Reinventing the Corporation

The public gives corporations their right to exist and asks very little in return. It doesn’t have to be that way

BY JONATHAN ROWE

When an act of simple human decency appears heroic, it’s time to ask some basic questions about the culture in which that act takes place. That’s what happened last December in an old mill town in Massachusetts. AT&T had just announced it was laying off 40,000 workers, even though profits and executive pay were soaring. U.S. corporations had inflicted over three million such layoffs since 1989, and there was a depressing new litany on the evening news: jobs down, stock market up. (More recently, it’s been the equally revealing counterpart: jobs up, market down.) The new Republican Congress was giving these corporations the store. Yet the more they got, the less they seemed willing to give back in return.

Amidst this grim backdrop, Aaron Feuerstein’s textile mill in Lawrence, Mass. burned down. Without hesitation, he announced that he wasn’t going to pull up stakes and move to Mexico. He was going to rebuild the mill right there, in the state conservatives deride as “Taxachusetts.” Not only that, he was going to pay his workers a month’s wages to get them through the Christmas season.

Soon everyone was talking about Feuerstein. He was an ABC News “Person of the Week.” He sat next to Hillary Clinton at the State of the Union address. Yet Feuerstein himself couldn’t understand the fuss. “What?” he asked. “For doing the decent thing?” While his modesty may be excessive, his instinct is on the mark. By his example, he raised a pointed question: Why do we expect so little from major businesses these days?

Certainly, that thought is abroad in the land. Not since Ralph Nader’s heyday in the early seventies have the words “corporate responsibility” come up so often in political debate. Because the prime messenger this time is Pat Buchanan, much of the mainstream media has dismissed the issue as the benighted economics of Bible-thumping ignorami. But the notion that corporations have responsibilities, just like real people, touches a deep chord; and while the term “corporate responsibility” may strike jaded modern ears as oxymoronic and naive, historically it is exactly right. “The corporation is a creature of the state,” the Supreme Court observed back in 1906. “It is presumed to be incorporated for the benefit of the public.”

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How to get back to that original intent—to traditional moral values in the economic realm—is an urgent question. Conservatives say, correctly, that government should do less and individuals and business more. But if that’s so, we have to consider whether the dominant form of business is up to the job. If there is to be less top-down regulation and more voluntary well-doing, then we have to ask whether the Wall Street-oriented corporation of today is capable of such a thing.

The issue here is not the hoary ideological debate between the government and the market. Rather, it concerns the kind of entities that will comprise the market. The corporation is an artifice of government, no less than the welfare system or foreign aid. Historically, it has evolved as society has changed. The time has come to ask what the next phase of that evolution should be. In simple terms, how can we reconnect the corporation to the social and community concerns it was originally intended to serve?

The way the corporation drifted from that role is a story that has all the elements of a neoconservative morality play. Corrupt government; self-serving politicians seeking to fill the public coffers and give the voters something for nothing; elite Eastern lawyers riding roughshod over traditional moral values; liberal permissiveness, economic style, and unintended consequences galore—it’s all there.

Racing to the Bottom

Today we assume that corporations exist to make money. Ideologists-qua-economists like Professor Milton Friedman of the Hoover Institution assert this as a moral imperative. Yet if we travel back in time five or six hundred years, the European corporations of that era were very different from those of today. They were regulatory bodies, not acquisitive ones, which served to reconcile individual behavior with larger social ends. Gilds, boroughs, monasteries, and the like—today we would call them “mediating institutions,” bulwarks of the civil society that has fallen into such disrepair. “Corporations have constituted, for the most part, the framework of society subordinate to that of the state,” as John P. Davis put it in his exhaustive two-volume study back in 1905.

When the British Crown was eager to claim the wealth of the New World, it required commercial ventures of enormous scale. But few investors would come forward because they could be held responsible for the enterprise as a whole. The solution was the “joint stock company,” the forerunner of today’s business corporation. The corporate entity became a legal buffer zone between the enterprise and the actual owners. Ownership and responsibility were severed, so that a larger enterprise could result.

This was a radical step. Individual responsibility is a bedrock principle of the common law tradition. People must stand accountable for their actions and those taken on their behalf. To compromise this principle, something had to be given in return; specifically, the enterprise that gained this exemption had to serve the public in concrete ways.

Accordingly, in the early days, corporate charters were not granted to all comers the way they are today. They were granted selectively, one by one, for ventures that seemed worthy of public promotion and support. The trading companies that served as commercial agents of British foreign policy were prime examples; in today’s terms they were much like Amtrak or the Tennessee Valley Authority.

