduction

On May 23, 2012, at a meeting in Norwalk, Connecticut, the trustees of the Financial Accounting Foundation (FAF), the quasi-public authority charged with overseeing America's accounting-standards infrastructure, approved the establishment of the Private Company Council (PCC). Before this date, private companies generally issued financial reports to their stakeholders using the same accounting rules required of public companies: there is no compelling argument in accounting theory for why private and public companies should be governed by different accounting rules. But private companies and their intermediaries, concerned about the rising costs of complying with public company accounting standards and unsure of their ability to effect the political process that determines those standards, had lobbied to create their own accounting standards council and had succeeded.[1]

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. But the move to a system in which private companies have their own accounting rule-maker can have significant economic implications. Accounting rules are at the heart of modern market capitalism, shaping incentives and performance evaluations and the resource allocation decisions that drive economic activity. While it is too soon to tell whether the creation of the PCC will impose welfare losses on the economy, the fact that the accounting literature offers no strong arguments or evidence to support separate private company accounting rules suggests that the creation of the PCC could be the result of capture by special interests. As it happens, the process surrounding the creation of the PCC was both highly technical and highly specialized, and corporate managers (including auditors and finance executives), by virtue of their resources and experience, and the fact that this process largely took place outside the public eye, had a remarkable ability to affect its resolution. Here we ask: what responsibilities do managers have when engaging in these kinds of activities? In whose interests should they act, particularly in those cases that involve highly technical or specialized matters and for which there is no well-defined opposition or counterparty? When is it legitimate, for example, for managers to distort the rules that define accounting profit in the spirit of pursuing economic profit? More generally, how should we think about corporate managerial engagement in sustaining the institutions of market capitalism, particularly those determined through a 'thin' political process, where managers have a near monopoly on the necessary substantive expertise and experience little political opposition from the general interest?

[1] For more details on the process of establishing the PCC, see Ramanna and Viceira (2012).

The currently prevailing answer to these questions is that as long as they are careful to obey the law, managers should act in the interests of shareholders. Milton Friedman's famous suggestion to this effect, that "the social responsibility of business… is to increase its profits," is deeply grounded in the pragmatics of the managerial agency problem and in the ethical legitimacy of capitalism. Here, we draw on advances in our understanding of the dynamics of political influence to propose that there are strong arguments derived from both (enlightened) self-interest and ethics to revisit this conclusion when political markets are 'thin.' We discuss the conditions under which managers should actively strive to structure market institutions in such a way that they preserve the legitimacy of market capitalism, even if doing so is at the expense of corporate profits.

The case from self-interest flows from the argument that ensuring the conditions that underlie free markets are maintained—i.e., establishing and supporting the appropriate "rules of the game"—is central to preserving the legitimacy of market capitalism, and that this gives managers and owners of capital an interest in making sure it happens. Distorting market rules, whether through legal lobbying or through overt corruption, distorts market outcomes and erodes political and social support for market capitalism, with potentially negative consequence for any firm's ability to make sustainable returns. The public outcry against, and the accompanying distrust in, Wall Street firms that followed disclosure that these firms had a role in obtaining regulation and legislation that plausibly contributed to the Financial Crisis of 2008 is a recent example to this point (e.g., Kristof, 2011). In the U.S., public trust in banks is now at the lowest levels it has been in decades and trust in big business is lower today than it was in the late 1990s (e.g., Gallup Historical Trends, 2013)—populist movements such as Occupy Wall Street are clearly hitting a nerve. Drawing on substantial historical evidence, Acemoglu, Johnson, and Robinson (2005) suggest that when the private sector becomes too closely entwined with the public sector, both public welfare and the ultimate health of the private sector are threatened. The difficulties that the elites are experiencing in several emerging markets including China, India, and Russia is consistent with this idea: the image of many elites in these countries is that they have accumulated their wealth through corrupt means rather than through outstanding business-related skills.

Of course a case for action rooted in this perspective is contingent on a satisfactory resolution of the free-riding problem that it implies. While the majority of the firms in any given market will benefit from the social legitimacy and economic opportunity that free and fair institutions enable, there will be a few firms who will benefit immediately from bending the rules in their favor, and to the degree that acting to maintain appropriate institutions is costly there will

also be an incentive for any firm to free ride on the actions of others. However, we argue that examples of small groups of leading firms cooperating in the design of new institutions and standards suggest that it may be possible to overcome these barriers in a number of cases.[2]

The normative case flows from a rich literature in economic philosophy. Many scholars—including Milton Friedman himself—have rested their arguments for the legitimacy of capitalism and the pursuit of profit maximization firmly on ethical grounds, arguing that under a series of well-defined conditions capitalism increases aggregate welfare, while simultaneously promoting individual freedoms and inclusive fairness. Responsibility for maintaining these conditions has traditionally been allocated both to the market itself and to the state. At the most basic level, the legal system enforces both fiduciary duty and the sanctity of contracts. To our point above, notice that both duties are simultaneously rooted in ethical and economic concerns. Ethically, the law enshrines the belief that it is inappropriate to cheat. Economically, the widespread establishment and enforcement of fiduciary duty and contract law made possible the formation of both large scale capital markets and greatly expanded economic activity (e.g., LaPorta, Lopez-de-Silanes, Shleifer, and Vishny, 1998).

Within the private sector itself a wide range of competitive institutions—including, for example, auditors, the media, rating agencies, and securities analysts—have emerged to support the development of efficient markets. At the same time the responsibility for ensuring, for example, that firms do not collude to set prices or to limit entry is usually effected through government regulation. There is, of course, seldom ex ante certainty about what the "appropriate" rules of the market should be (e.g., what should accounting rules look like?) and the idea that private firms have an important role to play in providing information and insight that might shape regulation has been widely accepted. We argue here, however, that both conceptually and empirically it is difficult to specify where legal self-serving lobbying ends and overt corruption of markets rules begins and that even in those cases in which self-interested lobbying is clearly legal, in certain political markets it is not consistent with the ethical objectives of capitalism.

We suggest that, as Milton Friedman argued, corporate managers have a moral responsibility to increase profits in the context of fully competitive markets—both because fully competitive markets maximize freedom and welfare and because to do anything else is to betray

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[2] Some emerging examples in this regard are the International Council on Mining and Metals, which brings 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 in the financial sector.

the manager's responsibility as a fiduciary agent. Self-interested and shareholder-focused behavior is critical to achieving competitive equilibrium in price-based markets; and in cases where the political process to determine the "rules of the game" is vibrant and well attended, self-serving behavior from corporations and their agents can be critical to achieving welfare-increasing results. But when political markets are 'thin,' in that managers have a near monopoly on critical information and face little coherent opposition from the general interest and where there is an opportunity to distort the competitiveness of the market for one's personal gain, managers have a moral responsibility to seek to preserve the institutions of competitive markets and hence the legitimacy of market capitalism. In short, we argue that managers have a fiduciary responsibility to the system of capitalism itself as well as to their particular principals.

This argument is closely related to the literature on regulatory "capture" (e.g., Stigler, 1971; Peltzman, 1976). And although empirical evidence of capture is relatively uncommon (see Dal Bo, 2006, for a review), the notion that managers will attempt to influence the political process to obtain favorable regulation is not surprising. Moreover, in general, attempts at capture are not particularly worrisome if the political process is sufficiently 'thick,' that is information is dispersed across constituents and political participation is broad. For example, much of the empirical literature on corporate political engagement with the U.S. Congress suggests limited corporate influence in political outcomes (e.g., Ansolabehere, de Figueiredo, and Snyder, 2003). The problem we highlight here is distinctive because the nature of a 'thin' political market is such that traditional mechanisms to countervail special interests—either through broad public engagement in the issues (e.g., Dyck, Moss, and Zingales, 2013) or through the use of independent professional regulators (e.g., Rogoff, 1985)—do not apply. The esoteric subject-matter of regulation in thin political markets (e.g., accounting standards) precludes widespread public engagement, while the fact that expertise to design such regulations resides within corporations suggests that even "independent" regulators are substantially dependent on information supplied by managers.

