Lecture VI: The Modern Corporation

Financial Capitalism

I use the word "corporation" in the title of this lecture to describe what the financial sector of the U.S. economy has become, not what it was for much of its history. Until the Great Depression of the 1930s and, in many cases, until the Great Recession of 2007-2009, finance remained the domain of private companies (no shareholders or only a very restricted number) and partnerships. Banks, investment banks, stock brokerages, and other financial services providers are classic examples of companies that provide "services" and have very little "fixed investment." Even today, a bright young person with an MBA and the right connections can establish himself as a "financial advisor," or "money manager" and create a profitable business managing other people's money.

Historically, the rapid growth of the American economy during the 19th and early 20th centuries made high demands on the available capital. British capitalists, looking for good investments, made up some of the shortfall, but, in general, in a financial system based on the Gold Standard, money was relatively expensive and those hoping to form a new company had to turn to financiers like Morgan or Gould to obtain the necessary capital. Today, by contrast, the American economy has more money to invest than it has good investment opportunities. Thus, almost any kind of "start up" can attract investors looking to strike it rich. As a result, big financiers like Morgan and Gould are no longer as necessary for the functioning and growth of the American economy. Or, more correctly, there are so many would-be Morgans and Goulds that those seeking to start a business do not have to look far for venture capital.

Another difference between today and the fast-growth era of the American economy is that the Federal Government has become a major source of investment capital. The Defense Department budget alone funds more investment in manufacturing and research than any other single source, private or public. We have seen how canals, railroads, and other major infrastructure investments benefitted from generous government subsidies, including loans, grants, and large cessions of public lands. Clearly public investment has played a key role in America's economic growth.

The low inflation and low interest rate atmosphere of today's American economy is traceable largely to this very lack of good investment opportunities and the ready availability of both private and public investment funds. This, in turn, is attributable to the mature nature of the American economy and of many of the country's manufacturing and service businesses. Like individuals, companies grow most rapidly in their initial few years. Corporations that enjoyed rapid profit growth and rapidly increasing stock prices will eventually slow down and will require creative management decisions to maintain a steady rate of growth. New business opportunities need to be found and money-saving and profit enhancing innovations need to be pursued. Without creative management, and also some good luck, even the most respected corporations are likely to perish after fifty or sixty years of prosperous operations: e.g., Sears, Roebuck or, now, General Electric.

The low interest rates of the past few decades have also encouraged government borrowing during economic downturns and this borrowed money has often been used to support so-called "Zombie firms," defined as companies whose debt payment obligations have exceeded their income for three years running and that have no prospect of ever being profitable. As long as they are able to obtain new loans, they continue to stagger forward. Corporate debt in the U.S. now exceeds $20 trillion, by far the highest it has ever been. Current estimates are that almost 20 per cent of American companies fall into the "zombie" category. In a more perfect world, Schumpeter's "creative destruction" would be weeding out these "zombies," but instead they continue to limp along with large infusions of public and private money. Some economists point out that this tendency to keep non-performing firms alive (in order to maintain employment and protect creditors from destabilizing losses) means that younger, more innovative

companies find it difficult to obtain financing. It is not clear to me that keeping zombies alive (sort of) means short-changing other, more productive investments (which, as I point out, are not as numerous as one might think). The downside is more likely to be rewarding mismanagement and corporate "socialism" in which wealthy investors are protected from losses. By making investment almost risk free, government support and easy bankruptcy terms open the door to massive misallocations of capital. Big corporations like Boeing, Delta, Macy's, and Exxon have borrowed so much money that they are unable to meet interest payments on their debt and must seek additional financing just to stay in business. Hundreds of other firms, large and small, fall into the same category. This is a relatively recent phenomenon for the American economy, although both the Japanese and Chinese governments have long subsidized non-performing businesses and industries in order to prevent large scale unemployment and loss of market share to more competitive foreign firms.

The current pandemic has also had a terrible impact on large parts of the U.S. corporate world. A small item in the February 26 issue of the *Washington Post* notes:

> The Federal Reserve and other bank regulators are flashing a new warning sign for the U.S. economy: Businesses ravaged by covid-19 are sitting on $1 trillion of debt, and a high percentage of the economy is at risk of going bust. Watchdogs flagged 29.2 percent of complex corporate lending as troubled in 2020, up from 13.5 percent in 2019 . . . Real estate, entertainment, transportation, oil and gas, and retail were cited as particular problem areas.

