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PENSION FUND SOCIALISM: A CRITIQUE

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In a provocative book recently published[1], Peter F. Drucker undertakes to show how the generalization of pension funds in the last 25 years has brought about profound changes in the American economy and society. One of the theses developed in the book has in the past received a good deal of attention from economists. It has to do with the problem of separation of ownership from control in the corporate economy. In the treatment offered by Drucker this question is given a new dimension. In the author's interpretation, the emergence of pension funds as an important source of equity capital for the modern large-scale corporation is said to have basically changed the dynamics of the American capitalist system. Drucker argues that with some one-third of equity capital in the hands of pension fund trusts, the divorce of ownership from control is now "final" (p. 82). This result is brought about by pension fund trusts viewing themselves as investors rather than owners. In that capacity, their job is to search for the most profitable investment, not to exercise control on the management or to sit on boards of directors. Because of this lack of concern for control on the part of pension fund trustees or because of their inability to exercise it, corporation managers are supposedly left "without anyone to be accountable to". " . . . the new owners of American business" (p. 83) have no representatives on the board to protect their interests. Two main proposals are suggested by the author to solve this problem. "The first step . . . . is the appointment of 'professional' directors . . . who, as members of the board, can be truly independent of management . . . But, in addition, both business and pension fund need . . . strong, visible membership on the board by people who represent both true 'constituencies', such as consumers and employers, and the future new 'owners', — the country's employees" (pp. 91–92).

The purpose of this note is to challenge Drucker's pronouncement that the shift of ownership from individual and other institutional investors to pension funds has changed anything fundamental about the working of the American capitalist system. As a consequence the author's policy recommendations are viewed as offering a formal solution to a non-problem.

THE PROPERTY RIGHTS APPROACH TO THE MODERN CORPORATION

The suggestion that dissociation of ownership from control in the modern dispersed corporation has had far-reaching implications has received a great deal of attention from economists and others since first raised by Berle and Means and taken up again in 1965 by Kaysen.[2] In recent years it has proved analytically fruitful to redefine the problem in terms of attenuation of the owners' property rights to the residual income, i.e. to the profits of the firm. This outcome has originated not from any changes in the legal claims of shareholders, as is the case for regulated producers and nonprofit, cooperative or governmental enterprises. Rather the stockholders' property rights are attenuated because of the higher cost to the owners of controlling and policing managerial decisions.

Thus in large-scale corporations with a high degree of stock ownership dispersion, the usual benefit–cost calculus of individual shareholders is said to prevent rational investors from becoming well informed, even on such major issues as revising or terminating the membership of the management group. The reason for this apathy is found in the well-known free rider principle. Any loss resulting from bad managerial decisions will be borne in large part by the many other corporate shareholders. And so will the benefits of good decisions accrue to other investors. It thus becomes rational for every shareholder to abstain from attempts to monitor decisions that will affect the value of the firm's resources. To adherents of the separation-of-ownership-and-control school, stock ownership dispersion generates loss of accountability on the part of managers of large corporations.

What are the consequences of this state of affairs on the allocation of resources? For economists the question arises of whether the traditional framework for the analysis of the firm is still relevant, once the profit maximization hypothesis is abandoned. Further developments in the field of property rights economics showed that the answer to that question is yes. Those who attributed great implications to the separation of ownership and control rejected the classical view of managers operating to increase the owners' wealth. On the other hand what was required to salvage the methodology of economics was that the principle of wealth maximization be replaced by that of the managers' utility maximization. In this view of things, the management's behavior becomes an important element in the allocation of the firm's resources. To the extent that the nominal owners lost some of their effective property rights, managers gained an amount of discretionary power which they can use to divert a portion of the firm's resources to their own ends.

It is within this framework of utility maximization by the management that the analytical tradition introduced by Baumol and Williamson[3] is to be placed. In the former's model utility maximization is associated with value of sales maximization, whereas the arguments that enter into the utility function of the Williamson model include the managers' compensation, the level of staff personnel and discretionary investments offering few or no profitability prospects. In recent years this approach to managerial discretion has been applied with great success to the numerous forms of production organizations where the attenuation of the owners' property rights goes even further than in the business corporation. In nonprofit concerns like universities and hospitals, in mutual and co-operative enterprises or in governmental organizations and workers' enterprises of the Yugoslav variety, no one can claim titles to the residual. The purchase and sale of shares to the wealth of the firm are legally prohibited. Anticipated future improvements cannot be capitalized into present wealth. Restrictions on capturable profits are generally combined with publicly established barriers to entry by new competitors. Ample room is thus made for managers to appropriate monopoly rents as supplements to competitive profits.