The paper progresses as follows. We begin in Section 2 by exploring the normative arguments that have established the ethical legitimacy of market capitalism. A long line of scholarship has argued for capitalism as a system that efficiently delivers prosperity while promoting individual freedoms and inclusive fairness. In this context we evaluate the merits of Milton Friedman's famous dictum on "the social responsibility of business" being to increase profits, noting how this argument is fundamentally a proposition that flows from a normative commitment to classical liberalism and that is reinforced when the problems of agency and

uncertainty are internalized into the question of how to deliver on the ethical objectives of capitalism.

Section 3 lays out the conditions that must be in place if self-interested profit maximization is to accomplish these ethical goals. We note that many of the institutions that approximate these conditions in practice are provided by the private sector and indeed that the pursuit of profit often supports the development of industries and firms whose primary function is to facilitate competitive markets. Of course, as a long literature in the economics of regulation has established, many of the conditions critical to free competition are also provided by the state through a political process; but, even here, we note that the profit motive can help deliver effective regulation provided the political market is well attended. In Section 4, we focus therefore on cases where the political market is thin. As scholars since Adam Smith have observed, a myopic focus on private interest can, in these circumstances, lead managers to attempt to subvert the institutions of capitalism and the conditions they seek to create (see, e.g., Smith, 2005). We draw on evidence from two areas in particular: the determination of accounting standards and corporate responses to corruption in emerging markets, in order to make this idea concrete. The former is an illustration of an esoteric institution that is susceptible to capture by corporate special-interests in ways that can subvert the objectives of capitalism. The latter is a broader illustration of the problem where corporate managers can be locked in a dysfunctional prisoners' dilemma that undermines capitalism's legitimacy.

In light of this evidence in Section 5 we then turn to an exploration of whether, when, and why corporations and their managers should act to sustain the conditions for market capitalism even when so acting may not immediately maximize shareholder value. We begin by making "the case from interest" arguing that managers have a general interest in sustaining the legitimacy of market capitalism and that in the case of firms that are sufficiently large or who are able to form appropriate coalitions this interest may be sufficiently great as to enable them to overcome the free-riding problem inherent in this kind of action. We then turn to a discussion of whether corporations and their managers have an ethical duty to act, in that they should be characterized as "agents" for a society that is interested in the preservation of free and efficient markets. Moral reasoning is (now) relatively rare in economics papers, so we reinforce this discussion by reiterating the arguments underlying the ethical legitimacy of market capitalism and demonstrating the way in which these same arguments favor the kind of expanded responsibility that we sketch out. We suggest that in cases where:

> (1) private profit-seeking commercial activity is unlikely to generate institutions that approximate conditions for competitive markets—thus public institutions operating through a political process are necessary; and
>
> (2) the political market is likely to be sufficiently thin or one sided that we cannot expect the political process to function effectively,

managers have an active responsibility to refrain from self-dealing and act as agents of the system.

We close the paper in Section 6 by sketching out a framework for a research agenda based on these ideas. Here we have inductively identified 'thin' political markets, chiefly through the context of accounting standard setting. We see the rigorous characterization of 'thin' political markets in ways that allow them to be objectively defined, identified, and studied, as a major research opportunity in economics and allied social sciences. Further, if managers do indeed have a responsibility for the system in which they are embedded, then building a richer understanding of the kinds of institutions that might induce them to act on this responsibility is a potentially fruitful direction for future research. We lay out some emerging developments and opportunities in this area.

Our attempt to tackle these questions 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 study complements the related works of those approaching these questions from law, psychology, and sociology (too numerous to cite here). We see these questions as fundamentally important: finding a way to reconcile our 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 "crony capitalism" and corporate corruption is, we argue, one of the most important challenges of our time.

2. The ethical case for market capitalism and profit-maximizing behavior

Economic activity has not always been organized through markets. Anthropologists and historians have documented a wide variety of forms of economic organization, and until quite recently, a significant fraction of the world's population lived under regimes that subscribed to some form of centrally planned economic organization (e.g., North, 1977). The last thirty years, however, have seen the widespread embrace of market capitalism as not only a highly efficient form of economic organization but also as one that rests on strong normative foundations. Indeed

several observers have argued that the embrace of market capitalism is as much an ethical imperative as it is a pragmatic one (e.g., Friedman, 2002) and a substantial part of the public debate around the 2008 crash has highlighted the ways in which the legitimacy of capitalism as a mechanism for resource allocation in a complex society rests on the shared belief that capitalism is fundamentally an ethical system.

The normative arguments for capitalism have roots going back hundreds of years and indeed the notion that free markets are associated with normative goods is established to varying degrees in the popular culture. They can be broadly divided into three streams: a belief that free markets maximize libertarian freedom, or freedom from encroachment; the utilitarian argument that capitalism is Pareto efficient; and, lastly, the suggestion that free markets are fair, in that they are predicated on the widest possible participation of individuals in a society.

The idea that personal, individual freedom is 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 normative goals is deeply rooted in the classical liberal tradition of the 18th and 19th century and is a particularly popular theme in the American narrative. The seminal works of Friedman and Hayek draw heavily on this tradition and suggest that the free market's reliance on voluntary exchange as the primary resource-allocation mechanism in society emphasizes and sustains the freedom of the individual, which in itself is very desirable (see, e.g., Friedman and Friedman, 1980, and Hayek, 1951). Both men were particularly informed by the experience of the Soviet Union and their deep belief that centralized economic control was as inimical to freedom as political control.

Broadly, their arguments for market capitalism can be understood as deriving from the libertarian (or classical liberal) conception of freedom. Freedom, like capitalism, has no well-accepted definition, but in the libertarian context, it can be understood as "immunity from encroachment" or the ability to make decisions free from the interference of others (Sen, 1993). Libertarian freedom is principally procedural; i.e., it is concerned with the *act* of choosing, with little emphasis on the substance of that choice and thus has the cardinal property of equating more choice with greater freedom. In this sense, the ability of individuals to engage in "voluntary exchange," i.e., to *choose* to exchange, as in competitive markets, is consistent with libertarian freedom (e.g., Friedman and Friedman, 1980, and Hayek, 1951). Milton Freidman suggests that the ability of individuals to choose their field of employment is a particularly compelling example of this kind of freedom. Given a social objective of maximizing libertarian freedom, a reliance on markets can be ethically legitimized through their use of voluntary exchange.

Importantly, the libertarian justification for market capitalism is non-consequentialist: It is the *process* of voluntary exchange—not its outcome—that makes markets desirable.[3]

Another conception of "freedom" as a source of legitimacy for market capitalism is perhaps most clearly articulated by political economist Ben Friedman (2005). Here, the argument is consequentialist: Ben Friedman argues that the prosperity characteristic of capitalism sustains the conditions for political freedom, including, for example, democratic representation in government and the protection of certain discretionary rights of the individual such as freedom to marry. He argues that political freedoms in a large and diverse populace are not "natural" and that it is the expectation of prosperity—or, more precisely, of *increasing* prosperity—that enables the tolerance and willingness to invest in the common good that is one characteristic of effective democracies.

A second influential stream of work in economics and philosophy has argued that the ethical foundations of market capitalism lie in the fact that it is an *efficient* societal resource-allocation mechanism. In fact, efficiency is arguably the dominant legitimizing force for market capitalism, within both academic economics and popular culture. Fully competitive markets allow the matching of production to demand in ways that make it possible to fulfill widely differentiated human tastes, and market capitalism has led to unprecedented levels of material wealth. For example, since China enacted market-based reforms in 1978, its GDP has grown by a factor of nearly 40, or about 12.2% per year (World Bank, 2011).

