

Book Review I:

by Zhiyan Cao

Adolf A. Berle & Gardiner C. Means: *The Modern Corporation and Private Property*

The key insights in *The Modern Corporation and Private Property* by Adolf A. Berle and Gardiner C. Means are twofold: the separation of ownership and control, and the evolving, complex corporate capitalism. Or, stated in another way, the book is basically about how the evolution of modern corporation system destroyed the traditional concept of “private property” by such separation, which in turn poses great challenges on the survival and evolution of modern corporation and relative legal settings.

The first insight, i.e. the separation of ownership and control, is enduring. Today whenever we ask a policy-related question about corporate governance (i.e. the relationship between various participants in determining the direction and performance of corporations) or whenever we talk about the theory of accounting control in our seminar, we may always tend to cite, explicitly or implicitly, Berle & Means’ empirical result on the concentration of economic power in the early 20th century, which intrigued their concern of the separation of ownership and control -- Namely, that one-third of the national wealth lay in the hands of 200 large corporations, and that individual property had gone into the hands of “collective hoppers” which gave rise to industrial oligarchies with tremendous political influence. And it is at the presence of these facts that neoclassical model about some profit-maximizing individual entrepreneur offers little in explaining the equilibrium in market and many other phenomena of economics life. The reason lies in that the invisible force formerly regulating the multitude of small competing elements of private enterprises may fall short when we “think in terms of huge units”.

The second insight, i.e. the evolution of corporate capitalism, is made along the way Berle & Means documented the aforesaid separation. They point out, in their opening remarks of Book I “Property in Flux: Separation of the Attributes of Ownership under the Corporate System”, that “corporations have ceased to be merely legal devices through which the private business transactions of individuals may be carried on... The corporations has, in fact, become both of a method of property tenure and a means organizing economic life”. In going into more details on this, Berle & Means argue that great changes in corporate structure has destroyed the unity commonly called “property” by dividing ownership, which they define as “full power of manual disposition with complete right to enjoy the use, the fruits, and the proceeds ”, into nominal ownership and the power formerly joined to it (or “beneficial ownership” and control). As a result, the nature of capital also changed: to an increased extent, it is composed not of tangible goods, but of organizations built in the past and available to

function in the future. As dispersion of stock ownership furthers, wealth is “less and less in a form which can be employed directly by its owner” because it is no longer of direct use unless through sale in the stock market.

Noticing the above trends, and the gradual breaking up of the rigid protections (originated from the first half of the 19th century) of shareholders, Berle & Means proposed the law of trust, of which corporate law becomes one branch in substance. The rule in their mind is clear-cut: namely, that no power, however absolute in terms, is absolute in fact; that every power is subject to the essential limitations (controls) imposed by the court. Therefore, they say, “no form of words inserted in a corporate charter can deny or defeat this fundamental equitable control”, since otherwise it is to “defeat the very object and nature of the corporation itself”. In achieving this, new remedies may be worked out and applied by the courts in each case. All these may well indicate their inclination for the government intervention rather than a self-regulation approach in putting constraints on corporate powers and thus making it “powers in trust”.

In essence, in *The Modern Corporation and Private Property*, Berle & Means’ ultimate concern about the evolution of modern corporate system and changes in the attributes of private property is, as far as my understanding goes, that such evolution should by no means invade individuals’ personality and freedom, or bring forth discrimination against categories of men. And that is why they argue that “the shareholder’s right to spend the income from or use the liquid value of his shares as he pleases” should be “guarded as a defense of his right to order his life”, which is the right inherent of the civilization of the democratic processes. This is really profound. And I think I would hereafter always ponder for some time over the logo of “We’re the investor’s advocate” on the official web site of SEC instead of taking it for granted.