A related fact of what might be called "late corporate syndrome" comes when a successful manufacturing company or retailer reaches a certain point in its life and finds that the profits from its core business, its original reason for being, so to speak, can be most profitably invested in financial instruments of one sort or another. GMC may be said to have pioneered this idea when it created the General Motors Acceptance Corporation in the 1920s. This helped GM to sell cars on credit, but it also produced growing profits from the loans issued to buyers. This tendency to seek profits from loaning money is best exemplified today by the burgeoning credit card industry, in which companies partner with banks to offer customers high interest credit card loans. The industry argues that the loans are risky because they are "unsecured," i.e., there is no house or car that can be repossessed in the event of default. Still, the credit card business is highly profitable for the banks and the businesses that issue them, since in addition to the high interest rates on unpaid balances (usually 15 to 25 per cent), the issuers charge the business a one to three per cent service charge whenever the card is used. Major banks like Chase or Citi reap huge profits on the cards, which may explain why your mailbox is full of card offers.

Even as far back as the late 1920s, many major American corporations – such as Bethlehem Steel, Samuel Insull's Electric Bond and Share, and Standard Oil – loaned stock brokerages large sums of money which they in turn loaned to their customers at a higher rate of interest so that they could by stock "on margin" with the intention of reselling it at a higher price, paying off the loan and pocketing the difference. As explained by Sobel in his history of the New York Stock Exchange:

> Why invest in new plants, the corporations reasoned, if the return to be gained by entering the call money market (i.e., margin loans) was so much safer? A new plant might, at best, produce a return of 10 per cent per annum, while in 1929, call money brought what seemed to be a sure 15-20 per cent. (Sobel, p. 257)

In more recent years, other manufacturers have invested profits in high interest "junk bonds" (Westinghouse in the 1980s), providing "revolving credit accounts" (Sears and other retailers have always found such high-interest accounts profitable), and, most tellingly, General Electric's decision under Jack Welch in the 1980s and 1990s to create GE Capital to loan out the big profits it was making in its core businesses of power generation and jet engines. Such financial businesses have the virtue of being largely immune to foreign competition (unlike most manufacturing sectors) and employing relatively few, non-union personnel. GE could perhaps have developed a line of batteries for use in electric cars and trucks, or gone big on wind power and solar electric generation equipment (it did eventually get into the wind

power equipment business), but this would mean going head-to-head with foreign competitors and employing thousands of highly paid engineers and skilled workers with no assurance of a good return on the investment. The decision to go into financial instruments, to become, in essence, a bank as well as a manufacturing corporation, is what I would characterize as a "lazy call." No entrepreneurial effort is involved. No inventiveness, no new products, no messy building of factories or decisions on what to make oneself and what to outsource. All of these are decisions that every "start up" has to make, but established firms prefer to avoid such risky steps, preferring instead to "bank" their earnings and live on interest payments. In GE's case, it worked – for a while – but then came the Great Recession of 2008 and GE Capital became a terrible drain on the company as its portfolio of mortgage backed securities and other financial instruments became incredible liabilities. It is also true that – like today -- in the late 1920s, a Republican-led Administration cut taxes on corporations, leaving them with even more profits than they would otherwise have had, and instead of investing the money in new productive capacity – creating "good paying" jobs as the mantra goes – they loaned it out for stock speculation. This is no longer legal (since the 1930s), but companies do use windfall profits from lower taxes to buy back their own stock, raising the stock's price and thereby enriching the stockholders, many of whom are top corporate managers.

Moral Hazard and "Too Big to Fail"

Government bail-outs have become a standard feature of the response to economic crises, especially the 2007-2009 Great Recession and the current pandemic rescue for struggling businesses. Even before these most recent government interventions to avert collapse of major industrial or financial corporations, we had a federally-financed bailout for the Chrysler Corporation in the 1980s and a rescue operation for a big hedge fund, Long Term Capital Management in the 1990s, which could have precipitated a larger panic on Wall Street. The Chrysler bailout (and similar government-assisted restructurings during the Great Recession) aimed to preserve a major employer in the auto industry. The Long Term Capital operation, however, highlighted the need at times to save a struggling business whose crash might bring down many other businesses and investors. This latter instance of a government bailout most clearly epitomizes the terms "moral hazard" and "too big to fail." Hedge funds gambling on capital movements, and using "other peoples' money" to do so, have become a key element in the modern business system. The belief that super smart money managers could find ways to make big profits without running the risk of large losses came to pervade a large part of the financial community. To further cover possible losses, insurance giant AIG sold hedge funds insurance to cover their bets. When in 2008 the funds found themselves losing huge amounts on various investments (most tied to the sub-prime mortgage market), AIG was supposed to step in and cover their losses. Of course the losses far exceeded AIG's ability to pay the claims and only nationalization of the company and the government assuming liability for its losses saved the country from a far worse financial crash.