Within economics, efforts to formally prove or validate the efficiency claim can be traced to the welfare theorems and their antecedents. Here the notion of Pareto superiority is fundamental. One outcome is Pareto superior to another if it makes at least one individual better off without making anybody else worse off. The first welfare theorem establishes that an allocation of scare resources toward human preferences achieved through competitive markets is Pareto efficient (i.e., there is no Pareto superior allocation) (Arrow, 1951 and Debreu, 1951). Pareto efficiency is a consequentialist justification for market capitalism. It is a powerful notion, at least in informing the *necessary* conditions to defining a social optimum: Through Pareto efficiency we learn that any allocation of resources across society that can be improved upon without making somebody worse off is not an optimal allocation (e.g., Sen, 1993). Beyond that, Pareto efficiency has embedded within it strong protection for the individual, since even an

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[3] Hayek (1945) also makes the argument that the price system in markets is an efficient aggregator of distributed preferences across society. This argument is related to the broader proposition about the efficiency of markets as a resource allocation mechanism in complex societies, discussed shortly.

improvement for all but one individual in a society would not qualify as a superior allocation, if it came at that individual's expense. Implicitly, Pareto efficiency recognizes the difficulty of allocating scare resources across diverse human preferences: Difficult trade-offs have to be made in the process and Pareto efficiency resolves such trade-offs in favor of protecting *every* individual.

Pareto efficiency in itself is an insufficient validation for a reliance on competitive markets to satisfy human preferences, since there can be several different Pareto efficient outcomes (e.g., an outcome that makes all CEOs better off without making anybody else worse off or an outcome that makes all academic economists better off without making anybody else worse off) and not all of these outcomes are likely to be equally desirable to society. Recognition of this reality leaves lingering doubts as to whether a competitive market achieving *some* Pareto efficiency is any trophy at all.

The second welfare theorem goes some way in addressing this deficiency. It establishes that under certain assumptions (including the absence of externalities, no constant returns to scale, and no transaction costs to voluntary exchange), *any* Pareto efficient outcome can be achieved through competitive markets.[4] That is, regardless of which Pareto efficient outcome society determines as the socially desired optimum, it can achieve that outcome through the use of competitive markets. This proof can be another powerful validation for deploying market capitalism in satisfying human preferences, particularly if the assumptions underlying it are conceivable in practice or at least reasonably practicable. We come back to this idea below. Here we simply note that externalities and scale economies create problems in practice, and voluntary exchange in competitive markets is not costless.

The third legitimizing argument for market capitalism is grounded in the democratic conception of *fairness*. The central idea here is that market capitalism is fundamentally fair because the nature of fully competitive markets is such that wider participation ('deeper and more liquid markets') yields more competitive outcomes and thus that a reliance on markets can be ethically legitimized through their natural propensity to draw in maximal participation in pursuit of equilibrium prices. In contrast to hierarchical or feudal economic arrangements, for example, fully competitive markets (in principle) care nothing at all about a family's social standing, one's gender, or one's skin color. As with the libertarian justification for market capitalism, the democratic justification is non-consequentialist: It is the *operation* of markets, not

[4] This statement results from the combination of the second welfare theorem, as in Arrow (1951), and Coase's "theorem," as in Coase (1960).

their outcomes that makes capitalism desirable. It is, however, strictly distinguishable from the libertarian argument. The fairness argument maintains that "immunity from encroachment" is too narrow a conception of freedom—that "substantive" freedom also requires the ability to act. This "opportunity freedom" (e.g., Sen, 1993), unlike libertarian freedom, is not cardinal: The focus is on "what" freedoms, not on "how much" freedom. Supporting opportunity freedom can come at the expense of cardinal freedoms: Others in a society play an important role in ensuring an individual's opportunity freedom (e.g., Berlin, 1969 and Rawls, 1971). In this context, Pareto efficiency becomes a very limiting, almost absurd, condition, because it limits redistribution of natural endowments and many of the arguments that have called into question the ethics of capitalism have focused on just this aspect of its structure, questioning the distributional consequences of a market system in a world in which individuals have very different initial endowments.

If we put this issue to one side, however—and in many societies debate about the question of distributional justice is understood as one that should be contained within the political realm—the ethical case for market capitalism—as a system for allocating scarce resources in a complex society—has been made broadly on three normative grounds: freedom, efficiency, and fairness.[5]

This case has been very widely accepted, particularly within the business community—so much so that to the extent that market capitalism is deployed in a society, its core operating philosophy, particularly for corporate entities, has come to be understood through the maxim that the "business of business is business." In other words, in a market-capitalist society, the legitimate goal of the corporation is profit maximization in the service of shareholder value creation. Intellectually this belief is perhaps most closely identified with the works of Milton Friedman, whose succinct, simple, and powerful arguments in the 1970 *New York Times Magazine* article "The social responsibility of business is to increase its profits" continue to be cited and resonate broadly today.

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[5] Note that there is also a vast literature that altogether rejects the moral legitimacy of market capitalism (usually from communitarian perspectives). For example, Nussbaum's focus on "human flourishing" as the goal of human society is skeptical of the power of free markets as a resource allocation mechanism. Similarly, a long tradition of work in sociology fears that the increasing "commodification" of human relationships implicit in the triumph of markets may destroy social cohesion. Some extreme communitarian views regard voluntary exchange as uninformed and eventually exploitative to a vast segment of society. In this view, perhaps most effectually argued by Marx, conceptions such as "freedom" are not universal, but rather *ex post facto* justifications that "elites" in society have conjured to explain and perpetuate manmade institutions such as laws protecting property rights.

Friedman derided the idea that managers should take on any responsibility for the employees of a firm or for the community in which it is located, indeed for any aspect of the public good beyond that inherent in the maximization of profitability. He argued that any attempt to take on additional responsibilities was actively pernicious, and could lead directly to the betrayal of the fundamental values of freedom and prosperity on which the legitimacy of the firm, and ultimately of market capitalism, rested. He acknowledged that there might well be circumstances in which making gestures such as paying more than the prevailing wage or making philanthropic donations to local charity might serve the ends of profit maximization, but he saw such actions as entirely consistent with a rigorous focus on the maximization of economic profits.

Friedman's work has been fundamentally important in shaping and legitimizing the world views and actions of the vast majority of business practitioners: In essence his work permits the manager to focus single mindedly on profit maximization, secure in the knowledge that in so doing she is acting for the greater good of society. Indeed Friedman's work can be read as suggesting that even thinking about the broader implications of business activity is actively immoral in that it diverts attention and resources from the all-important goal of generating economic returns in the context of the free market. Any argument that managers should, in fact, focus on larger questions such as potential investments in public goods thus has to take very careful account of Friedman's arguments.

Friedman draws on two powerful ideas to support his argument. The first is rooted in the problem of agency, and the second in the problem of information. The agency argument is particularly well known because it was later considerably explored and amplified in the work of business academics such as Eugene Fama, Michael Jensen, William Meckling, and their collaborators.[6] This perspective starts from the observation that managers are the agents of the shareholders who have contributed the capital for the firm. As such, managers have both a legal and an ethical responsibility to maximize the return on that capital.

Any other investment of the firm's time or resources—whether in egregious expenditures such as lavish company headquarters or generously appointed company jets, or in less egregious but no less wasteful expenditures such as large donations to charities unrelated to the firm's business—is a moral violation in at least two respects. In the first place it is a violation of personal ethics in that it is a betrayal of shareholder trust. In the second place this betrayal of

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[6] See for example, Jensen and Meckling (1976), Fama and Jensen (1983), and Watts and Zimmerman (1986).

trust leads inevitably to the betrayal of the broader normative objectives on which the legitimacy of market capitalism relies. To the degree that self-serving managers spend the resources of the firm on their own needs they interfere with the workings of the free market and betray the values of freedom, efficiency, and fairness on which the legitimacy of capitalism resides, reducing both the prosperity of the entire society by misallocating resources and the freedom of the shareholders to spend their money in the way that they wish.

