THE CORPORATION IN THE 21ST CENTURY

JOHN KAY, 2024

The leading companies of the twenty-first century raise modest amounts of capital they raise are used to cover the operating losses of a start-up business. The physical assets required by twen-ty-first-century corporations are mostly fungible: they are offices, shops, vehicles and data centres which can be used in many alternative activities. These 'means of production' need not be owned by the business that uses them and now mostly they are not.

Modern businesses the 'boss'. Information, the commitment and, above all, the capabilities.

What we call 'profit' is no longer primarily a return on capital but is an 'economic rent'. An understanding of the concept, origins and effects of economic rent is essential to understanding not only the finan-cial accounts of firms but also the distribution of income and wealth in the modern economy.

LOVE THE PRODUCT, HATE THE PRODUCER: Virtually every company says: "Our clients' interests always come first". "Integrity and honesty are at the heart of our business."

STAKEHOLDERS: It is obvious that no organisation can succeed unless it has regard to the needs of all its stakeholders. And it is also obvious that these interests do not necessarily coincide.

LOSS OF CONFIDENCE: Business reputation has suffered many blows in the last two decades. The collapse of Enron in 2001. The financial crisis of 2008. The successful businesses that define the modern economy are not well regarded, especially by the young people who are often the most committed users of their products.

Goldman Sachs and Boeing, Merck and Pfizer, Google and Apple. These are businesses with distinctive combinations of capabilities that have enabled them to scale their operations, operate globally and employ thousands or tens of thousands of people.

A HISTORY OF PHARMACEUTICALS: A CASE FOR TREATMENT

The rise of scientific medicine / Antibiotics / The tide turns

The post-war pharmaceutical industry enjoyed an implicit contract with the public and the government. The arrangement was complex: drug pricing was, and remains, controversial. The most profitable drugs were not the lifesavers - such as antibiotics and vaccines - but those that alleviate but do not cure chronic diseases suffered by rich people - depression, hypertension, excess stomach acidity.

Drug companies continued to push the limits of customary behaviour.

The pharmaceutical industry illustrates modern business at its best and worst. Its products - antibiotics, anti-hypertensives, statins, vaccines and many others - have saved hundreds of millions of lives and improved the quality of life for almost everyone.

Its revenues have funded new research and made large profits for investors. Since stock in companies such as Merck, Pfizer, AstraZeneca and Roche.

The pursuit of 'shareholder value', the belief that profit is the defining purpose of a corporation, was one element in the decline of ethical standards. There is no shortage of 'patient capital'. But there is a shortage of patient individuals working in the finance sector, an industry remunerated almost entirely by transactions.

The history of pharmaceuticals illustrates much that is right and wrong in the relationship between business and society. Four problem areas: 1) the motivation and standards of behaviour of leaders of the industry; 2) the interface between business and finance, 3) the difficulty of constructing a regulatory regime that is relevant and effective; and 4) the sometimes too tenuous relationships between prices, costs and values.

ECONOMIC MOTIVATION

Humans are social animals. Opportunities to add value by collective action are all around us.

Employees take satisfaction from being associated with the creation of fine products and satisfied consumers.

Steve Jobs: 'The only way to be truly satisfied is to do what you believe is great work. And the only way to do great work is to love what you do."

Another account / The tripartite linkage: The connection from personal wealth to the provision of productive capital to control of business was a defining characteristic of the Industrial Revolution.

Today the most successful financiers are pioneers of algorithmic trading.

The nexus of contracts: Excessive emphasis on the transactional nature of business relationships we have undermined not only the relationship between business and society but also the effectiveness of business, even in transactional terms.

THE MECHANICAL FIRM: Social aspects of work, including both relationships within the workplace and those between business and society at large, are crucial to both personal productivity and personal fulfilment.

THE RISE OF MANUFACTURING: The mechanical model of the firm was inspired by, and influenced the development of, manufacturing industry from the dawn of the Industrial Revolution to the mid-twentieth century. And even if, as I shall explain, the relevance of that model to the twenty-first-century corporation is much diminished, its legacy remains influential.

LABOUR FIGHTS BACK: The growth of trade unions gave labour more power to demand better wages and conditions, and the extension of the franchise gave political power to working-class voters.

THE RISE OF THE CORPORATION

Corporation: An ingenious device for obtaining profit without individual responsibility. Ambrose Bierce, The Devil's Dictionary, 1911.

NEW CENTURY, NEW BUSINESSES: As mass manufacturing grew in significance, many goods could be traded across borders, and globalisation led to international competition in tradable commodities such as steel, oil and consumer goods.