There are quite a few points worth mention when we relate this book to the later theory of firm. In *The Modern Corporation and Private Property*, Berle & Means have identified five major types of controls, namely, 1) control through almost complete ownership, 2) majority control, 3) control through a legal device without majority ownership, 4) minority control and 5) management control. And of these, it was the last type that concerns Berle & Means most. It is worth note that here the idea of “control” is the control *of* the corporations, emphasizing more on the disparity of relative bargaining power of shareholders and management than the concept of control *in* the firm would do. In the view of firm as a set of contracts, there is no longer need to cut a distinct line between “nominal ownership” and “beneficial ownership”, since shareholders, as well as management, are simply one of the many contracting parties (in that symmetric picture of firm) that contribute resources and receive entitlements. Also in this view, the problems and challenges brought forth by the separation of

ownership and control are well framed into the more general name of “agency cost”. Berle & Means seem to be, in this light, overstating the power of the controlling management, since firms may finally get eliminated by market competition when their agency costs get too high, leaving the managers disadvantageous in the labor market consequently, or in other cases, other agents in the firm simply have the power to unilaterally terminate a manager’s contractual relationship with the firm without giving any specific reasons. Finally, Berle & Means did not give any explicit conjectures, but it is obvious that they had sensed the need for designing better self-enforcing managerial contracts, for they suggested that high salaries alone do not provide effective motives with the separation of ownership and control. Bonuses and stock options are widely used today, but I doubt there would really be consensus as to what the optimal compensation package should be like.

Berle and Means also had many interesting foresights in *The Modern Corporation and Private Property*. For example, many of the methods they listed for possible accounting manipulation, for example, “manipulation of inventory values”, revaluation of property “on reorganization”, etc. (see Book III, Page 272), are still concerns of accounting standard setting bodies and organizations of security market regulation. Another point is that one of the alternatives they pointed out for reorientation of corporate activity is that “neither the claims of ownership nor those of control can stand against the paramount interests of the community”. This urge to place the modern corporations into a position to serve all society as well as owners or the control is surely a positive standing and today it is not rare to find giant corporations claiming similar ideas and taking similar stance to get the favor of community and society.

Overall, I suppose I give this book an A. For one thing, it sure serves as a good source in giving us both historical context and implications of the evolution of modern corporation and the problem of management responsibility, which stemmed from the fact that separation of ownership and control released the management from overriding requirement to serve stockholders. For another, I think *The Modern Corporation and Private Property* is really a vital book in that many intriguing questions Berle & Means posed at the end of different chapters (yet left unanswered), are still good topics worth digging into today. And I believe such endurance will go for another long time.

Book Review II:

Jean-Jacques Rousseau: *The Social Contract*

Jean-Jacques Rousseau stresses, in *The Social Contract*, the idea of a social contract as the basis of society. The social contract was between all members of society, and essentially replaced "natural" rights as the basis for human claims -- i.e. In reaching such kind of social contract, human beings are said to have abandoned the state of nature in order to form the society in which they now live on. Rousseau's idea is somewhat similar to that of John Locke about the social contract. However, it was in a way much more profound because it bears an element of symmetry in its argument about contracting rather than emphasize a contract between the governors and the governed (with implied asymmetry inherent of the master-servant relationship), which was did in Locke's version. Rousseau's concept of social contract, along with those of equality and freedom, is used as justifications for both the American and French revolution and may well be the theme and the fundamental building block of the United States of America. (And I recall that someone also consider Rousseau's ideas in *The Social Contract* as a forebear of modern socialism and Communism, on which Karl Max had several great works.)

Rousseau's basic premise is that the means by which a group of people enter into a social contract is the "general will". The general will is constructed by the people who in turn obey it as citizens and considers only the common interest of people rather than a sum of particular wills, which he give the name of "the will of all". In the derivation of the general will, Rousseau emphasizes that every man is free and equal. In arguing so, he distinguishes personal freedom ("state of nature") from social freedom as well as equality from identicalness of degrees of power and riches. In explaining why the general will is necessary, Rousseau's idea seems to be that social freedom is superior to a state of nature, and that in a state of nature people are not completely free because they are ruled by their desires instead of by reason. The general will is rational and should then be the ruling body. He argues that "what man loses by the social contract is his natural liberty and an unlimited right to everything he tries to get and succeeds in getting; what he gains is civil liberty and the proprietorship of all he possesses."

Given the premise, Rousseau concludes that a nation can only be created when entirety (rather than majority) of the people want one to be created and that the nation has to be governed by the general will. He then gives further arguments as to what type of government best fits groups of people in different absolute or relative situations and how it is possible to reach the General will. Finally,

Rousseau says that every nation is destined to disintegrate and but it does not follow that the general will is exterminated or corrupted. Rather, the general will “ is always constant, unalterable and pure; but it is subordinated to other wills which encroach upon its sphere” and all one can do is to build as strong a nation as possible and make it last for as long as possible.