Friedman's second argument is rooted in the problem of insufficient information. He observes that managers often have only a very limited or local view of the problems of the societies in which they are embedded, and that they are thus likely to misconstrue both the nature of these problems and the potential power of possible solutions. Even if one were comfortable that it was appropriate to spend the private funds of others to contribute to the common good, he argued, it is unlikely that managers would spend these funds well from a public perspective.

The force of both of these arguments is evident in the influence they have exercised over both scholarly and popular thought. Indeed the vast majority of the recent literature that has exhorted managers to think beyond the confines of short-term value maximization by, for example, investing more in environmental protection (e.g., Esty and Winston, 2009) or in the long term health of the community (e.g., Porter and Kramer, 2011) has been careful to make the point that such investments are entirely consistent with profit maximization.

In this paper, we argue that recent developments in agency theory, in political economy, and in our understanding of the nature of public goods mean that we should reexamine Friedman's arguments, particularly in the context of the question of the degree to which managers can reasonably be thought of as agents to the system itself, and thus as having a responsibility to sustain the conditions that underlie market capitalism.

To make this case we begin by revisiting a longstanding debate about the conditions that sustain free market capitalism. Freidman and his colleagues were keenly aware that capitalism can only fulfill its normative promise when markets are free and unconstrained, and that managers (and others) have strong incentives to violate the conditions that support such markets (e.g., Stigler, 1971). But they argued both that dynamic markets are self-healing in that the dynamics of competition itself generates the institutions and actions that maintain competition and also that government could be relied on to maintain those institutions—such as the legal system—that are more effectively provided by the state (on this latter point, see, in particular, Hayek, 1951). Here we step through the conditions that are fundamental to the maintenance of free markets to lay the groundwork for the argument that in some circumstances this reliance is

misplaced and that we cannot rely on either the operation of the markets themselves or on the state to support them. We suggest that particularly in those cases in which the political process that determines the institutions of free markets is 'thin' that managers may have a responsibility to the system itself—a responsibility that flows from both self-interest and from the normative responsibilities of managers as agents of a society that has deployed capitalism toward certain ethical objectives.

3. The conditions that sustain competitive markets

At the most basic level, market capitalism can be understood as the deployment of voluntary exchange toward satisfying human preferences (e.g., Heilbroner, 2008). This voluntary exchange takes place in the context of a "market" where individuals and organizations engage competitively to match supply with demand through prices. In other words, *prices* formed in *competitive markets* are central to the notion of market capitalism. Thus, to identify the conditions that are fundamental to market capitalism is to identify what it takes for markets to function competitively through a price system (e.g., Stigler, 1946, 1952).

While it is impossible to specify every function critical to a competitive market, some well-established economic theory—in particular the theory of efficient price—is helpful in giving us a starting point.[7] Competitive markets rely on:

Well-defined property rights: Uncertainty over property rights in a product results in distorted market prices for that product, in the extreme resulting in the breakdown of such markets. The granting of property rights to knowledge, for example, through systems of copyright and intellectual property, is often credited as playing a critical role in supporting innovation and the development of "markets for ideas" (e.g., Scotchmer, 2006). Similarly, assignment of property rights to sulfur dioxide played a major role in reducing automotive pollution in the nineties in the United States (e.g., Stavins, 2011).[8]

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[7] For an excellent and accessible early overview of the theory of price, see Stigler (1946); see also Friedman (1962).

[8] In some cases, it is difficult to grant or maintain property rights due to significant "externalities," such as when it is impossible to prevent the exclusion of non-paying consumers (e.g., Bator, 1958). Such product markets include classic "public goods," such as atmospheric oxygen or national defense, as well as more esoteric products such as certification standards (e.g., accounting standards, product quality standards, etc.) (see, e.g., Samuelson, 1954, Cropper and Oates, 1992). In these cases, price-based resource allocation may break down altogether, so that buyers and sellers are forced to seek alternative exchange mechanisms outside of competitive markets.

Complete knowledge: For a market to be fully competitive, the parties to a voluntary exchange must be acting with "complete knowledge" of the value of goods or services at play (e.g., Stigler, 1946). At a practical level, this means that the parties to an exchange must be at least aware of the last bid/ask prices in their transaction. More conceptually, this condition implies that the transacting parties have complete knowledge of all *known* technical properties of the unit being exchanged and of the appropriate valuation function for those technical properties (e.g., Akerlof, 1970, and Gonedes, 1976). In other words, there can be no asymmetry of knowledge between and across buyers and sellers. Of course, this condition does not require the elimination of all uncertainty: Limits to human understanding mean that nature can influence the value of a transacted unit in ways that cannot be known before-the-fact (e.g., as in an earthquake); but if either the buyer or the seller has *private* information about the product being exchanged, the market will not be fully efficient.

Enforceable contracts: One of the most fundamental conditions of competitive markets is the existence of enforceable contracts. This is sometimes also described as the condition of avoiding no counterparty failure. Voluntary exchange in a competitive market usually pertains to the transfer of goods or services for consideration *at or over some finite period of time*. That is, the exchange is usually agreed upon *prior to* the physical transfer of goods or services and *prior to* consideration being made. Such a market transaction is meaningless if either party fails to honor the terms of exchange. For efficient prices to emerge in a competitive market there can either be no risk to each party that its counterparty will fail, i.e., there can be "no counterparty failure," or, if there is a risk of counterparty failure, then both parties to a transaction must have "complete knowledge" of this risk and be able to protect against it (e.g., Stigler, 1946).

No agency: Markets are more likely to be efficient when actors act for themselves. However, in many markets, including U.S. capital markets, transactions are carried out by agents on behalf of principals. Since economic actors have strong incentives to pursue their own interests above those of others, without perfect monitoring and/or complete incentive alignment, such agents are unlikely to act on behalf of their principals (e.g., Ross, 1973, and Jensen and Meckling, 1976). This gives rise to the classic economic problem of agency.

Non-collusion: At the heart of the idea that voluntary exchange will result in competitive-market outcomes is the assumption that transacting parties are functioning at arm's-length.[9] That is, buyers and sellers have not colluded by virtue of separate agreements or power

[9] For some studies discussing the importance of mitigating collusion in the context of insider trading, see, e.g., Leland (1992) and Meulbroek (1992).

asymmetries to transact at prices that are known to be unfavorable to either party. If prices are tainted by collusion, they are unlikely to facilitate resource allocation decisions in ways that meet the ethical objectives of markets.

Price taking and market clearing: Two other fundamental conditions of competitive markets are price taking and market clearing. Price taking refers to the notion that no single player in a market (buyer or seller) can affect market prices by virtue of their transactions. In other words, each player is so insignificant to the determination of prices that every player is a "price taker" (e.g., Mas-Colell, Whinston, and Green, 1995). This is the property of markets that encourages widest participation possible, thereby delivering on the normative goal of "fairness" in access or opportunity. Market clearing is the notion that there will always be a price at which a demand can be met with supply.

Free entry and exit: Competitive markets are also predicated on notions of "creative destruction" and "economic Darwinism" (on "creative destruction," see, e.g., Schumpeter, 1942). That is, *not every* market-based outcome is expected to result in a Pareto efficient resource-allocation decision; mistakes will be made. But poor resource-allocation decisions should be reversed over time as they face competition from better decisions. Thus, to be competitive, markets require the free entry and exit of players.

