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LEGAL IMPLICATIONS OF ECONOMIC POWER

This afternoon I want to discuss the economic power of our big corporations and suggest some of the economic and legal implications of this economic power. I am primarily concerned with the problem of the economic power wielded by big unregulated manufacturing enterprise though what I say may have some relevance to the big regulated enterprises and to big enterprises in distribution and the service industries.

I am strongly in favor of big business and what it can contribute to our society. At the same time, I believe big business has created a power problem for our society which must be resolved if we are to have the full advantages of big business. Also, I want to suggest that this problem lies outside the logic of both traditional economic and traditional legal theory. As such, it requires a basic re-analysis which may require solutions not directly derivable from these sets of traditional theory.

In my analysis today, I will consider three aspects of the problem: the institutional basis of traditional economic and legal theory; the role of profits and property; and the relation between power and profits. This analysis will give us a basis for considering a new approach to the problem of economic power.

Let us start our analysis of economic institutions with the very simple economic institution, the ancient Greek family. As all economists are taught, it was the management of the Greek family which gave us the term "economic." The extended Greek family with cousins and

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aunts, perhaps by dozens, was, in essence, a collective, producing for itself. There was no buying and selling and no market. Within the collective, consumers and workers and owners and managers composed a single entity and control over the instruments of production lay with this entity, the family. There could be no problem of market price or of economic power as we are considering it today and no problem of its legal implications.

Next consider the institutional basis of Adam Smith's economic theory and the body of law built around it. Adam Smith wrote before the industrial revolution had made much headway and the enterprise unit with which he was primarily concerned was the one-man enterprise of butcher and baker and candlestick maker. While he recognized the existence of apprentices and hired workers, he was not much concerned with them and when he spoke of labor he was referring, not to employees, but to the work of the owner himself. He envisaged a large number of small one-man enterprises competing with each other and so numerous and weak that no one producer had any significant power over price. True, he recognized the existence of government created monopolies and the tendency of competitors to get together on prices, but inveighed against both. His economic model and his theory of classical competition were concerned with competition among a large number of one-man enterprises. Today we have the prototype of his model in the vast number of family farms. And before the recent government intervention, we had the classical competition in farming which made the prices of wheat and cotton adjust so as to equate supply and demand according to the expectations of classical theory.

There are two things to be noted about Adam Smith's model. First, it involved a separation of consumers from control over the instruments of production. The one-man producer was worker-owner-manager all in one and controlled the enterprise. In contrast, the consumer

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influence production only through the market and must depend on his influence through the market for the protection of his interest. And second, according to Adam Smith, competition in the market would, in most cases, adequately protect the consumer. In such an economy, the main function of the law was to facilitate production by protecting property and enforcing contracts. Some regulation of free enterprise arose in making hostels open to all comers, in outlawing engrossing, and in similar measures. But in the main, the economic and legal theories for the one-man enterprise model were those of laisez-faire.

The industrial revolution brought the factory system and the separation of the worker from control over the instruments of production. Control over the enterprise rested with the owner-manager, while the workers, like consumers, could influence production through the market, but had no control over the instruments of production.

It was this separation of workers from control which provided Marx with the basis for his theory of the class struggle. And while we can reject his labor theory of value, we must recognize that factory enterprise required a reconsideration of the theories based on Smith's model of one-man enterprises.

However, economic and legal theory were slow to take full account of the factory type of enterprise. Economic theory, by treating labor as a commodity and each worker as a one-man enterprise selling labor, was able to retain Adam Smith's model. The only change that had to be made was to include labor as a raw material bought by enterprise like any other raw material. In Adam Smith's analysis the shoemaker bought leather, shoe twine and shoe pegs, combined them into a pair of shoes and sold the shoes. In the later analysis, the shoe manufacturer bought leather, shoe twine, shoe pegs and labor, combined them into a pair of shoes and sold the shoes. No significant modification of the model was made in 19th century theory because of the separation of

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worker from control. True, labor became a commodity of special interest and the forces influencing its long run supply and demand were given special attention. But outside the followers of Marx, little attention was given in traditional theory to the economic fact that labor was not a commodity.

