# what's wrong with the american corporation?

*At the American Sociological Association meetings in August,* Contexts *sponsored a forum on recent trends in how corporations are run and for whom. The panelists were Frank Dobbin, Harvard University; Nicole Biggart, Dean of the Management School at the University of California at Davis; and Neil Fligstein, from the University of California at Berkeley—all prominent economic sociologists who have written about corporate governance. James Jasper moderated the panel and edited the following transcript, a small portion of the original discussion.*

**James Jasper:** This year's sociology convention is centered on the question, "What went wrong," especially why in the United States and the United Kingdom progress toward social justice seems to have stopped or at least stalled, and in many cases was reversed. The answer almost certainly involves American and multinational corporations, which got much of what they wanted: a world with freer and freer markets, with fewer constraints on their decisions and on their profits.

At the same time we've seen an explosion of corporate scandals in the last few years, especially in the United States but elsewhere as well. This suggests corporations may have gotten too much of what they wanted. So let's start by asking, Are corporations managed differently now than they were in the past? Has something changed in the last 20 or so years?

**Frank Dobbin:** One of the obvious changes is that corporations are managed under a new conception of control—known as shareholder value or core competence. Before, companies were managed for growth, with profits as a secondary goal. The means to expanding in size was acquisitions, especially acquisitions of firms in different industries. That's really come to an end. Now firms are much more fixated on managing their stock price, not on growing, and certainly not on growing through diversification. They are more interested in growing within industries.

One of the changes that allowed this was the relaxation of antitrust in the early 1980s under the Reagan Administration—antitrust never really came back, so that firms could now grow by merging with their competitors instead of having to grow by acquiring firms in other industries.

Another change has been the relaxation of hostile takeover laws. This has allowed hostile takeover firms to break up the conglomerates and sell off their parts. Let me just mention two big changes that have resulted from some of these shifts.

One, firms are more sensitive to stock price because CEOs are now compensated on the basis of stock price instead of on the basis of how big the firm is. You used to make $1 million a year if your firm had 1,000 employees and $2 million a year if your firm had 2,000 employees. Now, the size of the firm really doesn't matter; what matters is how well you can manipulate the stock price. … Boards weren't ousting CEOs for poor stock performance as of 1980; boards were looking at whether firms were growing, and if firms were growing, they didn't care that much about the stock price from quarter to quarter. In the late 1990s, if your stock price wasn't doing well, the board threw you out.

Another big consequence of this shift from diversification to core competence is that the top management team function has changed a lot. The chief financial officer has a new role. The CFO used to do some accounting; now the CFO's main job is to manage investor expectations. … As a consequence, the CFO has become much more important.

**Nicole Biggart:** You asked, "What has changed?" Frank just gave a good, long-term, economic-sociology, historical-sociology answer. I'm sitting here as a dean of a business school. So I've hardly read anything in four years, but I can tell you what business people are talking about. This is qualitative research over lunch.

But let me put this in context: my qualitative research arena is in Northern California, a very interesting part of the world economy. We're very multicultural, we're high tech, biotech, IT. It's a pretty lively place in which to observe corporations, because things morph pretty quickly.

For the people I have lunch with, there's a before AND after, namely 2002, when the Sarbanes Oxley Act was passed, transforming (at least officially) corporate governance practices in the United States. Everything shifted, at least as a public performance. This is a bill that has 11 titles to it, and they do lots of different things. It was a response to World Com, Enron, and corporate abuses in the go-go days of the 1990s, when people got sick of watching their holdings melt through the malfeasance of corporate executives.

Since then, the world has changed for the people I have lunch with. They actually talk about governance; I think ten years ago the only people who talked about governance were transaction-cost economists. But now everyone talks about it. They have conferences on board governance; you have to learn how to become a board member, you have to learn how to behave yourself and what that means. The way boards are structured has changed—how many outside directors, who can be on the auditing committee, who can't be on the auditing committee. These are real, formal changes, so you can answer that in the last few years things have changed a lot in those regards.

The SEC has more mandates for oversight. The big accounting firms used to also be consultants, and they can't do that anymore. So you have the split of these very large firms that were imbricated with these other large firms they were consulting for. One of the titles of Sarbanes Oxley, I think it's 404, requires details of how internal accounting takes place, internal controls. Do you know what you're reporting to shareholders is really true, and how do you know it's true? We have a lot of logical and epistemological questions that corporations now have to answer for themselves, and major firms like SAP have come up with all this software, so whole industries have come about. The auditing profession has also flourished; zillions of undergrads are going out into the world to become auditors. So, in those ways, corporations certainly have changed.