This basically was the form of corporation that existed in Adam Smith’s day. When Smith called England a “nation of shopkeepers,” he was speaking literally. His notion of a divine market mechanism guiding individual ambition towards the betterment of all was premised on a world of individual business people, rooted in locality and place and subject to social mores and conscience. In one of the less prescient passages in the Wealth of Nations, Smith contended that corporations would never amount to much in the international marketplace. They were too cumbersome and bureaucratic, he said. Individual business people, with their superior “dexterity and judgment,” would run rings around them.

In other words, the notion of the invisible hand is premised on a pre-corporate world that no longer exists. So too were the founding premises of the American republic. The colonists were extremely suspicious of corporations, which were seen as oppressive agents of the Crown and poten-
tial usurpers of the public will. At the time of the Constitutional Convention, only some 40 business corporations had been chartered in all the colonies. Most of these were for bridges, toll roads, and similar public-works endeavors. So it’s not surprising the Founding Fathers omitted the corporation from the scheme of checks and balances by which they hoped to keep institutional power under restraint.

Even as business corporations became more common, they stayed grounded in the premise that they were agents of a larger public good. Charters typically spelled out that the corporation in question was created to serve “the public interest and necessity.” Some required shareholders to be local residents, and some even vested part ownership in the public. Before 1842, for example, the State of Maryland chose one third of the directors in the Baltimore and Ohio Railroad. There were also mandates to serve the public in specific ways: A bank charter in New Jersey, for example, required the company to help local fisheries.

As decades passed, the nation’s surging commerce pushed against these restraints. Legislatures were besieged by supplicants seeking the privilege of operating as a corporation. In addition, the corporate charter process had gotten a taint of special privilege. The result was the general incorporation laws, which made the corporate form available to everyone.

This didn’t mean that the suspicion of agglomerated power had died, nor the conviction that the corporate privilege was connected to a public purpose. Until 1837, for example, every state still required that corporations be chartered only for a particular kind of business. It took almost half a century for states to permit blank-check incorporation “for any lawful purpose.” Restrictions on size were common too. New York, which was not unfriendly to business, limited corporations to $2 million in capital until 1881; and to $5 million until 1890.

Similarly, as late as 1903, almost half the states limited the duration of corporate charters to 20 to 50 years. Legislatures would actually revoke charters when the corporation wasn’t fulfilling its responsibilities. With the rise of corporate mega-

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Standard Oil empire to grow far beyond the size the state laws permitted. Rockefeller’s conniving set off a wave of trusts—whiskey, sugar, lead, and others—which came to control much of the commerce in their industries.

Eventually these agreements came to light, and the state courts struck them down as exceeding the powers granted in the charters of the individual corporations that comprised them. The charter laws had done their job. Therefore, the charter laws would have to go, and the first to fall was New Jersey.

As Nader’s study recounts, in 1890 a young New York lawyer named James B. Dill made an offer that the governor of New Jersey couldn’t refuse. Enact the most liberal and permissive law in the land, Dill said. Let corporate managements do whatever they want, shareholders and public be damned. Corporations will flock to your state for new charters; revenues will pour into the treasury. Plus the clincher: Dill would form a company to handle the paperwork for the incorporating process, and the governor would get a cut.

Soon, Standard Oil, U.S. Steel, and other major companies were lining up for New Jersey charters. Prompted by the permissive new laws, there was an orgy of mergers and combinations, which hastened America’s transition from a nation of entrepreneurs to one of corporate employees.

But politically, the New Jersey regime reaped its reward. By 1905 the state was running a surplus

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of almost $3 million. "Of the entire income of the
government, not a penny was contributed directly
by the people," the governor boasted. These rev-
enues enabled him to push a rash of new social
programs and public works projects, all without
burdening ordinary taxpayers. In other words, tax-
and-spend liberalism was boosted by the move-
ment that set corporations free of every vestige of
social accountability and restraint.

Other states were helpless to counter New Jer-
sy's dirty deal. So, why not get a piece of the ac-
tion? Those revenues were pretty attractive, as
were the other benefits that flowed to politicians
more directly. West Virginia was among the first;
the "Snug Harbor for roaming and piratical corpo-
rations," a contemporary legal treatise called it.
Maine, Delaware, Maryland and Kentuckv fol-
lowed in this new race to set the lowest standards
and collect the most booty. At one point, the New
York legislature enacted a special charter for the
General Electric Company, based on the lax New
Jersey standards, to prevent the company from ab-
sconding across the Hudson River. The Commis-
sion on Uniform Incorporation Law declared that
the evolving system ensured "the maximum pro-
tection of fraud" and "the minimum of protection
and cover ... for honest dealing."

