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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, and, in particular, should these responsibilities shape their behavior when they are attempting to structure those institutions of capitalism that are determined through a political process? A prevailing view—perhaps most eloquently argued by Milton Friedman—is that managers should act 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 if the political process is sufficiently 'thick,' in that diverse views are well-represented and if politicians and regulators cannot be easily captured, then this shareholder-return view of political engagement is unlikely to reduce social welfare in the aggregate and thus damage the legitimacy of market capitalism. However, we contend that sometimes 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 opposition—such as in the case of determining certain corporate accounting standards that define corporate profitability. In these circumstances, we argue that managers have a responsibility to structure market institutions so as to preserve the legitimacy of market capitalism, even if doing so is at the expense of corporate profits. We make this argument on grounds that it is both in managers' self-interest and, expanding on Friedman, managers' ethical 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 had been subject to the same accounting rules as public companies since there were few conceptual arguments 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, successfully lobbied to create their own accounting standards council, the PCC.[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 world in which private companies have their own accounting rule-maker has significant public policy implications. Accounting rules are at the heart of modern market capitalism, shaping incentives and performance evaluations and the resource allocation decisions that drive economic growth. As it happens the debate surrounding the creation of the PCC was both highly technical and highly specialized, and corporate managers, by virtue of their resources and experience, and the fact that this issue was 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 that are largely outside the public's watch? 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?

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 problems of agency and uncertainty. Here we draw on recent advances in agency theory and in our understanding of the dynamics of political influence to propose that there are strong arguments derived from both self-interested and normative grounds to revisit this conclusion. We discuss when and why managers may have a responsibility

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

to structure market institutions so as to 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 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. 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 particularly salient recent example (e.g., Kristof, 2011). Internationally, capitalism's reputation in several emerging markets including China, India, and Russia has taken a blow following the discovery of widespread corruption. For example, in late 2012, Wal-Mart was embroiled in allegations of improper lobbying in India to change local laws on foreign direct investment (e.g., Pradhan and Katakey, 2013), while the telecom spectrum auction of 2008 in the same country was later revealed to have been "fixed."

The normative case flows from a long tradition in economic philosophy. The idea that business can legitimately pursue profits—and indeed that to do anything else is actively unethical—is strongly rooted in a set of ethical arguments about what profit maximization accomplishes. Many scholars—including Milton Friedman himself—have rested their arguments for the legitimacy of capitalism and the pursuit of profit maximization firmly on moral grounds, arguing that under a series of well-defined conditions capitalism will deliver prosperity, thus, perhaps, increasing individual 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. A wide range of competitive private institutions—including, for example, auditors, rating agencies, and securities analysts—have emerged to support the development of efficient markets, while at the same time the responsibility for ensuring, for example, that firms do not collude to set prices or limit entry has been effected through government regulation. There is, of course, seldom ex ante certainty about what should be the "appropriate" rules of the market (e.g., should there be a PCC?) 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 regulation begins and that even in those cases in which self-interested lobbying is clearly legal it may not be consistent with the ethical objectives of capitalism.

Our paper progresses as follows. We begin by exploring the normative arguments that have established the moral legitimacy of market capitalism (Section 2). A long line of scholarship has argued for capitalism as a system that efficiently delivers prosperity while promoting individual freedoms and an 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 an ethical argument: a proposition that emerges when the problems of agency and uncertainty are internalized into the question of how to deliver on the moral 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 the pursuit of profit often supports the development of industries and firms whose primary function is to facilitate competitive markets. However, as scholars since Adam Smith have observed, a myopic focus on private interest can, in some circumstances, lead managers to attempt to subvert or ignore the conditions for competitive markets, and thus, of market capitalism itself (see, e.g., Smith, 2005). In Section 4, we draw on evidence from two areas in particular: the determination of accounting standards and corporate responses to corruption, 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 of the commons, where corporations and managers can be locked in a dysfunctional prisoners' dilemma that undermines capitalism's legitimacy.