4. When profit maximizing behavior collides with market capitalism: some evidence

The theoretical conditions underlying competitive markets, outlined above, are unlikely to be met in practice in any given market. In fact, even with particularly well-developed market institutions, certain conditions such as "complete knowledge" and "no agency" are rarely attainable in practice (e.g., Jensen and Meckling 1976). Certainly, a careful enumeration of the conditions underlying competitive markets lays bare their fragility. But, as Milton Friedman, Friedrich Hayek, and others have pointed out, it is precisely this fragility and the economic opportunities it presents that make market capitalism a potent organizing force in society (e.g., Friedman and Friedman, 1980 and Hayek, 1945).

Incomplete or less than perfectly competitive markets generate opportunities for profit, and in fact it is often suggested that this is one of the strengths of free markets. A first mover in addressing a market "failure" can command some edge over competitors, at least in the short run, so deploying good managerial judgment in this regard can be a source of competitive advantage (e.g., Porter, 1979, and Porter, 1998). In this sense, capitalism drives itself toward efficiency. Milton Friedman, for example, famously suggested that the most important role managers could

play in creating competitive markets was to be competitive—that market failures create important competitive opportunities, and that in attempting to take advantage of these opportunities, markets naturally become more efficient (e.g., Friedman, 1970). To illustrate this point, consider, for example, the classic case of long-distance communication.

Two hundred years ago, postal communication was the dominant long-distance communication technology and the economies of scale in postal communication meant that national postal systems were natural monopolies. In fact, so central was the postal monopoly to the new American nation that the position of U.S. Postmaster General predates the country's Constitution (U.S. Postal Service, 2011), and in 1829 the Postmaster General was elevated to become one of only six cabinet-level appointments in President Andrew Jackson's first administration (e.g., McLaughlin and Hart, 1914). But today, the market for long-distance communication is among the most competitive in the world, as numerous sellers with varying technologies jostle for a share of customer demand. Alternative long-distance communication technologies include post, telephone, email, video chat, etc., and there is competition on many dimensions including cost, speed, security, and reliability.

The rush of entry that often occurs after significant technological innovation provides another example. The success of the Apple iPad, for example, temporarily created an inefficient market: Apple was the only supplier of such tablets and as a result was able to charge above-competitive prices. Apple's success, however, quickly led to the entry of a wide variety of competitors, and the tablet market now appears near efficient, with very low price premiums and continual innovation (e.g., Sherr, 2011).

Moreover there is substantial potential for profit in making markets work. In the case of U.S. capital markets, for example, the investment management industry, the banking industry, the accounting and auditing industry, the analyst and ratings industry, the financial media industry, the legal industry, and the insurance industry all play a role in sustaining the market. In fact, in developed market-capitalist economies, a significant share of GDP is represented by intermediary institutions that serve to bring product markets closer to price efficiency (e.g., Khanna and Palepu, 2010). Consider, for example, the recent case of tainted milk in China.

In 2008, infant milk powder produced by the Sanlu Group was found to have been adulterated with melamine to pass the product off as having high protein content. Six infants died and an estimated 300,000 more were affected. (e.g., Branigan, 2008) The scandal is a ghastly reminder of the very general phenomenon of tainted products across markets worldwide (ranging from toxic sprouts to toxic assets) (e.g., Dempsey and Neuman, 2011, and Lohr, 2009). In many

circumstances, tainted products enter the market because of information asymmetries and significant agency problems.[10] In principle, however, the very high costs of delivering tainted products (at least in those cases where tainted products are publicly discovered) mean that shareholders have a rational interest in curbing their proliferation (see, e.g., Spence's, 1977, arguments in this regard). The Sanlu scandal, as a case in point, created a very lively market in tests for melamine contamination and considerable pressure on Chinese milk producers to create mechanisms, such as better branding and food-safety certification, to close the information gap, and some lively discussion about the kinds of changes in governance regimes that might mitigate the agency problems that led to the contamination in the first place (e.g., *China Daily*, 2011).[11]

But, as the discussion above suggests, the operation of perfectly competitive markets is also critically dependent on a wide variety of publicly supplied institutional supports. Some of these—such as the SEC, the FDA, and the judicial system, are purely public—and others are somewhere in between public and private. The legal and accounting professions, for example, are run for profit but would not exist in their current form without the framework of publicly determined laws and regulations and of industry associations established in the public trust. Table 1 uses the example of the U.S. financial markets to illustrate the range of both public and private institutions that are central to maintaining its efficiency. There is a lively debate as to whether the market could, in principle, supply all the institutions necessary to create a free market, with some scholars suggesting that even in those cases where they cannot one should not rely on government intervention (e.g., Stigler, 1988). But at least within the United States the current political consensus is that certain conditions for capitalism cannot be supplied through profit-seeking institutions; rather these are "public goods" that must be supplied by institutions operating through a political process.

<Please insert Table 1 about here.>

This reliance on the political process to maintain at least some of the identifiable conditions for capitalism raises the question of what, if any, is the responsibility of the corporation and its managers when engaging in the political processes that shapes these institutions? If managers should not, in general, deviate from attempting to maximize profit

[10] Tainted products also sometimes result from incomplete human knowledge of natural phenomena or chance external circumstances. The Tylenol poisonings, for example, are an example of the latter kind, and it is probably not useful to think of them as resulting from market failure.

[11] In the case of the Sanlu milk scandal, several of the managers involved received death sentences after the fact. In the absence of any uncertainty on part of the managers about being detected, the severity of the penalty is likely to have eliminated any agency problems in this regard.

because they have a normative duty to the operation of the free market, how should we think about those cases in which the demands of profit maximization give them strong incentives to actively subvert the institutions that sustain the market?

Of course the idea that profit maximizing individuals will seek to subvert the conditions for capitalism has a long history—dating back, at least, to Adam Smith (2005, p. 111) who noted in the *Wealth of Nations*: “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.” And, in general, the empirical literature on regulation provides evidence that managers are broadly self-serving in their use of the political process (e.g., Dal Bo, 2006, for a review). In the United States, where data on political contributions and lobbying expenditures by managers and corporations are comparatively more accessible, a number of analyses show a relation between corporate political spending and favorable legislative or regulatory outcomes (e.g., Hillman, Keim, and Schuler, 2004, and Stratmann, 2005). This result is consistent with the hypothesis that such spending provides managers and corporations with special access to the political process, leading, at the extreme, to its “capture” (e.g., Stigler, 1971, Peltzman, 1976, and Kalt and Zupan, 1984). Internationally, there is evidence that politically connected managers and corporations earn higher economic rents, particularly in countries with higher levels of corruption and barriers to foreign investment (e.g., Faccio, 2006).

Beyond the direct involvement of managers and corporations in the political process, there is also a literature exploring their opportunistic use of *information* in the political discourse. As discussed earlier, equal access to information is critical to efficient market outcomes (including political markets). The opportunistic use of information, through strategic disclosure, strategic omission, and spin, can thus create distortions in the political process, ultimately affecting the ability of markets to function competitively. For example, there is evidence that corporations standing to benefit from a set of regulations (in particular, tariffs against competitors) opportunistically lower reported accounting profits just prior to political deliberation on those regulations, as if to appear more in need of those regulations (e.g., Jones, 1991). Further, in the United States there is evidence that corporations manage the information environment around elections in ways that appear to benefit political candidates with whom they have relationships: Moreover, this information management is more pronounced when those candidates are in close races (e.g., Ramanna and Roychowdhury, 2010).

In general, self-interested corporate political activity may not be a cause for concern, particularly if the political process is sufficiently ‘thick’—that is if diverse interests and viewpoints are well-represented in such a way that the fundamental public interest in the

operation of well-functioning markets is actively addressed. Other powerful interest groups such as labor unions, pensioners, and monopoly political parties also have incentives to erect barriers to competitive markets, and the contention amongst these interests and with corporations often has the effect of focusing attention on the benefits of the market itself.[12] For example, one takeaway from the empirical literature on corporate political engagement with the U.S. Congress is that corporations have limited influence in political outcomes: they provide an input to legislation, but are not dominant (e.g., Ansolabehere, de Figueiredo, and Snyder, 2003).