There was a brief flurry of rectitude in New
Jersey when Woodrow Wilson became governor in
1910. But others were only too ready to fill the
temporary gap at the bottom—Delaware most of
all. By the time of the Great Depression, Delaware
had become home to more than one third of the in-
dustrial corporations on the New York Stock Ex-
change; 12,000 corporations claimed legal resi-
dence in a single office in downtown Wilmington.

When other states made their own runs for the
bottom, Delaware dropped standards even further.
In the 1960s, it simply turned over the drafting of a
new law to a bevy of corporate lawyers. The legis-
lature rubber stamped the results. By the mid-
1970s, half the nation's largest 500 corporations
were chartered in tiny Delaware. Now only direc-
tors, rather than shareholders, could propose
amendments to the corporate charter. On top of
that, corporate officers and directors could be in-
demnified for court costs and settlements of crimi-
nal and civil cases without shareholder approval.

In other words, the concept of individual re-
sponsibility for corporate management was entire-
ly out the window. This trend had troubled the up-
holders of traditional morality from the very begin-
ning. "The pernicious movement has decreased the
personal responsibility on which the integrity of
democratic institutions depends," Professor Davis
observed seven decades earlier. William Carey,
former chairman of the Securities and Exchange
Commission and author of a leading textbook on

corporate law, declared that the only public policy
left in Delaware's corporation law was "raising
revenue."

Such developments did not go unnoticed politi-
cally. Theodore Roosevelt, a Republican, actually
established a Federal Bureau of Corporations to
monitor the impact of these new and disruptive en-
tities. Presidents Roosevelt, Taft, and Wilson all
proposed federal chartering for large corporations,
in order to stop the state charter-mongering and set
minimum standards for national businesses. (Most
corporations chartered in Delaware had little pres-
ence there besides a file in a lawyer's office.)
These corporations "are in fact federal," Taft said,"because they are as wide as the country and are
toentirely unlimited in their business by state lines."

But Congress chose instead the routes of an-
titrust and regulation, trying to restrain what the
permissive state charter laws had set loose. The
first big growth of federal government came from
new agencies, such as the Interstate Commerce
Commission and the Federal Trade Commission,
that were supposed to keep the burgeoning corpo-
rations in check.

In the New Deal-era, people like David Lillien-
thal, the first chairman of the TVA, tried to tilt the
balance back toward individual entrepreneurs and
local enterprise. But this group lost out, first to the
megaplanners, and then to the new Keynesian

techocrats, who reduced the economic problem to
the manipulation of the valves and levers of taxa-
tion, expenditure, the money supply, and the main-
tenance of "consumer demand." Those who raised
questions about corporate governance and the
scale of enterprise were dismissed as descendants
of the bumpkins and small-town nostalgics whom
Richard Hofstadter ridiculed in The American Po-
titical Tradition.

Chartering A New Course

That is pretty much where things stand today.
The Keynesian policy nostrums no longer hold,

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but the fixation on scientific “macro” policy still dominates the national debate. Just get taxes right, cut federal spending, and the Red Sea will open wide. When a Robert Reich or a Pat Buchanan suggest that something more is involved—that the economic entities that do so well in America perhaps owe America something in return—they are dismissed as demagogues and know-nothings.

But Buchanan has let the genie out of the political bottle. Whether you agree with his remedies or not, he has tapped a genuine feeling of betrayal. Americans think the high and mighty as well as welfare mothers have responsibilities—and that corporate America has been obscenely derelict in this regard. Business Week put it well when it observed, “U.S. corporations may have to strike a new balance between the need to cut costs to be more globally competitive, and the need to be more responsible corporate citizens.”

The problem, of course, is that corporations today aren’t constituted to be responsible. The large corporation whose stock is traded publicly on stock exchanges has become an extension of the Wall Street mind. A CEO who did what Aaron Feuerstein did—that is, who forsook a measure of profit for acts of decency to employees and the community—could have furious portfolio managers to contend with. Shareholders might have his or her scalp. The publicly-traded corporation does to the economic realm what the political action committee does to politics—it reduces people to lowest common denominator of self-seeking, and subordinates their best instincts to an institutional mandate to maximize pecuniary gain.

This might have been tolerable for a period in our history. But in a global economy, with the sense of community coming apart, institutional self-interest has flown out of orbit, sweeping up even smaller companies in its centrifugal pull. Yvon Chouinard, founder of Patagonia clothing, has put the problem eloquently. The goal in the entrepreneurial world today is to “grow (your business) as quickly as you can until you cash out, and retire to the golf courses of Leisure World,” he wrote. “When the company becomes the fattened calf, it’s sold for a profit and its resources and holdings are often ravaged and broken apart, disrupting family ties and jeopardizing the long-term health of local communities.”

