How Capitalist is America?

By Mark Roe

If capitalism’s border is with socialism, we know why the world properly sees the United States as strongly capitalist. State ownership is low, and is viewed as aberrational when it occurs (such as the government takeovers of General Motors and Chrysler in recent years, from which officials are rushing to exit). The government intervenes in the economy less than in most advanced nations, and major social programs like universal health care are not as deeply embedded in the US as elsewhere.

But these are not the only dimensions to consider in judging how capitalist the US really is. Consider the extent to which capital – that is, shareholders – rules in large businesses: if a conflict arises between capital’s goals and those of managers, who wins?

Looked at in this way, America’s capitalism becomes more ambiguous. American law gives more authority to managers and corporate directors than to shareholders. If shareholders want to tell directors what to do – say, borrow more money and expand the business, or close off the money-losing factory – well, they just can’t. The law is clear: the corporation’s board of directors, not its shareholders, runs the business.

Someone naïve in the ways of US corporations might say that these rules are paper-thin, because shareholders can just elect new directors if the incumbents are recalcitrant. As long as they can elect the directors, one might think, shareholders rule the firm. That would be plausible if American corporate ownership were concentrated and powerful, with major shareholders owning, say, 25% of a company’s stock – a structure common in most other advanced countries, where families, foundations, or financial institutions more often have that kind of authority inside large firms.

But that is neither how US firms are owned, nor how US corporate elections work. Ownership in large American firms is diffuse, with block-holding shareholders scarce, even today. Hedge funds with big blocks of stock are news, not the norm.

Corporate elections for the directors who run American firms are expensive. Incumbent directors typically nominate themselves, and the company pays their election expenses (for soliciting votes from distant and dispersed shareholders, producing voting materials, submitting legal filings, and, when an election is contested, paying for high-priced US litigation). If a shareholder dislikes, say, how GM’s directors are running the company (and, in the 1980’s and 1990’s, they were running it into the ground), she is free to nominate new directors, but she must pay their hefty elections costs, and should expect that no one, particularly not GM, will ever reimburse her. If she owns 100 shares, or 1,000, or even 100,000, challenging the incumbents is just not worthwhile.

Hence, contested elections are few, incumbents win the few that occur, and they remain in control. Firms and their managers are subject to competitive markets and other constraints, but not to shareholder authority.

In lieu of an election that could remove recalcitrant directors, an outside company might try to buy the firm and all of its stock. But the rules of the US corporate game – heavily influenced by
directors and their lobbying organizations – usually allow directors to spurn outside offers, and even to block shareholders from selling to the outsider. Directors lacked that power in the early 1980’s, when a wave of such hostile takeovers took place; but by the end of the decade, directors had the rules changed in their favor, to allow them to reject offers for nearly any reason. It is now enough to reject the outsider’s price offer (even if no one else would pay more).

American corporate-law reformers have long had their eyes on corporate elections. About a decade ago, after the Enron and WorldCom scandals, America’s stock-market regulator, the Securities and Exchange Commission (SEC), considered requiring that companies allow qualified shareholders to put their director nominees on the company-paid election ballot. The actual proposal was anodyne, as it would allow only a few directors – not enough to change a board’s majority – to be nominated, and voted on, at the company’s expense.

Nevertheless, the directors’ lobbying organizations – such as the Business Roundtable and the Chamber of Commerce (and their lawyers) – attacked the SEC’s initiative. Lobbying was fierce, and is said to have reached into the White House. Business interests sought to replace SEC commissioners who wanted the rule, and their lawyers threatened to sue the SEC if it moved forward. It worked: America’s corporate insiders repeatedly pushed the proposal off of the SEC agenda in the ensuing decade.

Then, in the summer of 2010, after a relevant election and a financial crisis that weakened incumbents’ credibility, the SEC promulgated election rules that would give qualified shareholders free access to company-paid election ballots. As soon as it did, the US managerial establishment sued the SEC, and government officials felt compelled to suspend the new rules before they ever took effect. The litigation is now in America’s courts.

The lesson is that the US is less capitalist than it is “managerialist.” Managers, not owners, get the final say in corporate decisions.

Perhaps this is good. Even some capital-oriented thinking says that shareholders are better off if managers make all major decisions. And often the interests of shareholders and managers are aligned.

But there is considerable evidence that when managers are at odds with shareholders, managerial discretion in American firms is excessive and weakens companies. Managers of established firms continue money-losing ventures for too long, pay themselves too much relative to their and the company’s performance, and too often fail to act aggressively enough to enter new but risky markets.

When it comes to capitalism vs. socialism, we know which side the US is on. But when it’s managers vs. capital-owners, the US is managerialist, not capitalist.

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