That profits are converted to the personal benefit of managers (and other parties) in enterprises where shares are not alienable has been empirically substantiated.[4] Utility-generating expenses are incurred which result in unit cost increases. These include fancier offices, generous expense accounts, higher salaries, greater tenure of office, fewer firings, easier life, excess quality, etc. More discrimination by race and age or on the basis of professional affinities is displayed in organizations where legal arrangements prevent profits from being taken out of the enterprise. Bureaucrats and executives of other limited-profit organizations are successfully lobbied. Factor suppliers including union officials are induced to such actions by the prospect of sharing in the surplus generated by the management's ability to gain monopoly rents in the firm. Promotional activities are profusely engaged in by non-owned firms of various kinds. Whether such actions serve to shift the demand for output in ways that raise the manager's rent or are prompted by the manager's altruistic desire to promote "good" causes and "merit" goods, is unimportant. In all cases managerial goals are reached at the expense of the consuming public who could otherwise have had lower prices or output levels more consistent with their preferences.

When applied to business corporations, as is done by Drucker, this approach raises as yet unresolved theoretical and empirical questions. Where purchases and sales of rights to the residual are allowed, shirking by managers is constrained even in diffused ownership corporations. This happens not because owners will scrutinize operations more closely but because investors will not accept returns on their funds which are lower than in less diffused enterprises. Rather than engage in the costly process of monitoring the management's decisions, it will prove more rational for every investor to remove his wealth from the control of those whose policies appear to jeopardize his interests. Capitalization of future events through the purchase and sale of shares implies in turn that the capital market will not ignore the superior performance of the management. In other words devices will be incorporated into compensation rules for rewarding managers who succeed in promoting the owners' interests. Competition in the capital market thus generates competition from would-be managers who seek to displace present management, both within the firm and without. Proxy battles are but one of the visible expressions of the constraints that the corporate structure imposes on managerial discretion. The major implication of the higher cost of policing executive behavior in diffused corporations is that we should expect varied types of managerial rewards, not higher overall remuneration nor lower wealth for shareholders.[5]

The distinctive feature of modern business corporations as opposed to non-owned forms of organizations thus rests on this power of shareholders to capitalize future changes in the firm's performance into present wealth through sale of their shares. In the view of many writers this attribute of the corporate organization has basically retained the effective control of the corporation in the hands of those who possess the property rights to the residual. Therefore the debate has to move from the analytical to the empirical level. Only factual evidence can determine whether the analysis of the classical firm is obsolete or not when carried on to the corporate form of organization.

In this respect it does not appear that the Baumol model of sales value maximization met the empirical test successfully. Authors like Lewellen and Huntsman[6] have found a positive relation between managerial compensation and profits but no relation between compensation and growth or value of sales. For his part, Williamson does provide some empirical support for his predictions that executive compensation is positively associated with the importance of staff personnel, the degree of industrial concentration, the importance of barriers to entry and internal representation on the board of directors. In his own words, "the evidence presented is clearly suggestive rather than definitive". Other implications of the separation of control from ownership have not received empirical support. Despite the presumption that the owners' interests are not adequately guarded, corporations have thrived. In contrast with the nonprofit and government sectors, no greater tenure of office by the management has been observed in the more diffused corporations. Stockholders profits are not lower. As mentioned earlier, executive compensations have been shown to be positively associated with the profit rate.