Chouinard, a mountain-climber who happened into the gear-and-clothing business, has gone the opposite route. Instead of cashing out, he decided to keep the company at a scale at which it can still embody the values he seeks to live.

You can’t legislate that kind of decency. But it is possible to encourage the kind of enterprise that gives it room to operate. Individual and family owners, for example, at least have the ability to temper their profit-seeking with civic and other concerns. (The Cleveland Browns’ owner, Art Modell, is a good reminder that not all of them will.) Family-owned newspapers have done this for decades, which is one reason that the corporatizing of the media is a tragedy.

Local ownership also can have a salutary effect, even from a business standpoint. Consider the Green Bay Packers football team, which is owned by about 2,000 individual shareholders, most of them residents of Green Bay. The Packers have a stability that is rare in business today, let alone pro sports. Packer fans don’t worry that a greedy owner will skip town—because they are the owner. The Packers won the first two Superbowls and made it to the conference championship this year. Yet NFL rules now bar franchises from Packers-style local ownership.

If community-centered ownership works in pro sports, which have become the ultimate business, then why not in other businesses? Inner cities, for example, have trouble luring supermarkets and other essential services. There’s lots of money to be made, but it takes a level of patience and hands-on commitment that most major corporations aren’t willing to expend when there’s such easy pickings in the suburbs. Local and community-based ownership can fill in the gap.

Employee ownership works much the same way. It’s not a panacea, but an employee-owned company is less likely to move jobs abroad or lay off 40,000 workers when business is booming. It is more likely to take seriously the impact of business decisions on the community at large. The New York Times recently highlighted this balance at United Airlines, where employee owners resisted taking over USAir because it would have caused layoffs there. But United has also found that employee owners are also willing to make sacrifices for the company, such as accepting pay freezes, in return for job security.

Unfortunately, the most common form of employee ownership is the Employee Stock Ownership Plan (ESOP), which is a passive investment
can be tested. We can only look, in the words of John Stuart Mill, to experiments “cast up by history.” And so, in the spirit of historical inquiry, I set out to compare a century’s worth of data on economic growth with the marginal tax rates on the top bracket of income and the capital gains taxes in the same periods. Wading through the data might not be as fun as beach-blanket bingo, but the question at hand is a crucial one: Do lower tax rates correlate with higher rates of growth? Unfortunately for the supply-siders, the numbers contradict their theory. The fact is that high income tax rates and healthy growth have often coexisted; so have high capital gains tax rates and growth.

Depressing Data

Modern day income taxation began in 1913 with the adoption of the 16th Amendment to the Constitution, which allows the federal government to tax income. The 81 years from 1914 through 1994 included all of the turbulent upheavals of this century—World War I, the Great Depression, World War II, the Korean War, and the Vietnam War—and dramatic fluctuation of tax rates. But there were 11 periods during which the tax rate for the top personal income bracket was about the same. The longest of those periods was 18 years, the shortest one year. Those 11 periods are the key to testing the supply-side theory.

The numbers show two things quite clearly: First, more often than not, tax rates and growth rates move in the same direction—in other words, higher taxes accompany higher growth, and vice versa. Second, the relationship between changes in tax rates for income and capital gains and economic growth is extremely weak. In other words, considered over history, changes in the top bracket rate don’t seem to make much of a difference to the economy as a whole.

Let’s start with the “Roaring Twenties,” 1922 to 1929. Supply-siders regularly use this period to buttress their arguments, since tax rates on top bracket families were cut by 57 percent over these seven years and real growth averaged a healthy 4.5 percent annually. But keep in mind that this was also the period of a strong recovery from the exceptionally severe depression, which reached its low point in 1921. Real output dropped by a cumulative 16.4 percent from 1919 through 1921, but this was followed by a robust recovery over the next two years. If we remove the recovery years from the picture, the economy’s real growth rate for the remainder of the Roaring Twenties was 3.6 percent. This is a good figure, but not exceptional; it’s about the same as the long-term historical average of about 3.5 percent (measured since 1893).

The 1930s brought the Great Depression—and more news to warm supply-siders’ hearts: an apparent relationship between an increase in tax rates and a decline in growth. The first sharp downturn, the October 1929 stock market collapse, came on the heels of a sharp tax increase pushed through Congress by Herbert Hoover. Output declined 33.9 percent from 1930 through 1933.