Also, the conception of competition as that between a large number of small units continued to be the core of traditional theory. Thus, Alfred Marshall built his analysis on the conception of the representative firm and his industry was a forest of enterprises each having a life cycle comparable to a tree in a forest, growing strong with the vigor of its owner-operator in his prime and declining in his old age.

I cannot go into the economic and legal implications of Marshall's owner-operated factory enterprise as such. What is important here is that it raises important questions of economic power which were never adequately explored by the traditional theorists and which arise in more intense form with the modern corporate enterprise with which we are primarily concerned this afternoon.

The modern corporation has provided us with still another institutional form of production, one which separates not only consumers and workers, but also the owners from control over the instruments of production. In the typical big corporation, the stockholders have ceased to have significant control over the enterprise. Occasionally a proxy-fight may bring about a palace revolution though even this is likely to be very infrequent. A recent study of 500 larger corporations suggests that, on the average, a big corporation would have a proxy fight less often than once every three hundred years. For practical purposes, and most particularly for the purpose of this afternoon's analysis, we can regard the modern corporation as an enterprise in which control over the instruments of production [illegible]

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with management and ownership can as a practical matter influence production only through the market for capital much as workers can influence production through the market for labor and consumers through the market for products.

The successive separation of consumers, workers and owners from control over the productive enterprise has made it possible to organize production on a scale and with efficiency never before realized. The separation of consumer from control made it possible for a single enterprise to produce for millions of consumers; the separation of worker from control made it possible for a single enterprise to organize the productive activity of tens or even hundreds of thousands of workers; and the separation of ownership from control made it possible to bring the capital of tens and hundreds of thousands of owners under a single unified control. The result has been the creation of great engines of production of a magnitude, efficiency, and vitality that the Greek family could never envisage, however large it might be, and that would be impossible to one-man enterprise and rarely possible to owner-operated enterprise.

At the same time, in a very real sense these modern engines of production have acquired one of the major characteristics of the Greek family, that of collective enterprise. In them a single management interrelates the capital of many thousands of investors and the labor of many thousands of workers and the wants of many thousands of consumers in a great collective enterprise. These collectives differ from the collective of the Greek family since the same group of people are not both owner and worker and consumer in a single collective. But they are even more different from the private enterprise of Smith's one-man enterprise or Marshall's owner-operated representative firm. It is the economic power of these great collective enterprises with which we are concerned today and, as we shall see, the problem is

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basic because collective enterprise does not fit into the traditional legal and economic theories which have been built around the concept of private enterprise.

Central to traditional theory is the concept of the drive for profits controlled by competition. Economic theory showed that when each of a large number of small private enterprises were operated under a drive for profits, competition among them would determine prices and force the individual to serve the public interest. The individual producer did not have to consider the public interest. It was enough if he sought to make more profit. Competition would guide and control his action. And legal theory developed consistent with this economic theory, allowing government to break up monopolies or to regulate them where monopoly was natural. If we only had to deal with small private enterprises, the problem of economic power would not be serious and could undoubtedly be handled under traditional legal theory guided by traditional economic theory.

It is with respect to the big collective enterprise that these theories fail to serve. The first failure is over who should receive the residual profits of collective enterprise, owners or managers. You are all familiar with the logical conflict between legal and economic theory on this point, but I will outline the conflict since it is essential to the problem of economic power. In an owner-operated private enterprise, profits, of course, go to the owners and serve two major functions. First, the prospect of profit induces the owners to risk their capital and, second, the owners' desire for profits induces the owners to operate their enterprise efficiently. But in collective enterprise, ownership and control are separated so that these two functions are divided. The owners supply the capital, but management controls the enterprise and determines its efficiency.

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In this situation, traditional legal theory says that the profits belong to the owners. A profit sharing bonus to management would be legal if it was expected to stimulate more profits than it cost, but bonuses to management at the expense of owners would presumably be outlawed.

On the other hand, traditional economic theory says that residual profits, that is, profits over and above enough to stimulate capital investment, should go to management as an inducement to more efficient operation. According to the logic of traditional theory the maximum drive for profits would be obtained if the residual profit went to management and only enough profits went to owners to provide the wages of capital. Here we have a clear cut conflict in theory. Should the residual profits go to the owners, to the management, or what? In whose interest should the corporation be run? Some say the management holds its powers in trust for the stockholders. This is a legitimate legal inference. Others suggest that management holds its powers in trust for a broader constituency. Few, if any, have suggested that in practice management should run collective enterprise in its own interest. Yet this would be the reasonable solution if, in fact, the public interest would best be served if enterprise is run to make the maximum profits.