In other words, just as liquid and deep price-based markets facilitate the objectives of market capitalism, liquid and deep "political markets" can ensure that a deliberative political process yields outcomes that promote freedom, efficiency, and fairness, the normative goals underlying capitalism. For example, the political market for patent regulation in the United States is one that is generally well-represented by diverse, powerful, and (importantly) competing interests, including the pharmaceutical industry lobby, the software industry lobby, lobbies for patients and their families, and labor-union lobbies (e.g., Scotchmer, 2006). And even in areas where only one special-interest group is particularly well-organized, competition amongst the media to sell entertainment and scandal to the general public can serve to temper or reverse regulatory capture (e.g., Besley and Burgess, 2002, and Dyck, Moss, and Zingales, 2013).

However there are a wide variety of market supporting institutions that are created through political processes, and not all of these political markets are equally liquid and deep. Some political markets address highly technical issues that themselves serve as barriers to political competition. Here, even the media is scarcely involved because the issues are opaque and do not make for lucrative headlines. In such cases, the traditional solution is to use an independent professional regulator (e.g., Rogoff, 1985, in the case of central banks). But this solution is only feasible if the regulator is not dependent on information from special interests. We focus on political markets where the underlying nature of the regulatory product is such that corporate interests possess a substantial fraction of the expertise necessary for regulation. In such 'thin' political markets, by virtue of their information advantage and the paucity of political counterweights representing the general interest, corporate managers have the opportunity to either propagate or to mitigate market incompleteness.

[12] If non-corporate special-interest groups accumulate disproportionate power, the institutions of capitalism could similarly become distorted, drawing the system away from competitive markets. In fact, one interpretation of the different "forms" of capitalism witnessed worldwide such as German capitalism, Japanese capitalism, and more recently, "capitalism with Chinese characteristics" is that they reflect institutional arrangements that help to shelter the monopolistic rents of one or the other special-interest groups in these societies.

For example, in the United States, the “market” for public policy on nationalized healthcare or Social Security is relatively active, with many diverse interest groups participating in the political process. By contrast, the “market” for the determination of accounting standards is relatively inactive, because the “product” is esoteric and the costs to the general public to remain informed about the options being advanced and their consequences is relatively high. Recall the example of the establishment of the Private Company Council given in the introduction. In that case, a handful of players from private companies, industry associations, and professional societies were able to create a new regulator for accounting standards largely outside the public eye and despite the dearth of conceptual arguments for the same. These dynamics appear to also exist in areas beyond accounting. Several commentators have suggested, for example, that regulating modern global financial institutions is particularly difficult because only those inside the institutions truly understand the technicalities of the market (e.g., Das, 2010). A similar situation likely exists in the case of the regulating the actuarial industry, the auditing industry, and the insurance industry. In cases such as these, the potential for special-interest capture by corporations and their managers (with all of the associated welfare losses) is relatively high, with, we believe, real implications for the functioning—and hence the legitimacy—of market capitalism.

To illustrate this point further, we outline below some additional examples from across the world, focusing first on the political process that surrounds the determination of a number of different accounting standards before moving to a discussion of corruption as another example in which the pursuit of profit maximization may actively undermine the operations of free markets.

We focus on the development of accounting standards because there is very little debate as to whether their existence is critical to the development of an efficient market-capitalist system. For example, 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. Both in the U.S. and overseas, however, the development of accounting standards has been highly influenced by private interests.

In the U.S., for example, existing standards for accounting for mergers and acquisitions (M&A), particularly those associated with the treatment of acquired “goodwill” (the excess of the purchase price in an acquisition over the current value of identifiable and measurable net assets), were shaped by the lobbying interests of investment banks (Ramanna, 2008). Investments banks have a strong financial interest in promoting the volume of M&A as well as in boosting deal values, which, all else equal, increases acquired goodwill. These M&A accounting standards have been shown to compromise acquirers’ accountability for acquired goodwill

(Ramanna and Watts, 2012). With decreased accountability for acquired goodwill, the frequency and magnitude of overpayment in M&A can increase, with benefits to investment banks, but potential welfare losses to the economy at large.

Similarly, international accounting standards for the definition of ‘related parties' in preparing consolidated financial reports were shaped by lobbying from the Chinese Ministry of Finance specifically representing the interests of Chinese state-owned enterprises (SOEs) (Ramanna, 2013b). The definition of related parties is central to the credibility of consolidated financials. Conceptually, transactions between subsidiaries and other non-arms-length transactions should not be included in the calculation of consolidated income; thus, accounting standards for consolidations typically require the disclosure of such related-party transactions. Under the previously existing international standards, many of the transactions of Chinese SOEs with each other and with the government would have qualified as ‘related party' transactions and thus would have required extensive disclosure. The Chinese government, recognizing the disadvantages these rules would place the SOEs under, lobbied for looser standards for ‘related party' disclosure for SOEs as part of its negotiating strategy during the conversations about adoption of the international accounting standards. While the revised standards almost certainly benefit Chinese SOEs, they may also generate significant welfare losses because they leave investors with less information about the related-party component of the SOEs' profits.

In India, as another example, multinationals with overseas operations suffer from high exposure to foreign currency fluctuations, given the Indian rupee's relatively high volatility in international currency markets. Thus, Indian multinationals have a strong incentive to seek exceptions to international accounting standards requiring foreign currency translations in the preparation of consolidated financial reports (Ramanna, 2013b). Perhaps unsurprisingly, these firms have lobbied to obtain the exceptions in the accounting standards as applied to India.

There are other examples of the potential for special-interest capture in the determination of accounting standards. The audit industry internationally is an oligopoly that includes four large players. In the U.S. there is some evidence that these players have lobbied for accounting standards that socialize the risks of auditing by reducing the level of professional judgment required, so that the large auditors can benefit from the scale economies their size offers without having to bear the full costs of the litigation and regulatory risks inherent in their business model (Allen, Ramanna, and Roychowdhury, 2012).

Another issue is the nature of the U.S. accounting standards body itself, the Financial Accounting Standards Board (FASB). Over the last twenty years, concurrent with the growth of

the financial services sector in the U.S. economy, the proportion of regulators from this sector represented on the FASB has increased. Before 1993, the FASB included no financial services veterans (where "financial services" is defined as investment management and investment banking); by 2007 such members made up more than a quarter of the board. There is evidence to suggest that the increased proportion of FASB members from the financial services sector is associated with an increased incidence of accounting-standards proposals that benefit that sector (Allen and Ramanna, 2013) particularly in ways that make the sector's performance appear more favorable than it actually is (Ramanna, 2013a). Given accounting's role in evaluating and compensating managers, such standards can result in misappraisal of the performance of financial services executives and thus in inefficient wealth transfers.

In suggesting that all of these examples are cases of 'thin' political markets, or cases in which the participating firms possess an information advantage that cannot be easily mitigated, we note that ordinary investors and the general public—those who are most likely to be affected by these kinds of distortions—are not actively lobbying against them. This is because these general-interest groups usually lack the technical experience necessary to participate in the political process—the experience rests with corporate special interests—and because the effects on the public welfare are generally too diffuse at the individual level to precipitate collective action. In theory, investment managers, who act for ordinary investors in capital markets, could mitigate the effects of lobbying by audit firms, industrial firms, and investment banks. But the evidence suggests that investment managers are themselves among the special interests seeking self-serving accounting rules (Allen and Ramanna, 2013), consistent with an agency problem between investment managers and ordinary savers (Desai, 2012).