CHANGING FORTUNES: “All fortune is good fortune; for it either rewards, disciplines, amends or punishes, and so is either useful or just.” Boethius, The Consolation of Philosophy, written in 524, while in jail awaiting execution.

The Fortune 500 now: The leading corporations of the twenty first century is perhaps found by asking which companies have the largest profits and stock market value. As I write, there are six trillion-dollar companies - Alphabet (Google), Amazon, Apple, Nvidia, Meta (Facebook) and Microsoft.

Those who are lucky enough to possess rare talents or occupy positions of authority sometimes feel embarrassed by earning more than those who work to satisfy more basic elements in the hierarchy of needs.

The Industrial Revolution was built on the substitution of mechanical work for human - or animal - labour.

This is largely a gender issue: when you ask for examples of 'real jobs', they will usually be functions that have traditionally been undertaken by men. Mining and metalworking are real jobs; cooking and caring, however skilled or arduous.

In the modern economy, value comes not from building something bigger or heavier but from creating something smarter.

Economic growth is low-cost air travel and the immediate arrival of an Uber. Economic growth is promoted by ideas that seem banal and obvious once invented but which make our lives easier. Modern economic growth is about building collective intelligence into familiar resources to create new products and still more advanced capabilities.

THE SECRET OF OUR SUCCESS: Successful businesses find new or distine-tive combinations of capabilities to offer new or distinctive products, creating an output more valuable than the same resources could produce in alternative uses.

BETTER AT EVERYTHING: The accumulation of collective knowledge and the development of collective intelligence have made humans better at - almost everything.

VALUE: “What is a cynic? A man who knows the price of everything and the value of nothing.” Oscar Wilde, 1892

The rationale of economic organisation is that it adds value.

A subjective definition of value focused instead on the utility of the output. From this perspective, value was found in the mind of the consumer rather than originating in the effort of the producer. This led Adam Smith to the diamond-water paradox: why are diamonds, which only look pretty, much more expensive than water, which sustains life?

Markets: Willingness to pay is the combined product of need or want and ability to pay.

Economic rent in organisations: All productive activity is directed to adding value through organising resources in such a way that they are more valuable than they would be in an alternative configuration. That is what we mean by productive activity. And thus successful organisations create economic rents.

At the margin of cultivation, yields barely compensate the costs of agriculture.

MONEY CAN'T BUY YOU LOVE: The 1960s was an era of social and political turbulence.But it is not only the future that is subject to radical uncertainty.

Information about the present is also imperfect - and unevenly distributed. Knowledge and problem-solving capabilities that are necessary to achieve the objectives of the firm will be found among its employees, customers and suppliers.

THE MYTH OF OWNERSHIP: "You are undone if you once forget that the fruits of the earth belong to us all, and the earth itself to nobody." Jean-Jacques Rousseau, Discourse on the Origin of Inequality, 1761.

Friedman's answer was clear - the objective of the organisation is to maximise its profits.

How can the principals (the shareholders) induce the agents (the executives) 'to conduct the business in accordance with their desires'?

Different cultures and different legal systems are likely to view these issues differently - and they do.

"Shareholder value is a result, not a strategy ... Your main constituencies are your employees, your customers and your products." Jack Welch, CEO, General Electric, 1981-200I.

"I'd be a bum on the street with a tin cup if the markets were always efficient." Warren Buffett, 2013.

"I do it to do it. Deals are my art form." Donald Trump, The Art of the Deal, 1987

Mergers and acquisitions had once been a friendly business.

This description of private equity presents a puzzle. If the tactic of loading companies up with debt which often results in them failing is so destructive, shouldn't investors recognise this and charge a higher price for making those loans? The limited evidence available suggests they don't: junk bonds sponsored by private equity firms have tended to underperform relative to similar bonds.

Dare to be great: The commercial success of Trump's ghostwritten autobiography - the book topped The New York Times best-seller list for three months - suggests that dealmaking skills, real or claimed, are more widely admired than the political and administrative abilities required to manage large organisations.

A central skill of investment bankers is the ability to cultivate and maintain a contact list that ensures that they will be called on when the transaction is envisaged.

The economic impact of M&A: Systematic evaluation of merger performance is not easy.

A better approach looks at the effects of the transaction on the output and costs of the combined business over a longer period.

THE FALL OF THE ICONS: “When people say I changed the culture of Boeing, that was the intent, so it's run like a business rather than a great engineering firm. It is a great engineering firm, but people invest in a company because they want to make money.” Harry Stonecipher, CEO of Boeing, 2004

“I would rather see finance less proud and industry more content.” Winston Churchill (1925)

A report on the HBOS failure by the regulators the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) took the view that the board lacked non-executives with sufficient experience and knowledge of banking, particularly corporate banking'* While this may have been true, I believe it is also important to have non-ex-ecutives with little experience and knowledge of an industry who can offer challenge to the conventional wisdom of those who have spent their working lives in it. Diversity of thought and perspective is necessary, and not the same as the appointment of 'diverse persons'.