But here we come to a second failure of traditional theory--the failure of both economic and legal theory to deal adequately with market power in the presence of competition.

As you all know, up to a generation ago, economic theory drew a sharp distinction between competition and monopoly. An industry was either competitive and the benefits of classical competition were presumed to flow or it was subject to monopoly with results likely to be detrimental to the public interest. Legal theory paralleled

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this analysis and supported anti-trust laws to break up monopoly where it appeared "unnatural" and supported government regulation where monopoly appeared to be "natural". What both systems of theory failed to recognize is that competition among the few is not likely to produce the results in the public interest which could be expected from competition among the many. Neither economic nor legal theory took account of competition among the few. Conceptually, competition was the classical competition of Adam Smith and Alfred Marshall. And the legal efforts to maintain competition were outstandingly successful in preventing monopoly and outstandingly unsuccessful in maintaining or establishing classical competition. The result is that most of manufacturing industry is today dominated by the big three or the big four actively competing with each other but with effects quite different from those to be expected from classical competition.

An important break in theory came with the publication in 1933 of Edward Chamberlin's Theory of Monopolistic Competition in the United States, and Joan Robinson's Theory of Imperfect Competition in England. These two books made it abundantly clear that competition among the few could not be expected to serve the public interest in the same degree as classical competition. Where competition was among a few, market forces could not be expected to determine prices but only limit the range in which prices would be set. And with this range, often fairly wide, there was an area of discretion within which a price maker or price leader could determine price and an opportunity to make more than competitive profits through the exercise of pricing power. This opened up a whole new area of investigation.

Unfortunately in both of these ground breaking books, the exploration of the new territory was made with the traditional tools of monopoly analysis. It was assumed that each of the few competitors

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uld seek the price which would maximize his profit just as would a classical monopolist. Further, it was assumed that the price-maker would start with estimates of demand and costs and calculate from these the most profitable price under various assumptions as to what the few competitors would do. Then the interaction or interplay of the few competitors with such calculations as background would result in a price but one which was not likely to be that which would be produced by classical competition. There are undoubtedly some situations to which this approach applies. But it would seem to be of quite limited application, at least among the really big companies.

Both theory and the empirical evidence support quite a different approach. In the typical big business situation there are two considerations which appear to dominate the administration of prices. First, it is important that as far as possible, the minutiae of pricing decisions should be delegated to subordinates with only the crucial decisions made by top management. And second, the main consideration in the actual price is not the price which will yield the maximum profit, but the price which will keep down new competition and yield the maximum value. As we shall see, these are two quite different objectives and each involves quite a different calculus. One is focused on demand and costs; the other on the rates of return which will induce or keep out new competition. In the first, the problem is to determine the maximum profit. In the second, the problem is to determine the optimum balance between a higher rate of return and a greater risk of new competition.

As far as I know, the first logical presentation of this pricing calculus was made, not by an economist, but by a management engineer. In 1924, Donaldson Brown, then with DuPont and later a Vice President of General Motors,

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outlined a pricing procedure which is now extensively used by big manufacturing enterprises.

Because this procedure is so different from that derived from monopoly theory and because it opens up a new possibility for corporate management, I want to list the five steps which it involves.

The first step is to determine a target rate of return on capital--a rate which will represent the optimum balance between high returns and the risk of new competition. General Electric, General Motors and, presumably, DuPont, each uses a target rate of 20 percent after taxes in their pricing. Union Carbide uses 18 percent after taxes, Johns-Manville, 15 percent. US Steel formerly used 8 percent after taxes, but a few years ago revised its target rate upward considerably. It may now be close to 15 percent. A particular corporation may use different target rates for different branches of its activity and for new and for established products, or it may use a single rate for all its pricing calculations.