Collectively, this evidence is consistent with the hypothesis that, at least in the case of accounting standards, corporate special interests are consistently obtaining results that are self-serving and that may be actively distorting the market, imposing significant welfare losses on society more broadly. These various special interests are almost certainly acting with the goal of profit maximization. As we noted before, such a motive is "moral" in the context of competitive markets, but in a thin political process, such as accounting standard setting, this kind of behavior is likely to distort efficient capital allocation in the economy and thus distort the operation of the free markets. Following our discussion above, we believe this behavior to be actively "immoral" in that in compromising the working of the market it compromises the values of freedom and prosperity that give the pursuit of profit maximization its ethical legitimacy. We also suspect it is unwise from managers' own perspective, in that the widespread perception that the market is

tilted towards insiders is likely to undermine the legitimacy of the capitalist system and to provoke a populist backlash (e.g., Rajan and Zingales, 2003)

The discussion thus far has focused on corporate engagement in thin political processes where the 'thinness' is due to corporations having unique access to the expertise necessary to create effective market institutions and to the absence of any effective organized opposition from the general interest. We now turn to another class of thin political markets: those in which the political process is thin because it is undefined or emergent. We argue that here again managers have a responsibility to act on behalf of the system itself, rather than in the interests of their firm.

The case of corruption, particularly in emerging markets, is a compelling setting for exploring this issue. Corruption is a serious issue in most emerging markets: A recent World Economic Forum survey of business leaders revealed corruption as the biggest hurdle to business in Russia, the second biggest in India, and among the top five hurdles in China. Corruption distorts the conditions for capitalism by compromising contracting, promoting collusion, and eroding property rights. It decreases efficiency, reduces individual freedoms, and creates a perception of unfairness in outcomes. But while corruption imposes high moral and economic costs, corporations and their managers are often reluctant to take action against it. This is both because corruption often yields short-term benefits for those who engage in it, and because the reduction of corruption is a classic "public good" whose benefits are widely dispersed across society. From a pure profit-maximization perspective, corporations and managers may rationally reject combating corruption, and even embrace it.

For example, in a study of the response of managers in Russia to anti-corruption efforts, one CEO argued that while combating corruption was noble, it was not his responsibility because (he said, paraphrasing Milton Friedman) the "business of business is business." Another CEO feared for the "wellbeing" of his business and his employees if he were to resist corrupt politicians and bureaucrats (Healy, Ramanna, and Shaffer, 2012). Thus, individually rational business decisions can act to perpetuate corrupt practices. Corporations and their managers may get locked into a dysfunctional prisoners' dilemma that sustains and even exacerbates a market that is very far from being either complete or free, running the risk that they will eventually undermine the legitimacy of market capitalism itself.

What is the appropriate response for the corporation and its manager in these circumstances? How should managers respond to incomplete or thin political markets? Should they actively seek to exploit the political process in the interests of their corporations? The following section begins to explore these questions.

5. Beyond profit maximization?

The traditional answer to these questions is that managers should do 'nothing beyond profit maximization.' There is a long literature acknowledging that many public institutions will necessarily be imperfect—not least because private firms will attempt to capture them—but several economists, particularly those of the Chicago School, have explicitly accepted such capture as a necessary cost of market capitalism. For example, Milton Friedman (2002, p. 28) discusses the problem of natural monopoly extensively and suggests that he believes 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 (also see, for example, Stigler, 1971; Posner, 1975; and Shleifer and Vishny, 1991). Moreover, as we discussed earlier, in those cases in which political markets are relatively 'thick' there is some evidence that the checks and balances imposed by the political process can serve to generate institutions that approximate the conditions for competitive markets. Recall, for example, the case of patent regulation in the U.S. discussed earlier. Other examples include regulation of automobile safety and of tobacco, although in both cases active lobbying by the firms concerned to delay the imposition of regulation likely imposed significant health costs on their consumers (e.g., Vogel, 1996).

But here we suggest that if we are to remain true to the spirit of Freidman's admonition and to accept a responsibility for the normative ideals that legitimize market capitalism, the acceptance of regulatory capture and the hope for deep and active political markets are not always sufficient responses. We suggest that in those cases in which private activity is unlikely to generate institutions that will approximate the conditions for competitive markets and in which the political market is likely to be sufficiently thin or one sided that we cannot expect the political process to function effectively that managers have an active duty to refrain from self-dealing, and that as a society we should invest in developing institutions and norms that enforce this duty.

Of course to go from our observations on the limits of profit maximization to the suggestion that business has either an interest in or a responsibility to sustaining the conditions for market capitalism is a big step. Here we try to make the case that both are true.

The case from interest

Fully competitive markets—with a comprehensive set of institutions meeting the conditions for efficient prices—create two forms of private benefit. First, they make it possible for new firms to enter the market and for existing firms to diversify into new markets. Since the

subversion of competitive markets overwhelmingly benefits the most powerful incumbent firm, there are a number of cases, most notably those of newly founded, "second tier," and actively diversifying firms, where it is clearly consistent with profit-maximization for private interests to support institutions that will make markets competitive.

Second, to the degree that the ethical legitimacy of market capitalism rests on a widespread belief in its ability to sustain normative ideals such as freedom and fairness, and to the degree that the ability of market capitalism to deliver against these promises rests on competitive markets, the gradual destruction or subversion of the institutions that sustain such markets can threaten capitalism's legitimacy and thus the very existence of a market society.

Historically the perception of "crony capitalism"—and the escalating prices and exclusion from participation that often accompany it—have often triggered serious social unrest. Major market failures such as the Great Depression can incubate political ideologies that are actively hostile to free markets, including communism, fascism, and socialism. The emergence of activist anti-establishment groups such as Occupy Wall Street and the Tea Party in the United States since the financial crisis of 2008 is a reminder that the legitimacy of market capitalism is not immune to ideological attacks. Similarly much of the unrest in China appears to be triggered by the perception that the playing field is titled and a favored few are getting rich at everyone else's expense (e.g., Liu, 2012).

If these risks are real, then one can make the case that—at least in the longer term—it is profit maximizing for business to care about the legitimacy of the market capitalist system, although this legitimacy will still be a public good and many firms might attempt to free ride in its provision (see, e.g., Bower, Leonard, and Paine, 2011, who have explored this line of thought in their book *Capitalism at Risk*). In those cases in which a few large firms dominate an industry where this is a critical issue, however, some form of collective action may serve to override this problem. The efforts of the major mining and minerals companies to define and enforce transparency in their dealings with government, for example, appear to be consistent with the idea that it is sometimes in in firms' immediate self-interest to invest in the creation of well-structured institutions. (See, for example, the Extractive Industries Transparency Initiative and Locke, 2013).

The argument from "responsibility:" Friedman's agency argument reframed

Another powerful argument for the idea that corporations and their managers should play a central role in sustaining the conditions of market capitalism comes directly from the very

considerations of ethics and duty that underpinned Milton Friedman's contention that managers should focus only on profit maximization.

Recall Friedman's arguments for why the manager's primary duty is to maximize the value of the shareholder's capital: First, he argues that capitalism—the free allocation of capital by individuals in the service of their individual ends (within the framework of a fully competitive market)—maximizes not just economic efficiency but also civic freedoms. Second, he argues that capitalism can best be served by managers acting unambiguously as agents for shareholders. Anything else would be both to deviate from capitalism—which would compromise its legitimizing principles—and would also betray both the trust that shareholders place in managers and the manager's legal responsibilities.

While much of the current conversation assumes that economic growth and national income are self-evidently the ultimate goals of the political and economic system, Friedman's work—and a rich tradition in normative economics that complements and builds on it—suggests that markets are also justified for their ability to provide libertarian freedom, democratic fairness, and opportunity freedom.