“I know I'm not alone in missing the hum of activity, the energy, creativity and collaboration of our in-person meetings and the sense of community we've all built ...”

“For all that we've been able to achieve while many of us have been separated, the truth is that there has been something essential missing from this past year: each other.” Tim Cook, CEO of Apple, email to employees, 27 May 2021.

Entrepreneurship: The modern firm is a community, rather than an office or a factory. It is defined not by its plant and machinery but by its capabilities. The successful business is characterised by the distinctive nature of its collection of capabilities and the match between these capabilities and the needs of its customers - and other stakeholders.

“If you want to hire great people and have them stay, you have to be run by ideas, not hierarchy. The best ideas have to win.” Steve Jobs, 2010

The bureaucratic hierarchy / Hierarchy requires chains of authority, responsibility and accountability.

Accountability is the process by which the consequences of decisions including the decision to delegate authority are evaluated.

The most common device for diluting or deflecting responsibility is the meeting - better still, the committee. If many people are associated with a decision, then no one is really responsible for it. That is how bureaucracies come to waste resources while making bad decisions.

Mediating and ratifying hierarchies are the reality of most successful businesses, but it is easier for the lazy journalist to attribute such success to the all-seeing, all-knowing, CEO.

Yet the caricature is influential; we should not underestimate the importance of the ways business is described for the practice of business, and the importance of both description and practice for the legitimacy of commercial activity in the broader community.

“Lawyers who will prepare sixty-page contracts for their clients (because they know that businessmen can't be trusted) will organize their own office on a scribbled piece of notepaper that may not even be signed by anybody because they know they can trust their partners.” Ian Macneil, 1973-4.

Honesty is a character trait, not a policy. Selfishness of motive, narrowness of objective and instrumentality of behaviour are corrosive of collaborative and cooperative activities such as parenthood or education or scientific research.

Michael Jensen: The application of cost-benefit analysis to one's integrity guarantees you will not be a trustworthy person (thereby reducing the workability of relationships); and, with the exception of some minor qualifications, also ensures that you will not be a person of integrity (thereby reducing the workability of your life). Your performance, therefore, will suffer.

Religion and the rise of capitalism: The link to religious tradition is significant. Trust is markedly higher in societies with predominantly Judaeo-Christian traditions than in countries that are predominantly Buddhist, Hindu or Muslim. The Protestant religion seems to have been particularly favourable to the development of commerce and business.

Many legal forms appear to be consistent with economic efficiency. The skill of businesspeople is to find arrangements that work, and the best of these people are those who succeed in this pragmatic activity. The mechanisms to implement these arrangements are the product of history and the social and political context in which they operate.

Franchising and platforms: Common branding helps with marketing and gives the collective franchise far more bargaining power with suppliers than any individual franchisee could enjoy.

CAPITAL IN THE TWENTY-FIRST CENTURY: The word 'capital' is used in many different senses. Capital is a factor of production for the twenty-first-century corporation; much of it takes the form of plant and machinery, offices and warehouses bought from specialist suppliers. The term 'capital' is also used to describe the value of the net assets, tangible and financial, actually owned by the firm itself. In the early Industrial Revolution these measures were often similar but no longer are.

And the term 'capital' is also often used with reference to personal or national wealth, tangible and financial. This conflation also dates from an era of much simpler economic and social organisation.

Finally, in the twentieth century several new usages of 'capital' - such as human, social and natural capital - have been created. The word capital is indispensable but should be used certainly more carefully and perhaps more sparingly. And if the meaning of 'capital' is ambiguous, who should we identify as the 'capitalists' of the twenty-first century?

Capitalism without capital: As I write, Amazon is valued on the stock market at over $2,000 billion. The assets on its balance sheet totalled $464 billion? But that figure repays closer inspection. The business of Amazon requires large warehouses, vehicles and stocks of goods. But Amazon owns few of these things. Its property assets are largely rented from real estate investors, and most of its mechanical assets are leased from financial institutions.

This analysis may be difficult and disturbing to people unfamiliar with accounts.

Capital and wealth: In his widely cited Capital in the Twenty-First Century Thomas Piketty acknowledges the different uses of the term 'capital'? However, he continues, 'To simplify the text, I use the words "capital" and "wealth" interchangeably, as though they were perfectly synonymous.

Both land and location are factors of production, and most of the value of land today is derived from its location rather than its fertility.