Is this all window dressing? Have we just swung in this way, and we're going to swing back? My guess is, probably. But right now, there are huge costs and huge systems that have to be managed by large corporations in this country, and there's a lot of talk about it. There's a lot of hand-wringing around "Who are you going to get to be on your board? Do they meet the requirements?" Executives talk about their accounting firms, and the software, and the "God, I have to sign that disclosure." That's the everyday conversation now, and I don't think it was ten years ago. In some ways American capitalism has won, global capitalism has won. At the same time, they're feeling constrained by having to publicly disclose a lot of stuff they used to be able to just talk to their buddies about.

**JJ:** So in a nutshell, was Sarbanes Oxley a good thing?

**NB:** I think accountability is a good thing, but part of what has happened as a result of Sarbanes Oxley is you have to disclose it, and that's pretty expensive. And that stock is in your portfolio, and a lot of us here probably have retirement investments in firms whose accounting costs have skyrocketed and think "Oh, that's a waste of money." On the other hand, it's also driven a lot of firms underground—they've gone private. Equity firms, private equity funds, have been buying up American corporations left and right, and that way they don't have to tell us anything. So, is it a good thing? I'm not sure it's good driving them out of public markets. KKR, Blackstone Group, a lot of big ones have just been buying up corporate America. Part of it is a response to the fact that they have a lot of money, and they want to make super-duper returns, but there's also the fact that they're not accountable then.

**Neil Fligstein:** I'm going to take this in a complementary direction, with two sorts of points. The first, going on what you've said—"capitalism has won"—I think there's been this increase in "financialization" that Frank talked about. But I think two kinds of financialization have occurred.

The first is the growth of the financial services sector itself, and if you go back to the early 1980s and take finance, insurance and real estate, which are typically thought of as the financial sector, it was about a quarter of the American economy. It's now almost 35 percent of the American economy. So this financialization hasn't just been internal to companies and the way they operate; in fact, we have seen this massive growth in this part of the economy. The manufacturing sector has maintained its size, about 20 percent and has been that way for the last 20 years.

And if we look at profits, one of the reasons this part of the economy is growing so fast is that this is the most profitable part of the economy. If we go back to about 1984, the amount of profits in the American economy going to this sector was about a quarter, which was about roughly its size. This is now increased to about 40 percent, so the most hugely profitable part of the economy is also the part that's the most rapidly growing.

Second, in the spirit of what Frank said earlier, I'd like to take this back into the firm. What are the effects of firms engaging in this type of financial planning or thinking about the world in purely financial terms? I think it's had a big effect on their internal functioning. It's hard to connect this change to some of the other changes that have occurred, like the growing insecurity of workers, the inability of people to find health insurance, growing in quality in wages in America.

It's very difficult to put these things together, but we now have some research about that. When institutional investors and top managers pay attention to the share price, they have to find a way to wring costs out of the company. One of the ways they've done that is by trying to lower their overall wage bills, and this has put pressure on all the workers in the company. You can actually demonstrate, at the level of publicly held companies, that the more CEO pay is tied to these performance-related measures, the more inequality comes to exist in the firm. There's been a redistribution of profits from the middle part of the firm—that is, the workers and managers who are in the middle of the firm—upwards: part of this goes to the shareholders and part to the CEO.

This is one of the most negative things that have happened as a result, for at least the American population in general. And because we have no countervailing forces to this in society—that is, we have no way to redistribute (because tax policies have all been moving the other way), and because we also don't have strong stake-holder rights for labor and communities, it means that there's no pressure to push back on this. I think the most pernicious result for the American population is that it has made life a lot tougher.

**NB:** I agree with Neil's last point about squeezing the "excess" out of the corporation. You see it in a lot of other kinds of corporate activities that are now seen as superfluous because they don't return shareholder value. … There are all sorts of community programs, whether it's the Little League or big things, that are much more on the block now. There's much less sense of being a corporate citizen as a necessary thing to do.

**FD:** But let me ask something as a devil's advocate: a lot of people would agree with Nicole that private equity is a bad thing, but if it really took hold, there's a reason to think it would be a good thing, because if these companies were not flipped back into the market, then CEOs and companies could not make money by lying about their profits. I think that's the dysfunctional part of this whole system, and the problem with Sarbanes Oxley is it didn't solve that. CEOs, if they can find an accounting device to lie about their profits, can still make a lot of money; there are still 500 companies a year that are lying and then later admitting that they lied—because there are still 500 companies a year that are restating their earnings. … That's still happening; Sarbanes Oxley didn't change that.

So, I guess I have two provocative things to say. If private equity really took hold, and firms were privately owned, it would undermine the lying about the profits to increase the stock price. The other thing is, if Congress made stock options illegal, a lot of this dynamic would disappear because CEOs wouldn't be able to make a lot of money by lying about corporate profits.