The second step is to adopt a standard rate of operation. This may be the actual average rate of operation over a period of years or a rounded figure close to the actual experience. Thus, if an enterprise finds that in the past, with the ups and downs of business activity, it has operated its plant at close to 80 percent of rated capacity, it is likely to use 80 percent as its standard rate for pricing purposes.

Final decision in these first two steps is usually taken by top management and the target rates of return and the standard operating rates to be used for pricing purposes are likely to remain unchanged for years and even decades at a time and provide the basis for price decisions at lower levels of management. These rates apply to general categories and may be decided on long before specific products to which they apply are made.

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The third step applies to specific products and consists of calculating or estimating the total cost per unit for the particular product on the assumption that operations will be at the standard rate. Thus, if the standard rate is 80 per cent of capacity, the operating costs, depreciation on plant and equipment and other overhead costs are calculated per unit for the output which would be produced if the plant and equipment were operated at 80 per cent of capacity.

The fourth step is to calculate the price which would just yield the target rate of return if demand were just sufficient to absorb the output at the standard rate of operation, using the figure for total cost already arrived at. This price would be the target price.

The final step is consider the target price in relation to the actual market and decide on the actual price. Here the prices of similar products and the likely demand for the particular product are considered. If it seems likely that under average business conditions, the target price would result in a sales just about sufficient to support the standard rate of operations, then the target price is likely to be adopted as the actual price. Likewise, if sales are likely to be greater, the target price will usually be adopted and capacity will be expanded as quickly as possible to allow the standard operating rate under average conditions. On the other hand, if the volume of sales at the target price seem likely to be significantly less than the standard requires because competitors are setting lower prices or for some other reason, then either the product would not be made or a lower price would be set and a major drive be made to reduce costs so that, at the lower price, the target rate of return would be made at the standard rate of operations.

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These last three steps are primarily the responsibility of the lower levels of management. On important products, the decisions are likely to be carefully reviewed by top management and final decisions made there. Also, where the target price is not adopted, there is good reason for higher review and final decision. But on less important items where the target price is adopted as the actual price, final decision can often be left to executives below the top management.

Let me run through these five steps again.

The sharp contrast between this pricing calculus focused on a target rate of return and the traditional calculus focused on demand and cost must be obvious. Target pricing starts with the target rate of return and works from that to costs and demand. Indeed, as I have said, the target rate may be decided on months or years before it is decided to make a particular product and before its costs or demand could be considered. In contrast, the traditional theory starts with demand and costs. Also, the target calculus involves a balancing of greater profit and greater risk of new competition. The traditional monopoly calculus, though it involves uncertainties of demand and cost, does not involve a risk factor.

One important effect of target pricing is to make prices relatively insensitive to changes in demand. The target rate of return is not a rate to be made in any particular year, but only the rate to be made under average conditions. In years of high demand, the target price will yield more than the target rate and in years of recession, it will yield less than the target rate. For a number of manufacturing companies examined in a recent Brookings study, all but one had averaged a little better than their target rate of return over an eight year period, yet in individual years the rates earned departed considerably from the target rate. At the same time, the target prices will

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e the same whether demand is high or low, except as costs change. This, undoubtedly, explains the insensitivity of administered prices in many industries.

Of more immediate importance for our present discussion, is the economic power reflected in target pricing. The purpose in target pricing is to obtain a rate of return above the competitive cost of capital but not so much above the competitive cost as to stimulate new competition. The more difficult it is to enter an industry, the greater the discrepancy between a competitive rate of return on capital and the target rate that can be successfully achieved. A target rate of return of 20 per cent after taxes would probably represent more than double the competitive cost of capital. The public utilities whose prices are regulated to allow only six to six and a half per cent return have had no difficulty in raising new capital for expansion. Whether, the <u>average</u> risk in the big manufacturing corporations is greater is open to debate. The big corporation is in many ways equivalent to a combination of smaller companies so that the risks in one division are in some degree offset by those in other divisions and the average risk is less. I strongly suspect that an average return of 8 per cent, after taxes, would allow most of the big collective enterprises to raise all the equity capital they need for expansion. Certainly an average rate of earnings very much below 20 per cent would be sufficient. Who among you would not invest new equity funds in a big established enterprise which held out a high probability of averaging 20 per cent on your actual investment?