Corporate Stock Buy Backs versus Paying Dividends

Another corporate financial practice of recent years is the proliferation of the "stock buy-back" as a way to increase share prices and reward stockholders. Instead of investing in growing a business, corporations increasingly take profits and use them to bolster their stock market standing, rewarding both shareholders and management, with many of the latter being among the largest individual shareholders. There is nothing inherently wrong with this practice. All of the major tech companies as well as other less profitable businesses have engaged in it. Still, one must wonder why, instead of increasing dividends, management chooses to reduce the number of outstanding shares as a way of raising share prices.

The decline in dividend payments since the 1990s has been quite striking. An on-line article in *Investopedia* by Sean Ross (May 5, 2020) noted:

During the 90 years between 1871 and 1960, the S&P 500 annual dividend yield (how much a company pays out each year relative to its stock price) never fell below 3%. In fact, annual dividends reached above 5% during 45 separate years over the period. Of the 30 years after 1960, only five saw yields below 3%. The sharp change in S&P 500 dividend yield traces back to the early to mid-1990s. For example, the average dividend yield between 1970 and 1990 was 4.03%. It declined to 1.90% between 1991 and 2007. After a brief climb to 3.11% during the peak of the Great Recession of 2008, the annual S&P 500 dividend yield averaged just 1.97% between 2009 and 2019.

Ross attributes much of the decline in dividends to decisions under Federal Reserve Chairman Alan Greenspan to lower interest rates in response to market downturns in 1987 and 1991 and again in 2009 under Greenspan's successor Ben Bernanke. The lower rates buoyed the stock market by driving investors with "cheap money" into equities, causing stock price increases that greatly outpaced corporate decisions to increase dividends. The second factor has been the great increase in the number of technology companies in the 500 Index. These new companies have eschewed dividend payments, retaining profits either for investment purposes or to use in stock buy-backs. Money that used to go to shareholders as dividends, in other words, helps to increase the company's stock price. If the shareholder wishes to reap some of these gains, he must sell some of the stock rather than await the arrival of a dividend check.

The Organization Man and the Cult of the CEO

During the 1950s sociologists and economists wrote numerous studies about America's rapidly expanding class of "white collar" employees. In fact, C. Wright Mills entitled his book *White Collar: The American Middle Classes* (1951). The other major work on the new corporate bureaucrats was *The Organization Man* (1956) by William H. Whyte, a sociologist and journalist who was commissioned by *Fortune* magazine to interview and analyze the "middle managers" at some of America's largest corporations. The 1950s is remembered by those of us who lived through that decade as an era of conformity, where group-think replaced individualism and everyone sought to "fit in." How much of this mentality was traceable to the preeminence of large corporations during these years is hard to say, but, in general, Americans did not question authority and seemed motivated by a desire to improve their material condition – new homes, new cars, new appliances of all sorts – and unconcerned or even repelled by idealistic notions of social justice and questions about "the meaning of life." Corporate America both helped create and then catered to this mentality, but, as the 1960s were to show, there was an undercurrent of unrest among Blacks and a significant portion of the younger generation that threatened to upset this cheerful world of "Leave it to Beaver," and "Father Knows Best."

Many of the traits attributed to the 1950s "organization man" were already apparent during the 1920s, when "scientific management" first took hold of the corporate world. The most famous example from that era would be Alfred P. Sloan, CEO of General Motors from 1937 to 1956, and before that president of the company from the mid-1920s. An engineer by training (MIT, 1895), Sloan sought to organize GMC into a well-oiled machine that produced cars, but was primarily concerned with producing profits. His rather bloodless persona created problems for him in his relations with the auto workers' union and with the public generally. Still, his name is attached to one of the first management training programs in America, the Sloan School at MIT, and he was a noted philanthropist in his later years (the Sloan-Kettering Cancer Center in New York, among others). Sloan's career marks the transition from corporate founders such as Carnegie and Ford, to the administrators who took over their creations and sought to turn them into smooth-running organizations that consistently produced big profits and expanding market share. Sloan identified the need for a credit unit at GMC as early as 1919, creating the General Motors Acceptance Corporation to enable customers to buy their GM vehicles on the installment plan. Henry Ford persisted in thinking customers should pay cash for a Ford car until later in the 1920s, thereby losing market share to GM, which came to dominate the American automobile industry until the arrival of cheaper imported cars in the 1970s.

Another 20th century figure who personified the "cult of the businessman" was David Sarnoff, whose three decade tenure as head of RCA and its affiliated National Broadcasting Company made him one of America's most influential executives from the 1920s to the 1950s. Unlike Sloan, Sarnoff came from an immigrant Jewish family, arriving in the United States in 1900 at the age of nine and working his way up the corporate ladder. He early-on identified radio as a major commercial opportunity and moved to sew up the RCA/NBC quasi-monopoly of broadcasting in the 1920s and early 1930s. He also effectively stymied efforts by competitors to develop the new technology of television until RCA had perfected its own system for filming and broadcasting images. As with many pioneers in the electronics industry, Sarnoff recognized that controlling patent rights and fending off competing claims to ownership of key inventions were crucial to success in this rapidly evolving high-tech business.