There were several points that Rousseau made along the way that I thought were interesting, particularly in finding echoes in the view of the firm as a set of contracts.

For example, Rousseau says that “... in the social contract, any real renunciation on the part of the individuals, that the position in which they find themselves as a result of the contract is really preferable to that in which they were before.” This is similar to the argument in the firm model that by contracting with other agents, each of them would improve their lot. The only difference may be that while the agents in the firm model are assumed to be rational in that they do not deliberately choose the less desirable actions, Rousseau does not tell us if people knowingly choose to enter the social contract because they are aware of the favorable outcome of becoming a member of such association by rational comparison.

Also, Rousseau asserts that in place of the individual personality of each contracting party, the act of association into a social contract “creates a moral and collective body, receiving from this act its unity, its common identity, its life and its will”. An operating firm is no different from such “collective body”, in a way that once formed, it has the will and right to maintain business in its own name, to sue and to be sued on its own behalf irrespective of the individuals and to have perpetual succession (unless some contracting party withdraws from it in favor of his situation before such association).

In Rousseau’s view, the fundamental problem that Social Contract provides the solution is “to find a form of association which will defend and protect with the whole common force the person and goods of each associate, and in which each, while uniting himself with all, may still obey himself alone, and remain as free as before.” In Rousseau’s mind, every subject in such association is equal and has no more power or influence on the general will than any other citizen in the society does. In doing so, he implicitly, present a symmetric picture of social contracts which involves no such things as master-servant and superior-inferior relationship.

A final snippet: Rousseau also says that “the clauses of this contract are so determined by the nature of the act that the slightest modification would make them vain and ineffective; so that, although they have perhaps never been formally set forth, they are everywhere the same and everywhere tacitly admitted and recognized, until, on the violation of the social compact, each regains his original rights

and resumes his natural liberty, while losing the conventional liberty in favor of which he renounced it.” The reason why I am quoting this with great length is that Rousseau here gives very vague conditions under which breach of social contract takes place. Neither does he discuss much about the possibility and the mechanism of renewing the social contract,

There were several ideas of Rousseau I think may be too idealistic. (And what accounts for my only dissatisfaction about the book is that Rousseau never explains how the ideal, stable government he describes can take place in the presence of other nations which might not be running along his principles. Actually, he seems to know the answer but simply “didn’t have time” for further explanation.)

Firstly, Rousseau thinks that we mature as human beings in such a social setting, where we are not simply driven by our appetites and desires but become self-governing, self-disciplined beings. He requests people to abandon their personal freedom in order to sacrifice for social freedom. This is not very much consistent with the common assumption that people are instinctively selfish and that to eliminate this fact would be very difficult. Secondly, Rousseau believes in order to fully express the general will, there must be a complete democracy with no representation. This may be feasible to some extent with his notion of country at that time. But in a large country of the size as that of US, China and India, this is physically impossible and inefficient, hence, wasting too much resource. A compromise of this may be an equilibrium that most democratic countries are struggling for: the largest number of representatives along with the greatest administrative efficiency and effectiveness. Thirdly, Rousseau says “it is always an evil to unit several towns to one nation”, but in reality the entire population needs to get together to have a national meeting of “all citizens” in a regular basis. Fourthly, Rousseau says that in a healthy government there should be no debate or disagreement about should be done. This is doubtful, since I regard different voices as an indispensable element of a healthy democratic government and any consensus should only be the favorable result of all those debates rather than being the criteria for “healthy”. Finally, Rousseau believes that nations should produce exactly as much as is needed and that imports / exports cannot be allowed and his definition of “success” of a nation obviously does not count immigrants. This sounds a far cry from what the modern society looks like.

Overall, I thought Jean-Jacques Rousseau’s *The Social Contract* was fairly clear (though there were some points where I got lost due to unfamiliarity with certain part of history) and gave me a good feel of the historical origin (though very far away) of the thoughts about the symmetry of accountee-accountor relationship. I do not agree with everything in it, but I do feel that it is worth a reread sometime later because there are still quite a few abstruse points that I cannot get past.