What does this mean from the public point of view? It means that the drive for profits in these great collective enterprises does not serve the public interest. In three important ways the profit objective as the guide to operations conflicts with the public interest.

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First, prices result which are above the economic costs of production and profits are above the economic cost of capital. This represents a distortion in income distribution which may or may not be socially important.

Second and more important, it aggravates labor-management relations. Excessively high earnings on capital offer a constant target which in a sense justifies pressure from labor for increased wage rates. At the same time the focus on the drive for corporate profits amply justifies labor in adopting the same drive to get higher wages.

And third, and in my opinion most important of all, a high target rate of return means that the collective enterprise is not making full use of its potential. If a big corporation with its great resources of technology and organization and access to captial and labor will only make those things which will yield a 20 percent return when it can get equity funds for 8 or 10 percent, an economist must say that it is not serving the public interest as it should, or more exactly, as it would have to if it were subject to classical competition. And if a big corporation will only replace existing plant and equipment when the new will make 20 percent on the investment, it will fail to make full use of modern technology. I believe that, in the light of the Russian threat, this failure to make full use of the great potential of big business is the biggest public cost of a reliance on the profit drive in collective enterprise. From the public point of view, the drive for corporate profits is not a satisfactory guide to the operation of the big collective enterprise.

Some corporate managements have attempted to justify high rates of return on capital on the ground that high profits provide equity capital for expansion and that this is in the public interest. Such is the argument the management of the United States Steel Corporation gave when it raised its target rate of return from 8 percent to a

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much higher figure. But is it really in the public interest? From the economic point of view, the argument amounts to saying that it is in the public interest for customers to be overcharged so as to supply capital for expansion while the future profits from the new capital go to the credit of stockholders. If the customers were given stock in exchange for the overcharge, argument might carry some weight, but not when the benefits go to owners. Capital for expansion is important. And insofar as corporate earnings are legitimate, the withholding of these earnings for expansion is legitimate and legitimate profits made on such reinvested earnings appropriately go to the credit of stockholders. But for greater capital expansion the market for securities is an adequate source. The regulated public utilities have raised billions of equity capital for unprecedented expansion in the last decade, while unregulated big business has raised almost none. The idea that, for the big collective enterprise, expansion depends on or justifies a rate of profit above that corresponding to the competitive cost of capital does not seem to have a basis in economic logic. Nor can it justify the operation of collective enterprise under the profit drive.

Where, then, does this leave us? On the one hand, the separation of ownership and control has raised the very real question of who should get the residual profits from collective enterprise. On the other hand, the economic power of collective enterprise is such that the drive to make residual profits falls far short of serving the public interest. Can both problems be solved by a fresh approach to the operation of collective enterprise?

From the public point of view, just what do we want from the men who manage our collective enterprises?

First, we want the great engines of production which they operate to be operated efficiently and economically in the production of useful goods. This means that labor and capital and other resources should be combined as economically as possible and the products sold at prices which cover their economic costs. This means prices must cover the costs of material, labor and capital and the costs of capital must include both the recovery of capital through depreciation charges and a competitive rate of return on capital. This objective has been spelled out in classical economic theory, not as the objective of an individual enterprise but as the end result to be expected in the operation of an industry of many small units operating under conditions of classical competition and without economic power. Where economic power exists in the big collective enterprise, we want it used in such a way that it achieves much the same end results that made classical competition such a valuable institution where technology made it appropriate. The theory of classical competition can point to the end results that would be in the public interest but not the method that is appropriate to modern technology.

The second thing we want from the management of a big collective enterprise is unbiased arbitration between the parties at interest. By the very nature of the economic power of management, it is in the position of an arbiter, balancing the interest of investor and worker and customer or consumer. In almost any major decision it makes, it can bend that decision in greater or less degree in favor of or against one or more of the parties at interest and with little recourse by a losing party.

The fact of this arbitral role is well expressed in a recent statement by the President of the United States Steel Corporation, who said:

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We of management are responsible to manage the business in accordance with our judgment as to what will best serve the long-term interests of: the employees whose livelihood is dependent upon the Corporation; the stockholders whose invested money provides the tools of production and jobs; the customers who buy our products and thus provide employment; and the people of the consuming public who depend upon steel as one of the basic commodities of modern life.