Similarly, the suggestion that managers owe a duty to their shareholders is not only a claim about efficiency but also a claim about ethics. Shareholders are inherently vulnerable, and thus "ought" to be protected. Of course the duty to act as a responsible agent is also enforced by law (such as through the creation of "fiduciaries") and (in some geographies) by the discipline of the capital market. But both enforcement mechanisms flow from the social consensus that the larger goals of efficiency, freedom, and fairness are best served by holding managers strictly to account as agents for shareholders.

We thus argue that the injunction that managers should consider themselves first and foremost the agent of shareholders—and the extensive attention to the mechanisms that might persuade them to behave in this way—reflect first and foremost a set of ethical principles about the right ends of the firm.

As we have learnt from many years of research in agency theory, there is no reason to believe that the interests of the individual manager are necessarily (naturally) aligned with those of the shareholders, so in maximizing the interests of the shareholder the manager may be, paradoxically, acting on an ethical imperative rather than an economic one. Now, of course, much of the thrust of agency theory is to design mechanisms that align the interests of the manager with those of the shareholder, and in the heavy details of research papers on agency

theory there is usually no mention of the fact that managers "ought" to align themselves with shareholder interests. But, nonetheless, in both business education and popular discourse, managers sometimes clothe themselves in the mantel of virtue by claiming that they are acting on an ethical imperative—and implicitly sidelining their own interests—in maximizing shareholder return.

We argue that the same logic—the same combination of ethical imperative and associated mechanism design—can and should be applied at the level of the capitalist system, as well as at the level of the firm. That is, we argue that managers should consider themselves agents of society with respect to the maintenance of the institutions of capitalism, as well as agents of individual investors. Firms are, after all, legally the creations of the state. The first corporate charters (for corporations as we would recognize them today) were granted in the UK in the expectation that the corporation would create benefits for society—in the case of the East India Company, increased revenue for the Crown; in the case of the companies that built canals and railroads, public infrastructure, and so on (e.g., Scott, 2011).

Today, the modern (U.S.) corporate charter grants a number of important legal rights, including limited liability to shareholders, survivorship beyond founders and unlimited life, and corporate personhood (e.g., the right to participate in the political process through the exercise of free speech). What are the offsetting corporate duties to society that are inferred together with these rights? The deliberate vagueness of corporate law on this matter—e.g., boards of directors are not obligated by law to simply maximize shareholder value—suggests pure profit maximization is not the only expected duty of corporations. An easy answer beyond profits might be "jobs," and that certainly seems consistent with much of the public discussion, particularly around elections. A slightly more complex one might be the expectation of the creation and maintenance of the kinds of economic and political freedoms that Milton Friedman thought was such an important objective of market capitalism.

As our discussion above suggests, however, we think that a more accurate answer would be that the charter expects two major duties of corporations and their managers. The first is to maximize profitability within the bounds of the law. The second is to play an active role in maintaining the conditions that sustain free markets, or at the very least to refrain from actively subverting them. We hypothesize that when there is no active (political) market to check the consequences of self-interested profit maximization that distorts the conditions for capitalism and the firm has an informational advantage over the public and the state that cannot be easily remedied—as in the setting of accounting standards, for example—then when the private interests of the firm are in conflict with the creation or maintenance of institutions designed to

support fully competitive markets, the firm and its general manager, acting as an agent of the state that chartered it, has a duty to advance the interests of the market capitalist system as a whole. This duty might at times require subverting the interests of the firm itself.

To summarize, our hypothesis is that managers in corporations are agents for both shareholders of the corporation and the society that grants corporations the license to generate profits. One rule of thumb under this view is that when managers are functioning within markets, their agency relation to shareholders dominates, and that they should maximize profits within the bounds of the law, and that when they are functioning within the political process—particularly in the case of thin political markets, their agency relation to society dominates and they have a responsibility to create and sustain the conditions for competitive markets.

6. A framework for future research

The hypothesis developed above raises a number of issues for future research. First, we have emphasized that the manager's responsibility to the system itself is relevant when the political process that structures market institutions is 'thin.' We have attempted to provide some illustration of what such thin political markets look like and to contrast thin political markets with those where the general interests or, at least, powerful competing special interests are represented. In focusing on the case of corruption we have explored a case in which there may be no organized political market at all. But, our characterization of thin political markets is anecdotal and inductive. If we are to define a general duty along the lines we suggest, it will be critical to develop greater clarity around how "thin" political markets and cases of "specialized knowledge" can be identified. Thus, we see the development of analytical and empirical models that distinguish political processes where managers have a heightened agency for the system as a fruitful theme for future work.

The second question is that of monitoring and enforcing this responsibility. Recognition of the agency relationship between managers and shareholders led to an enormous body of work that has explored designing, implementing, and evaluating incentives and performance metrics. The recognition of an agency relationship to the capitalist system will also require research in this direction. The emerging field of corporate accountability reporting is promising a 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, we expect metrics in the manager-society relationship to include technologies addressing information asymmetries (such as auditing) (Ramanna, 2013c). Over time, and with

the development of theory and practice in this area, we expect more sophisticated reporting systems to assess the extent to which corporations and their managers do indeed assume their responsibility for sustaining the conditions for market capitalism.

Of course, monitoring through corporate accountability reporting is just one institution of many that might emerge to address the agency relationship between managers and the system in which they are embedded. It might also be fruitful to explore the possible scope for innovation in institutions that promote and enforce business standards that address managerial agency for the market system. For example, we see a role for research that explores the development of standards and professional codes for business lobbying (especially in cases of technocratic regulations that are outside the public eye) and 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.

Finally, there is scope for significant teaching and curricular innovation, particularly within business schools and economics and political science departments. 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 we suspect it will be useful to document examples 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 alternatives courses of action in such situations.

7. Summary

This paper raises questions about the role of managers in sustaining the conditions for market capitalism to achieve its normative objectives. We began with a discussion of the normative arguments for fully competitive markets as a resource allocation mechanism in complex societies. We suggested that Milton Friedman's assertion that the business of business is to increase its profits was in fact a *moral* admonition rooted in this normative framework. Next, we discussed the conditions for the existence of competitive markets and offered a brief overview of the institutions that provide them, noting that a combination of for-profit, pure public, and public-private institutions are needed to sustain capitalism. We then turned to a discussion of the competing incentives that managers face when they have the opportunity to engage in the political process that shapes these institutions. We acknowledged that in many cases the opportunity to provide market-completing institutions is a significant profit

opportunity, and that when institutions are provided by the public sector and when political markets are 'thick' firms may have an important role to play in advancing their own interests in the political process. On the other hand, we suggested that in those cases in which the provision of an institution is a scarcely attended political process in which firms possess significant information advantages, managers may have a duty to mitigate this market incompleteness, even if it is not immediately profit maximizing to do so. We suggested that managers have both selfish and ethical motives to behave in this way, but that ultimately, their actions in this regard are likely to shape the ethical and political legitimacy of market capitalism.

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Table 1
Public and private institutions of capitalism: examples from U.S. financial markets

Condition	Private institutions	Public institutions
Property rights	Asset custodial and security firms	Corporate and securities laws, state and federal enforcement
Complete knowledge	Accounting and auditing firms, financial analysts and ratings agencies, the financial media (including financial advertising), and financial intermediaries such as investment managers	SEC disclosure laws, Consumer Financial Protection Bureau
Enforceable contracts	Financial insurance industry, third market-makers	Contract law, bankruptcy law, the Federal Reserve System, federal deposit insurance, expectation of federal support in times of crisis (e.g., TARP)
No agency	Boards of directors, auditors	Fiduciary duties in corporate and trust law
No collusion	The “entity concept” in accounting	Anti-trust law
Price taking and market clearing	Securities exchanges, asset custodial firms, and prime brokers	Federal interventions to create markets, e.g., regulations to have a single clearing point for derivatives
Free entry and exit	Going public, mergers and acquisitions, delisting	Anti-trust law