A more pertinent example of modern corporate management would be General Electric CEO Jack Welch, who ran this mighty conglomerate for twenty years from the 1980s until the early 2000s. Trained as a chemical engineer at the University of Illinois, Welch joined GE right out of graduate school in 1960 and remained with it until his retirement in 2001. GE was a company that had a reputation for training effective managers, hiring college graduates in the 1950s and grooming them to run the highly-decentralized business according to overall principles of scientific management. Welch famously shook-up this "organization man" enterprise immediately after taking over as CEO in 1981. He decreed that annual personnel evaluations of mid-level managers would identify the lowest ten percent of performers and force them out. Of course there was nothing terribly revolutionary about this practice: the U.S. military and the State Department's Foreign Service have long maintained a similar "up or out" system of personnel evaluation. Still, the "10 percent rule" could result in some quite arbitrary personnel decisions and brought an atmosphere of fear into an organization that seemed to be operating perfectly well without it. Welch also moved GE into the financial business with the creation of the already-mentioned GE Capital. While profits at GE and the company's stock price greatly increased during Welch's tenure, the company's downward spiral since the Great Recession has wiped out most of the gains and raised questions about the wisdom of Welch's "short-term thinking." It may also be true that no amount of management acrobatics could truly revitalize an old-line manufacturing company facing competition from German, Japanese, Korean, and, now, Chinese businesses.

Corporate Executive Remuneration

In recent years, income inequality has become a major subject of interest for economists and social commentators. We often see charts showing how much more the CEO makes than the average worker at a large company. Whereas in the 1950s, the top salary might have been 20 or 30 times greater than the average salary, we now see compensation – salary, bonus, stock options, etc. – running two or three hundred times greater for the CEO than for the average worker at the company. These numbers are startling, to be sure, but the compensation committee of the board of directors seems convinced that in order to get top-flight executives to manage the business, they must pay competitive salaries. This leads to a race to the top, with top management salaries rivaling those of highly paid professional athletes or movie stars. The iconoclastic economist and social critic Thorsten Veblen would have recognized this phenomenon as a form of "conspicuous consumption," although in this case it might better be termed, "conspicuous accumulation." Corporate executives and other billionaires and multimillionaires face the need to compete for social status by accumulating huge fortunes while performing their executive duties. Beyond any satisfaction they may gain from managing the company well, they can pride themselves on gaining vast wealth due to their position at the top. Even if they should happen to fail to measure up, and the board of directors requests their resignation, they can be sure of receiving an outsize payment in recognition of their services. This corporate munificence has become over the years an accepted practice, but it does raise the question: Does it make sense to pay executives such huge salaries, even when the results for the company are only mediocre?

To justify their large compensation packages, top management tends to focus on the short-term. They need to show the board and the stockholders that they can bring a big increase in profits and share price in a short period of time, regardless of possible long-term harm to the business. The old idea of "stewardship" is absent in this sort of corporate leadership atmosphere. On the other hand, perhaps a company like General Electric would have seen its share price and profits steadily decline regardless of who the CEO had been. Like many other old industrial companies, GE diversified into finance and health care, including a long-term care insurance company that portends huge uncovered liabilities. These issues have weighed down the old giant and it is currently spinning, with divestitures and acquisitions taking place on an almost daily basis. Welch, it should be noted, left GE after his forty years with the company with a retirement package that included over $400 million in cash and stock, access to a company plane and chauffeur-driven care and a slew of other perks. His successor, Jeffrey Immelt, left the company in 2017 after overseeing a decline in the company's stock price of 30 per cent during his tenure at a time when the S & P Index increased 135 per cent in value. His departure package was considerably less generous than that for Welch.

Of course, nothing compares to the enormous wealth of the new tech company titans. But then these are not just CEOs; they are actual "founders." Vast amounts have been written about the skyrocketing tech firms like Apple, Google, Facebook, Tesla, and Microsoft, just to name the most prominent high-priced stocks, and, in each case, the company's founders and subsequent leaders are portrayed as management geniuses: Steve Jobs, Sergei Brin, Mark Zuckerberg, Elon Musk, and Bill Gates are the modern-day equivalents of Andrew Carnegie, Henry Ford, and David Sarnoff. Then there is Jeff Bezos of Amazon, whose vision of a company that produces nothing but distributes almost everything (and now offers on-line entertainment and "cloud computing" services) is testing the limits of what a corporation can be. How will these companies evolve in the coming years? They can't keep growing at the same rate, but how will they adjust to the constraints of employee unionization or government regulation. The old days of Pullman and Amoskeag strikes or government regulated monopolies like AT&T and RCA are unlikely to be repeated. But then, who knows?