Then, in 1934, the economy began to recover. Over the next three years, real output grew at an astonishing annual average of 11 percent. Encouraged by this growth, the Roosevelt administration in 1936 raised the top bracket tax rate to 79 percent hoping to balance the budget. The result was a disaster: The recovery ended abruptly. Real output fell by 5 percent in 1938, and another 8.6 percent the next year. Again, on the face, the 1930s would seem to confirm supply-side theory. But the Hoover and Roosevelt tax increases, while bad policy because they exacerbated declines in output, did not cause those declines.

The third crucial period for testing supply-side economics is the “Reagan Revolution”—1982 to 1986. Reagan entered office promising sweeping tax cuts, and he delivered—particularly for those in the top bracket, who saw their rates decline 29 percent. As I’ve noted, Reagan’s promise that increased output would bring in more tax revenue and balance the federal government’s budget turned out to be a false one. Still, supply-siders find solace in the fact that the annual average growth rate increased in these years compared to the previous 18. The increase, however, was a minuscule 0.3 percentage points. If you factor out the unintended Keynesian effect of Reagan deficits on the economy, the growth rate is entirely negligible.

So, only one of these three periods—the 1920s—offers much solace for supply-siders. The 1930s are inconclusive. And in Reagan’s first six years in office the economy grew only moderately, despite massive priming of the pump through de-
fense expenditures and tax cuts.

If you follow this sort of analysis through each of the 81 years from 1914 to 1994, you find much the same story. Eliminating both world wars and the transition years immediately following each war, we are left with 69 years in which history has cast up "experiments" for testing supply-side theory. In 55 of those years—80 percent of the time—higher top bracket marginal tax rates are associated with higher growth rates—not lower ones.

Consider the period between 1950 and 1963. Today there is much nostalgia for this time, but not among supply siders. After all, the top bracket marginal tax rates were higher than at any time in the post-World War II era (91.1 percent). At the same time, the annual average growth rate hit a postwar high of 3.8 percent. Even excluding the Korean War years, when a new surge of military spending pushed real growth up to an 8.5 and 10.3 annual rate, the fifties' growth rate averages 2.8 percent—the same as during the Reagan '82 to '86 period. This growth coexisted with extraordinarily high tax rates.

The history of changes in capital gains taxes is even more unfavorable to supply-side theory. For five of the seven periods following 1921, the relation between an increase in the capital gains tax and growth was a positive one—they both went up; this was true 52 of the 73 years after 1921. The rate went up and growth went down in only two periods.

The problem with capital gains tax cuts is not just that the numbers contradict the supply-side hypothesis. It's also nearly impossible to devise a capital gains tax break that truly rewards enterprise, as opposed to mere speculation. As Keynes explains in his classic, The General Theory of Employment, Interest, and Money, enterprise involves the production of new, real wealth, such as starting a new business, building a new factory, or developing a new product. Speculation, on the other hand, involves an increase in the monetary value of things that already exist; this adds to the wealth of individuals, but not to the real wealth of the nation. The reality is that existing practices in the taxation of capital gains reward speculative activity as much as they do enterprise activity. And, ultimately, it is the bulk of Americans who suffer from the lost tax revenue. The Reagan tax cuts, remember, weren't just a failed experiment in that they failed to produce the promised growth. They also saddled us with so much debt that 15 percent of the annual federal budget is consumed entirely with interest payments.

Despite this evidence, we can be nearly certain that the supply-side fantasy will continue to command attention in the Republican party. Bob Dole, to his credit, is skeptical of supply-side arguments. His reluctance to embrace tax cuts, in fact, is what got Steve Forbes into the race to start with. Even though he's conceded the race, Forbes is unlikely to concede the validity of the evidence laid out in this article. But that's no reason for the rest of the population to be taken in.

This argument is not merely about numbers, of course. It's also about psychology. Supply-siders would have us believe that people are driven to work and achieve solely by the desire to accrue money, but that is clearly not true. If they had to pay more in taxes, would Steven Spielberg, George Soros, or Bill Gates work less hard? Of course not. These men—like most Americans—are driven not just by monetary reward but also by prestige, power, and genuine love of their work. Furthermore, a dollar earned but taxed heavily is still more than nothing. Ronald Reagan's acting income was taxed at 91.1 percent—a rate no one would dream of enacting today—but he not only didn't turn down any good roles, he also made all those monkey movies.

Yes, Forbes, Wanniski, Kemp et al. will keep rambling on about the flat tax. But the numbers—and theory—of supply-side arguments just don't add up. Now it's as clear as ever: Snake oil remedies are still snake oil, and voodoo economics is still voodoo economics.