In light of this evidence we then turn to an exploration of whether, when, and why corporations and their managers may also have a "social responsibility" to sustain the conditions for market capitalism (Section 5). We explore whether corporations and their managers should be characterized as "agents" for a society that is interested in the preservation of a system of market capitalism, focusing both on the case from interest—or on the degree to which it is in a manager's (long run) self-interest to invest actively in sustaining the institutions of capitalism—and on the case from responsibility—or on the degree to which managers have an ethical responsibility to the system of which they are a part. Reasoning from ethics is rare in economics papers, so we reinforce this discussion by reiterating the arguments underlying the moral legitimacy of market capitalism. We propose that these same arguments can 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 by suggesting that 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 and we begin to sketch out a framework for such a research agenda (Section 6).

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 moral 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 a moral 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 a moral 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 18^{th} and 19^{th} 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 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). A compelling example of such freedom, offered by Milton Friedman, is the ability of individuals to choose their field of employment. Given a social objective of maximizing libertarian freedom, a reliance on markets can be morally 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.[2]

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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[2] 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.[3] 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 morally legitimized through their natural propensity to draw in maximal participation in pursuit of equilibrium prices. As with the libertarian justification for market capitalism, the democratic justification is non-consequentialist: It is the *operation* of markets, not 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

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

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 moral 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.[4]

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.

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

[4] 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.

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 suggestion that managers should, in fact, focus on larger questions such as potential investments in public goods thus has to pay very careful attention to 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.[5] 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 an ethical 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 trust—in itself a moral problem—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 betray the values of freedom, efficiency, and fairness on which the legitimacy of capitalism resides, reducing both the

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

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 have 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 tend to be self-healing in that the dynamics of competition itself generates the institutions and actions that maintain competition and 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 suggest that we cannot, in some circumstances, rely either on 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.[6] Competitive markets rely on:

Well-defined property rights: Uncertainty over property rights on 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).[7]

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 very practical level, this means that the parties to an exchange are 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

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

[7] 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.

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.[8] That is, buyers and sellers have not colluded by virtue of separate agreements or power 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

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

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.[9] 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

[9] 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.

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).[10]

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 in the literature 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; 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 are supplied through 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 process that shapes these institutions? If managers should not, in general, deviate from attempting to maximize profit 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?

This question assumes particular salience in those case in which by virtue of their information advantage within both product markets and the political process, corporate managers have a relative advantage in knowledge and opportunity to both propagate and mitigate market incompleteness.

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10 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.

When faced with market-supporting institutions shaped by a political process, managers of corporations are faced with two broad choices: (i) opportunistically lobby to subvert the institutions' purpose and thus perpetuate market incompleteness; or (ii) lobby with the intent to enable the institution to meet its market-completing purpose.

In general the empirical literature provides fairly robust evidence that managers consistently choose the first option, and are self-serving in their use of the political process, consistent with pursuing the profit motive. 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., Stratmann, 2005, and Hillman, Keim, and Schuler, 2004). 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, 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 an economics-based 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 the 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).

The basic tendency of managers to use their knowledge and access advantage to structure political and regulatory institutions in their own interest has attracted the interest of academic economists. For example, Raghuram Rajan and Luigi Zingales (2003) argue that the primary threat to market capitalism comes from incumbents, or "those who already have an established position in the marketplace and would prefer to see it remain exclusive." And 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."

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, but the contention between these interests often has the effect of focusing attention on the benefits of the market itself.[11] 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).

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. 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 cases such as this the potential for special-interest capture by corporations and their managers is relatively high, with, we believe, attendant implications for the legitimacy of market capitalism.

To illustrate this point further, we outline below some additional examples from both the U.S. and internationally describing the political process that surrounds of the determination of

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[11] In fact, the different "forms" of capitalism witnessed worldwide such as Anglo-Saxon capitalism, German capitalism, Japanese capitalism, and more recently, "capitalism with Chinese characteristics" may indeed reflect euphemisms created to excuse political barriers that shelter the monopolistic rents of one or the other power elites in those societies.

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.