We have already seen that the drive for profits cannot be expected to achieve the first of these two objectives, that of an economical engine of production. Also, the drive for profits insofar as it activates management through bonuses or otherwise must introduce a bias into its decisions affecting the parties at interest. Who ever heard of giving a bonus to a group of arbiters for favoring one of the parties to the arbitration? Clearly, the drive for corporate profits cannot be expected to serve the public interest in either efficient operation or unbiased arbitration.

What, then, can take the place of the drive for corporate profits? I believe there are two institutional changes which, in combination, would provide an effective alternative.

The first depends on the target techniques of pricing. So far as the mechanics of pricing are concerned, the actual target rate of return is not important. The pricing process would be essentially the same whether the target rate adopted was 20 per cent or 10 per cent or 8 per cent. If top management found that adequate capital could be obtained from the public market when an average of 8 per cent on capital was earned after taxes and if it adopted 8 per cent as the target rate, the rest of the pricing process would follow and prices would tend to correspond to average economic costs.

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Under given economic conditions this would result in a greater volume of sales because of the lower price and a greater plant expansion would be required. This would reflect the more effective use of resources. Also, it would give legitimacy to management in its demand that labor be reasonable in its wage demands, a legitimacy that is certainly lacking when management is under a drive to make more profits.

However, while a target rate of return geared to the actual cost of capital would be an effective guide to pricing it would not provide the other pressures for economical operation which is provided by corporate profits. To find a substitute we must consider the factors which motivate management.

Perhaps the four most important motivations of top corporate management are:

1. The drive for power
2. The drive for prestige
3. The satisfaction of a job well done, and
4. Money rewards

Obviously a big corporation can serve the desire for power and whether this power will increase or decrease will largely depend on the public attitude toward corporate operation and is not a product of profits as such.

Both prestige and satisfaction with a job well done depend in large measure on the definition of the job itself. If the objective of the game is to make profits, then prestige and satisfaction depend on making profits. But if the objective of the game can be redefined, then prestige and satisfaction in accomplishment need not be tied to corporate profits.

Money rewards to <u>management</u> also do not need to be tied to

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corporate profits. Many corporations now have two bonus systems, one for top management that is geared to corporate profits and the other for lower levels of management that is geared to performance. Under the latter, a plant manager might receive bonuses for cutting costs in his plant or improving product or reducing down time in the operation of his equipment. Modern management engineers have gone a long way in developing measures of performance for executive below the very top and bonuses for performance are regarded as superior to profit sharing bonuses for lower management.

I believe a system for performance bonuses for top management could also be worked out. Such a system would include a bonus for making a target rate of return arrived at on the basis of capital costs. This would make a legitimate profit a prime objective of management. The performance bonus system would also, presumably, include bonus factors for cost reduction, product improvement, research and development, and for such other items of good management as could be effectively measured. To some degree it might be effective to make performance bonuses to top management a ratio to performance bonuses earned by lower management. I will not here go into the problems which would be involved in the designing of performance bonuses for top management. For present purposes it will be sufficient to assume that performance bonus systems could be designed and that the management drive for such bonuses would lead to operations more closely in the public interest than operation under the drive for greater corporate profits.

However, there is one problem with respect to bonuses that we do need to consider. This is the effect of income taxes on bonuses.

In the past, most of the big companies have given cash bonuses to top management for increased profits. But with high income tax rates, cash bonuses have very little incentive power. A high salaried executive is likely to pay most of any cash bonus to the Federal government.

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If the president of a big company receives $200,000 as salary (more than half already going to the government) a bonus of $200,000 is likely to net him only $18,000. As a result, many corporations have adopted a stock option plan whereby the top officers are given rights to buy stock from the corporation at the market price prevailing at the time the right is given and good for a period of years. If the stock rises in price and the option is exercised, the gain from the sale of the stock after six months will be taxed as a capital gain. Such options place top management under great pressure to increase profits so as to raise the market value of the stock and obtain income not subject to the very high tax rates.

If cash bonuses for performance are to be substituted for profit bonuses and made effective with top management, changes in tax law would be needed to increase the take-home pay from such bonuses. This I will consider after discussing certain legal problems.

