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Did Berle and Means get it wrong? Reflections on Thorstein Veblen, Paul Samuelson, and 'Corporate Strategy Financialized'

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ABSTRACT

This article has two main aims. One is to reconcile Berle and Means' conclusions in 1932 about management control in large US corporations with the earlier views of Thorstein Veblen, who from much the same starting point reached a seemingly contrary position. The explanation offered in terms of changes in financial control puts many subsequent developments in a different light. The other aim, drawing on the views of Paul Samuelson about product market competition, is to question the precise contribution of the 'financialization of corporate strategy' to the institution of 'the era of shareholder value'.

1. The problem

An important contribution of the article by Andersson, Haslam, Lee, Katechos and Tsitsianis (in this issue) is in reminding us that there was a substantive literature examining governance issues in the large corporation and the nature of financial performance in the early years of the 20th century, stemming especially from the writings of Veblen (1904, 1923). In 1904, Veblen made the observation that 'the management is separated from the ownership or property, more and more widely as the size of corporation finance widens' (p. 157). He also identified the conflict of interest between managers and stockholders and others that was later to form the basis of principal–agent theory, nowadays associated with first Berle and Means and then Jensen and Meckling. The classic agency theory problem was posed by Berle and Means (1932), and then formally developed and extended by Jensen and Meckling (1976) in terms of the 'positive theory of agency' (Clarke & McGuinness, 1987; Cohen & Boyd, 2000; Williamson, 1996). The aim of this paper is to put the views of Veblen in the context of the later literature, and in this way offer some different perspectives on the issues under consideration.

2. Three stages in the principal–agent gap literature

In broad terms, the literature on the 'principal–agent gap' has proceeded in three stages. First, there was the study by Berle and Means (1932) documenting the importance of the large corporation and the implications for ownership and control. As Table 1 shows, a steady (if unremarkable) growth of the relative share of manufacturing output of the largest corporations has been a feature of the United States, Britain and France since 1909, although apparently occurring earlier in the United States than in the other two countries. However, from a shareholder's viewpoint it is not the size of the corporation itself that presents special difficulties, but rather the nature of the shareholding, in particular its dispersed nature (Ricketts, 1987).

In this respect, Berle and Means drew attention to four significant features of the 'modern corporation.' First, no one person owns a substantial fraction of the shares of any one corporation. Second, the assets of large corporations are increasingly

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Table 1
Net share of manufacturing output of the top hundred firms: United States, Britain, France, 1909/12 – 1962/3.

	1909	1929	1935	1963
United States	22%	25%	26%	33%
Britain	16%	26%**	23%	38%
France	12%*	16%	–	26%***

Source: Schmitz (1993) drawn from Prais (1976), 4, 213; Hannah (1983), 180; Daviet, in Pohl (1988), 73.
* 1912
** 1930
*** 1962

under the control of small self-perpetuating groups of professional managers with small personal ownership of the assets they control. Third, the constraints placed upon managerial behaviour by the capital market are increasingly ineffective because of the change in the financial policies of the firms in which most capital requirements are internally generated. Fourth, the interests of management will often diverge from those of shareholders at large. There is in these four ways a separation between ownership and control. For 1929–1930, Berle and Means found 44% of the 200 largest non-financial companies by number, and 58% by wealth, to be subject to management control. In 1962, Berle stated that '30 years have markedly accentuated this separation' (Berle, 1962, p. 437).

Second, the next stage was the development of principal–agent analysis, either in terms of 'the positive theory of agency' (Jensen & Meckling, 1976) or 'the principal–agent theory' (Ross, 1973). Within the principal–agent framework, the firm's shareholders can be seen, collectively, as the principal delegating actions to the manager as agent (Clarke & McGuinness, 1987). This conception does leave the position of the directors in limbo, since the legal framework under which most companies operate provides for a strict two sequence line of delegation running from shareholders to directors to management (Lewis, 2002). In this sense, strictly speaking, there is a double agency problem. Nevertheless, the two agency theory approaches share the objective of developing a theory of how contracts can be designed such that self-interested individuals act in the best interests of the party (whether it be shareholders or the board of directors) designing the contract.

In effect, there are two main solutions to the management control problem. Shareholders can threaten to remove management and replace them with others who will act more in their interest. However, as Knauth (1948) argued, 'Management must fail obviously and even ignominiously before the dispersed forces of criticism become mobilised for action' (p. 45). Alternatively, shareholders (via directors) can design a remuneration package that attenuates management's incentives to move in different directions from those that are in shareholders' interests (Clarke & McGuinness, 1987).

Third, the next stage in closing the principal–agent gap has taken the form of 'the era of shareholder value' and the 'financialization of strategy' (which constitutes the backdrop to the Andersson, Haslam, Lee, Katechos and Tsitsianis article), that has served better to align the interests of managers and shareholders. Essentially, the legal requirement that shareholders must look to directors to protect their interests has been replaced or supplemented by one in which shareholders delegate the management of their wealth to institutional investors.

Institutional investors, in turn, enforce shareholder value through at least three mechanisms. First, the previously dispersed individual shareholdings become concentrated in the hands of large institutions (pension funds, insurance companies) able to exert pressure on corporate management. Second, many small funds (and wealthy individuals) themselves delegate investment to professional fund managers (investment banks, specialized investment managers) who are under pressure to perform and transfer that urgency to investee companies. Third, an industry has developed that ranks firms financially in terms of measures such as EVA (Economic Value Added) and MVA (Market Value Added) designed to ensure that management deliver to shareholders, either in price increases or in dividends, a competitive return that reflects not just profits but the benchmark cost of capital (Lewis, 2003).

3. Questions posed by Veblen's analysis

In this author's view, this three stage interpretation of the development of thinking about the divorce between ownership and control and the principal–agent gap and its resolution is in itself unexceptional and broadly corresponds to the views reflected in Andersson, Haslam, Lee, Katechos and Tsitianis along with others. However, the discovery (or rediscovery) of the ideas expressed by Veblen raises questions about how we are to relate Veblen's views to the interpretation given above.

Consider again the following quotations:

> '. . .the rate of profits or earnings on investment has in the nineteenth century come to take the central and dominant place in the economic system. Capitalization, credit extensions, and even the productiveness and legitimacy of any given employment of labor, are referred to the rate of earnings as their final test and substantial ground. (Thorstein Veblen, 1904, p. 47)

> The primary goal of the corporate managers of such companies was to maximize the value of their common stock. Veblen put corporation finance as the centerpiece of his analysis of large, acquisition-minded companies. In Veblen's analysis, the corporate finance structure was capitalized on the earnings capacity of the corporation as a going concern (cited in Ganley, 2004).