There is very little debate as to whether the existence of accounting standards 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, the standards for accounting for mergers and acquisitions, 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). Since investments banks have a strong financial interest in promoting the volume of mergers and acquisitions as well as in boosting deal values, it is not surprising that these standards have been criticized as compromising acquirers' accountability for purchase premiums (Ramanna and Watts, 2012). Similarly, the international accounting standards for the definition of related-parties in preparing consolidated financial reports were shaped by lobbying from the Chinese government. Chinese state-owned enterprises are widely suspected of concealing their true profitability through the use of state transfers, so these firms have a strong incentive to ensure weaker standards for disclosure of related-party transactions (Ramanna, forthcoming).

In India, 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, forthcoming). Since Indian firms lobby extensively within their home country, it is perhaps unsurprising that these exceptions have been forthcoming.

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 intriguing evidence that these players have lobbied for accounting standards that systemize (socialize) the risks of auditing, so that the large auditors can benefit from the scale economies their size offers them without having to bear the full costs of the litigation and regulatory risks inherent in their business model (Allen, Ramanna, and Roychowdhury, 2012). Another cause for concern is the nature of accounting regulators themselves. 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 U.S. accounting standards body has increased. Before 1993, the U.S. accounting standard-setter included no financial services veterans; by 2007 such members made up more than a quarter of the board. There is evidence to suggest that standards bodies dominated by regulators who have previous worked in the financial services sector are more likely to generate accounting standards that benefit that sector (Allen and Ramanna, 2013).

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. The various corporate special interests that capture accounting standards in the cases discussed above are almost certainly acting with the goal of profit maximization, but in the aggregate such behavior can distort efficient capital allocation in the economy and eventually compromise the moral legitimacy of that system.

The discussion thus far has focused on corporate engagement in the political process creating public institutions to address market incompleteness when this political process is relatively ‘thin.’ We now turn to those cases in which many of these institutions do not (yet?) exist or where the political process is itself undefined. What should be the responsibilities of managers under these conditions?

The case of corruption, particularly in emerging markets, is a particularly compelling setting for exploring this question. 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 markets that when a response that seeks to complete the market is not immediately profitable? Should they do nothing? Should they collusively align themselves to earn economic rents from the existence of market incompleteness? Should the actively seek to make markets incomplete, even if they cannot maximize short run profits in doing so? 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) 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 (p. 28). 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 on automobile safety and on tobacco usage, although in both cases active lobbying by the firms concerned to delay the imposition of regulation 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 mechanisms that enforce this duty.

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, of course, 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. The subversion of competitive markets overwhelmingly benefits incumbents and, within that, overwhelmingly the most powerful incumbents. There are thus a number of cases, most notably those of newly founded, "second tier," and actively diversifying firms, where it is clearly consistent for profit-maximizing private interests to support institutions that will make markets competitive.

Second, to the degree that the moral 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.

Moreover if the subversion of the market takes place not only through the suppression of competition but also through the failure to price externalities, on a larger scale, this too may lead to the widespread questioning of the legitimacy of business profit and potentially to the destruction of the stocks of natural and social capital on which business relies. Any individual firm emitting CO_2, for example, has the incentive to lobby against carbon pricing or regulation, but if steadily rising CO_2 emissions do destabilize the climate then some businesses, at least, will find their costs rising and the markets for their products under pressure. Moreover, if the degradation of the environment is believed to have been the result of "corporate greed" the legitimacy of the entire system may come into question.

Examples from history suggest that major market failures such as the Great Depression can incubate political ideologies hostile to free markets, such as communism, fascism, and socialism. Ironically, major market failures have in the past also resulted in centralization of resources within governments resulting in "crony capitalism," which benefits few and undermines freedom and fairness in society. The emergence of activist and anarchist 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.

If the risks described above 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*).

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

A more 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—i.e., from agency theory, but from a richer perspective as to the principals to whom managers should feel responsible.

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.

Beyond Milton Friedman, as noted earlier, there are many other influential arguments for capitalism that variously stress its efficiency, its inclusive fairness, and its ability to sustain political freedoms. We read these arguments as fundamentally ethical in nature. Since this is not how they are usually understood and communicated within academic neo-classical economics and in business practice, it is worth spending some time exploring why.