For purposes of legal discussion, let us concede that the economic logic of collective enterprise points to a target rate of return geared to capital costs and performance bonuses to top management. We must then ask, would these two institutional changes be legally feasible?

First consider a voluntary shift on the part of management. Suppose that the management of a corporation deliberately adopted the dual program of a performance bonus system for top management and a policy of target pricing at a rate of say 10 percent when it could average 20 percent. Would this stand up in the courts? I am not a lawyer, but I presume that unless the program were presented for a stockholder vote it would not find legal support. And even if a majority of

holders interest. Perhaps a moderate move in the direction of a lower target rate could be successfully defended by management on the ground that the long-run interest of stockholders would be served. Also, some degree of performance bonus for top management could be adopted provided it was combined with a profit bonus which could be expected to stimulate even greater profits. But for both changes the legal argument in defense would presumably have to be in terms of the stockholder interest. Without new legislation, I would not expect such a shift to carry very far.

Next consider tax legislation which greatly reduced personal income tax rates on performance bonuses paid by collective enterprises which adopted a legitimate target rate of return. The legislation might, for instance, treat such bonuses as capital gains. There would be problems of delimiting the corporations which would fall into the class of collective enterprises. I shouldn't think there would be more than 100 or 150 such enterprises at most. Also, there would be the problem of distinguishing performance bonuses from profit bonuses or stock option plans. This I should not expect to be too difficult. At first the line could be leniently drawn and only made precise with operating experience. Finally, there would be the problem of distinguishing between legitimate target rates of return and excessive rates. Here also the initial interpretation could be lenient and gradually sharpened as the actual experience of each particular corporation in raising capital became available. In this respect, I would not be a perfectionist. The difference between a 20 percent return after taxes and 8 percent can have important social consequences, that between 10 and 8 percent would probably be minor.

The real legal question is whether, with such legislation in operation, the adoption of the dual program by management could be overturned in the courts. As I envisage the tax law, it would provide a big inducement to management to adopt the performance bonus system, particularly if the same legislation removed for collective enterprises

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the capital gains provision associated with stock option bonuses. But it is difficult for me to find any great advantages to the stockholders from the reduced target rate of return and reduced prospective earnings. Therefore, I assume that a stockholder appeal to the courts would be equally successful whether or not there was a change in income tax law.

On what basis can the stockholder be made to have an interest in putting such a dual plan into effect or be forced to accept such a plan?

Here it seems to me we break into new legal ground--or perhaps, as a non-lawyer, I should say here is where I get out beyond my depth. If I have analyzed the economic problem correctly the rates of return on capital are currently too high for the public interest to be fully served because there is neither public regulation or a close approximation to classical competition. From the public point of view, the stockholders are getting returns out of proportion to their contribution to production and the public problem is to bring these returns down.

One way to do this would be legislation which delineated the class of collective enterprises, denominated them as vested with a public interest and required them to use a target rate of return related to their costs of capital. Such legislation would not be nearly as difficult to police as direct regulation and would give much more freedom of action to the individual enterprise. Also, if a legitimate target rate of return was required, then it would be in the interest of both stockholders and management to adopt a performance bonus plan provided it included a bonus for making the target rate.

The question is then whether such legislation could be successfully defended in the courts? I suppose that the strongest line of defense

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would be that these collective enterprises are so big that competition does not adequately control their behavior and that they involve the life and property of so many people that they have become vested with a public interest and are therefore subject to regulation, and that the type of regulation involved in the legislation is a mild form indeed. Would it strengthen the legal case to point out that the stockholders had surrendered practical control over the enterprise and therefore were not entitled to more than the wages of capital? Would it strengthen the legal case, if instead of requiring the adoption of a legitimate target rate of return, the stockholders were given a choice of 1) accepting the status of a collective enterprise with all that implies, or 2) breaking the enterprise into smaller units so that it was beneath the size and importance which gave it the vestments of a public interest?

In the Modern Corporation and Private Property, Berle and I suggested that the separation of ownership and control made both the logic of property and the logic of profits inapplicable to the modern corporation and that corporate developments "have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society." I now suggest that target rates of return based on the cost of capital and suitable bonus plans based on performance would go a long way toward meeting this demand. As an economist I look to the law to make this possible.