PENSION FUND CAPITALISM AND THE CORPORATE ECONOMY

I hope the lengthy argument above will not be construed as an attempt to guide the reader away from the main problem discussed in Drucker's work. It is my belief that this analytical detour was essential to prove the contention of this paper that the acquisition by pension fund trusts of a large fraction of total equity capital has not changed in any significant respect the basic rules of the game governing the American corporate economy. Clearly the accumulation of shares in the hands of pension fund trusts has in no way affected the legal property rights to the firm's residual. More importantly shareholders' rights, including pension funds' rights, to capitalize future developments into present wealth remain untouched by this shift in the distribution of ownership. For the sake of analysis, compare present-day property rights of pension funds with those of the employees of the Yugoslav firm or with those of the profit-sharing pension funds idealized by Louis Kelso and others.[7] Workers in these models legally possess the property rights to the residual. In that capacity they also have the power to revise the contractual arrangements of employees, including those of the managers. Yet the content of their property rights differs in one important respect from those of their American counterparts: they are not allowed to sell their rights on the open market or to take them away when they leave the firm. This of course is a radical departure from the American corporate model, with obvious implications for their ability to influence managerial actions decisively. But nothing of this sort has accompanied the advent of pension fund capitalism in America.

As regards the cost to shareholders of exercising control on managerial decisions, it has if anything declined as a result of the shift in the distribution of ownership from individuals and other institutions to pension fund trusts. Again it should be remembered that today, as in the past, the effective exercise of the shareholders' power derives from impersonal competition in the capital and manager markets. No "professional director" can adequately substitute for this mechanism as a guarantee of accountability. Clearly the stockholders' incentive and ability to see to it that their wealth is well guarded can only have been enhanced by the emergence of 50,000 or so specialized asset managers named pension funds. Granted that "today's capital market is dominated by no more than 1000 to 1500 large corporate pension funds" (p. 69), which are subject to an "excess of competition" (p. 70), then both their greater stake and expertise should have induced them to invest more in information on corporate activities than each of the 25 million or so individual American stockholders. In other words, the advent of pension fund capitalism should have reduced the extent of discretion enjoyed by managers and thereby their ability to deviate from the owners' interests.

I conclude that there appears to be no analytical basis for the pronouncement that "the emergence of the pension fund trust makes final the divorce of traditional "ownership" from "control". If analytically significant dissociation ever existed prior to the advent of pension funds, its implications should have been weakened by this development. On the other hand, in the alternative and conventional analysis which views the manager as constrained by competitive forces to operate to increase owners' wealth, then we still have corporate business as usual. Pension fund capitalism followed the rise in life expectancy combined with increasing income. Analytically, this is a shift in the distribution of ownership, clearly a social phenomenon of massive proportion. On the other hand if capitalism and free markets, as a system of penalties and rewards, still have a meaning, equity ownership by pension funds is but a technological step in the evolution of the corporate economy.

NOTES

1. Peter F. Drucker, *The Unseen Revolution: How Pension Fund Socialism Came to America* (New York: Harper & Row, 1976).
2. Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933); Carl Kaysen, "Another View of Corporate Capitalism," *Quarterly Journal of Economics*, vol. 79 (1965).
3. William J. Baumol, *Business Behavior, Value and Growth* (New York: Macmillan, 1959); and O. E. Williamson, *The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm* (Englewood Cliffs: N. J., Prentice-Hall, 1964.)
4. William A. Niskanen, *Bureaucracy and Representative Government* (Chicago: Aldine Atherton, 1971); J.-L. Migué and G. Bélanger, "Toward a General Theory of Managerial Discretion," *Public Choice* vol. 17 (Spring, 1974), pp. 27–47; J. P. Newhouse, "Toward a Theory of Nonprofit Institutions," *American Economic Review*, vol. 60 (March, 1970), pp. 64–74; Armen A. Alchian and Reuben A. Kessel, "Competition, Monopoly and the Pursuit of Pecuniary Gains," in *Aspects of Labor Economics* (Princeton: Princeton University Press, 1962); Alfred Nicols, "Stock Versus Mutual Savings and Loan Associations: Some Evidence of Differences of Behavior," *American Economic Review*, vol. 57 (May, 1967), pp. 337–346; H. E. Frech III, "The Property Rights Theory of the Firm: Empirical Results from a Natural Experiment," *Journal of Political Economy*, vol. 84 (Feb., 1976), pp. 143–152.
5. For a more detailed analysis of this, see Armen Alchian, "Corporate Management and Property Rights," in Henry Manne, ed., *Economic Policy and the Regulation of Corporate Securities* (Washington: American Enterprise Institute, 1969), pp. 337–360.
6. W. G. Lewellen and B. Huntsman, "Managerial Pay and Corporate Performance," *American Economic Review*, vol. 60 (Sept., 1970), pp. 710–721.
7. Described and ably criticized by Drucker, pp. 36–40.