First, the arguments of Milton Friedman and others are about the highest goods to which a society should aspire. While much of modern political and economic conversation assumes that economic growth and national income are self-evidently the ultimate goals of the political and economic system, as we discussed above markets are also justified for their ability to provide higher goods beyond efficiency including libertarian freedom, democratic fairness, and opportunity freedom.

Second, within this larger ethical frame, the suggestion that managers owe a duty to their shareholders similarly has an ethical dimension. 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 we view both enforcement mechanisms as flowing from the implicit social consensus that the larger goals of efficiency, freedom, and fairness are best served by holding managers strictly to account as agents for shareholders.

Indeed perhaps the best evidence for this latter perspective is how highly contested both the interpretation of the legal duty of managers is and how effective the market for corporate control is in serving the broader goals of capitalism. There is, for example, a lively debate about the degree to which a manager's primary legal duty is the maximization of shareholder value (e.g., Bebchuk, 2005; Stout, 2012). Senior managers are certainly fiduciaries for shareholders and must exercise care, candor, and loyalty in managing the firm, but corporate law in the United States does not require shareholder value maximization (e.g., Paine, 2009). Similarly, again in the United States, the courts have given broad discretion to managers to refuse to sell the firm even in the face of cash offers significantly over current market value, instead adhering to the "business judgment rule" and to the contention that directors (and by extension senior managers) have responsibilities to the long-term health of the corporation.

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 beliefs 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 market capitalist system, in addition to the level of the firm. 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 the market capitalist system, or at the very least to refrain from actively subverting it. 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—as in the setting of accounting standards, for example—when the private interests of the firm are in conflict with the creation or maintenance of institutions designed to support fully competitive markets, then 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.

In other words, we advance the notion that there is an agency relationship between firms and the society that chartered them in precisely the same sense as managers are agents for shareholders (on this point, also see, Hill and Jones, 1992).

There are important corollaries that arise from this proposition for multinational corporations that operate across several jurisdictions or that are incorporated in a jurisdiction that grants corporations the authority to focus solely on shareholder value maximization. While our argument above is motivated from the nature of the corporate charter in the United States, we see the duties we describe as being relevant to any society that has deployed market capitalism as a resource allocation mechanism.

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 illiquid 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

This hypothesis that managers have an agency relationship with society that behooves them to structure market institutions so as to preserve the legitimacy of market capitalism raises a number of issues for future research.

First, we have emphasized that this responsibility to the system manifests in particular when the political process to structure market institutions is 'thin.' We have attempted to provide some illustration of what such thin political markets look like—in the context of accounting standard setting—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 political market at all. But, our characterization of thin or absent political markets is anecdotal. At the moment identifying such situations is a matter of judgment. 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.

Second is the issue of monitoring managers in this new role. Just as the agency relationship between managers and shareholders has given rise to an enormous body of work in designing, implementing, and evaluating incentives and performance metrics, so too can the agency relationship between managers and society. The nascent yet emerging field of corporate accountability reporting is a step in this direction. The lessons from agency-based accounting work in the manager-shareholder relationship will almost certainly be helpful in developing a reporting framework for the manager-society relationship. 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, 2013). 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 can emerge to address the agency relationship between managers in corporations and a society that deploys a market-capitalist system. There is also scope for innovation in institutions that promote and enforce business standards to address this agency-based void. 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. Additionally, we see the development of case studies that describe managerial decisions in the presence of dual principals (i.e., shareholders and the market-capitalist system) as being an important next step in this research agenda.

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 suggestion 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 suggested that this perspective has two implications for managers. On the one hand, in many cases the opportunity to provide market completing institutions is a significant profit opportunity. On the other hand, in those cases in which the provision of an institution is a scarcely attended political process or a public good that cannot be easily realized by managers, managers may have a duty to mitigate this market incompleteness, even if it is not immediately profit maximizing to do so. Ultimately, their actions in this regard are likely to shape the moral 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