**NB:** I didn't say that private equity was bad, but we can easily see that you can do a lot of nefarious things when you're out of the public view. But as you just said, you can also do nefarious things when you're in the public view, so maybe that's not really what the issue is. But there's an interesting link I've been told about why CEO compensation is so high—the extraordinary pay packages when they retire or they're brought on to a new corporation—and I was talking to a CEO, and I asked, "Why?" He said that a lot of it has to do with private equity funds. There are so many CEOs being lured by high pay packages that are outside the public view that it's been shrinking up the market for very capable managers, and the ones who are left—you've really got to bid for them. I don't know if that's true …

**FD:** No one will work for $100 million any more!

**NB:** That's right. I'm just reporting from the field!

**Audience:** Are there any movements out there that would provide a more democratic model, a model for something different?

**NF:** I think many of the Democratic presidential candidates have said they want reform to the labor laws to make it easier to organize unions, and I think if that happens there's no doubt it would have an effect. There's an interesting paper coming out … which shows that if labor has a big operation against the company, their share price goes down. If we had a labor movement that was reactivated, that's a possibility. I also think the other thing that's possible is ending up with health care, universal health care of some kind. I think those things do provide countervailing forces. I think there are a lot of social movement people within the union movement who, if they were really given the opportunity to organize, really might make some inroads.

**JJ:** Do you want to name names among the Democratic candidates who would help?

**NF:** Edwards. He's the person who's been the most out there on this issue. The others—you can't tell what they're saying sometimes. Obama is all over the place, but Edwards has taken the strongest position.

**FD:** The Democrats are talking about improving labor conditions, reducing pollution, and the like; they're not really talking about changing the regulatory framework in which companies operate, and no one is talking about changing the preferable tax treatment that hedge funds get. A lot of Democrats have come out against that change, even though the preferable tax treatment doesn't make any sense. Nobody's seriously talking about real legislation that would reduce the kinds of paychecks that hedge fund managers, institutional investors, and CEOs take home, or about increasing real shareholder control over corporations. So I don't see how a change in government, even all Democrats all the time, is going to change things.

**JJ:** Is there any hope for shareholder activism to affect corporate governance?

**NB:** I actually called a couple of people I know this week to ask them, expecting you would ask that. I happen to know a couple of people who run pension funds, including the chief investment officer of CalPERS, the largest pension fund in the world with $260 billion. I did ask him about shareholder activism. There are two types of activism: shareholder activism and social-issue activism. People often confuse them. Shareholder activism is about making it more transparent for people who own the stock: reporting, the way the board decides, board composition and democracy for shareholders, and separation of ownership.

Social-issue activism is about having pension funds, as shareholders, lobby for social issues like no child labor, no polluting, etc. I think they do it because they need to politically; I don't think in my heart of hearts that it makes a lot of difference. Their activism comes from where they put their money. Something as big as CalPERS influences the world by where they invest. That's a huge thing—if you have that many billions of dollars, you make a difference by how you invest. CalPERS has to invest 25 percent of their money in California by mandate, but the rest of it can go anyplace, and right now they're building housing in the Middle East, in Egypt.

I think we make a difference by how we invest, in what companies, in what sectors, what regions of the world. They're incredibly global, and they're looking for opportunities to develop. One of my finance colleagues, Brad Barber, won an award … this last year looking at CalPERS, … and he shows that in fact companies have returned more money to investors when CalPERS does go after them. They don't go after social issues, but they go after shareholder values, making companies more democratic, more transparent. At least from pension funds, big institutional investors, I think it really has to do with how they manage and where they put their money.

**NF:** I agree with that. … I think it must be working if these guys are screaming so much. They wouldn't be screaming if it wasn't really having an effect on their decisions. But I think the principal beneficiaries have been institutional investors who have an easier time trying to figure out what these guys are really doing. It's much harder to do the kinds of things Enron was doing before.

**FD:** I think there's good evidence that CalPERS and other huge public pension funds, which only essentially manage money from public employees, have been pretty influential in promoting the agenda of shareholders. Since the early 1980s, a dozen or so of the biggest public funds have gotten together and decided on a list of things they wanted to see companies do, like appoint outside directors, and I think they've gotten companies to do those things. It turns out that the irony of having outside directors is, if you look at who they are, they're buddies of CEOs—they're just not company employees. So, that was a great theory, but in practice it's not working very well.

One of the reasons shareholder activism hasn't worked better is pointed out by Peter Gourevitch and James Shinn in their new book [*Political Power and Corporate Control*]. They show that private funds, which hold a lot of money—companies like Fidelity—don't get into shareholder activism, because Fidelity wants to sell its pension instruments to the same companies. If you want to sell your pension instruments to GE—if you want to have GE make Fidelity the first option people can check off when they decide which 401k their money goes to, or the only thing people can check off—you really don't want to rub the CEO's face in shareholder resolutions. So they work behind the scenes. There's some evidence that Fidelity in particular tries to get companies to do the things they want, but what they want are things that increase shareholder value. They're not the things that as a stake-holder, much less as a social democrat, you'd want out of companies.