Conversely, government debt and bank deposits are key components of personal and institutional wealth but are not factors of production.

Measuring the value of capital as a factor of production: The value of capital as a factor of production - as distinct from capital as wealth - is usually measured by aggregating what has been spent to create it.

WHO ARE THE CAPITALISTS NOW?

Business founders: Bezos, Gates or Musk. These modern business people own financial assets - stock in the businesses they helped create. Unlike their predecessors, they do not own tangible productive assets, such as steelworks, oil wells and pipelines, and no longer do the companies own them; these titans of twenty-first-century business control only their companies.

Leading executives in large corporations. The skills of the successful professional manager are different from the inspiration of the founder.

Venture capital and private equity: Other financiers focus on more specialist roles. Examples include leaders of venture capital partnerships such as John Doerr of Kleiner Perkins and Michael Moritz of Sequoia Capital. Venture capital firms are providers of finance to early-stage businesses, generally to cover the operating losses most will incur in their activities. These investors hope to profit from an IPO or a trade sale of the business to an established corporate purchaser.

Specialist providers of capital as a service. Examples: Prologis and AerCap, Evereocen and Triton - firms that supply the capital services that constitute the means of production in modern business. Their funds are, directly orindi: rectly, mostly derived from the retirement and other savings of small investors and loans from conventional banks.

Leading executives of international economic organisations. Examples: Christine Lagarde (president, European Central Bank).

Influencers: These rich men have attempted to parlay their wealth into political influence.

Asset managers. Examples: Blackrock, Fidelity, Vanguard. Blackrock is the largest such business and manages assets of under just sIo trillion.' This total includes investments in almost every listed company in the world through its passive funds, which attempt to replicate the performance of the widely publicised equity indices, such as the S&P 500. These asset managers also offer active management, involving the purchase and sale of individual stocks and also, but secondarily, engage in the provision of funds to early-stage companies that are not traded on any stock exchange.

All capitalists now?

AerCap and Prologis, major owners of the modern means of production, are nevertheless rather unimportant intermediaries in the modern economy. Both corporations are listed on the New York Stock Exchange (NYSE). The largest holders of Prol-ogis stock are Blackrock, State Street and Vanguard. These asset managers are the largest providers of passive funds, which replicate a stock market index and therefore simply hold the same proportion of all listed shares in them. But most of the funding of these capital service providers comes not from equity but through loans from other financial institutions: banks, insurance companies and pension funds.

IN SEARCH OF CAPITAL: "People are the most important asset in the company." Mary Barra, CEO General Motors, 2018.

The anxiety of many people to call attention to something they think is important - education, trust, the environment by describing it as 'capital' is a tribute to the impact Marxist rhetoric continues to make on those who would run from any suggestion of Marxist association.

AMBIGUITY IS A FEATURE, NOT A BUG: And it was the collective knowledge and collective intelligence which arose then that made the Industrial Revolution possible. The economies and societies that emerged from the scientific revolution advanced through disciplined pluralism.

Pluralism is the freedom to try new ideas or new ways of doing old things or promoting new products. A society with freedom of speech and a vibrant research community enjoys a surfeit of claims to new knowledge. Likewise, a competitive business environment stimulates the adoption of new business processes and the offer of new goods and services.

Flourishing: The proper goal of corporate activity is the flourishing of the multiple stakeholders of the corporation: employees, investors, suppliers and custom-ers, the communities in which it operates and the corporation itself. For the corporation to flourish, it must contribute to the flourishing of the society in which it operates. And 'the doctrine of the mean' is as relevant to the business organisation as it is to the individual. The directors and executives of a flourishing company operate within a mediating hierarchy, which meets the needs of all its stakeholders, gives them an opportunity for voice and protects the business from the adverse consequences of stakeholder exit.

AFTER CAPITALISM. Marx died in 1883.

In the business environment that followed the Industrial Revolution, production resulted from the combination of physical capital and physical labour. The distribution of income was the outcome of a class struggle between the providers of these two factors of production, between the owners of capital and the suppliers of labour.

Until the end of the twentieth century political parties were defined by the economic interest - capital or labour - that they represented.

The modern business is defined by its combination of capabilities, not its production function. The success of twen-ty-first-century firms is derived almost entirely from the diverse capabilities of the people who work in them. The workers are the means of production.

It is impossible to construct a theory of the firm without insights from organisational theory, psychology, anthropology and other social sciences.

The focus on the firm as a collection of capabilities gives a different and more illuminating perspective for understanding the extraordinary diversity of business organ-isations and of business people over geographies and over time.

'The pain of parting is nothing to the joy of meeting again.' Charles Dickens.