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Impact of Firm Governance During Recessions

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Abstract: While recessions manifest as market imbalance, deeper underlying causes always exist. At the firm level, governance structure can matter more in a crisis than others have thought. The specific dynamics of recessionary profit challenges essential pillars of conventional theory. Extra firm revenue undermines the image of market forces as an equilibrating, efficient, and unbiased mechanism. In such a context, firms become exposed as a reservoir for profit in several forms. Tendencies arising around distributions of such revenues can exacerbate a crisis and prevent recovery. Multilevel coordination failure licenses a rival model of the firm as a microfoundation for improved macroeconomic performance.

JEL Codes: P16

Key Words

recessions, firms, stakeholders

1. Introduction

A foundational belief in modern economics has been that markets protect individuals from firms. Accordingly, the greater degree that revenue escapes market influence, the more firm governance matters. Non-market allocated revenues lead to the existence of profit that raises important questions. To what extent do these profits contribute towards income stratification? Does the extra revenue lead to rent-seeking allocations and distributive inefficiency? Do the trapped profits become excessive accumulation of retained earnings undermining macro stability? In harsher and blunter terms, profit making suggests exploitation, predation, and havoc.

Ironically, rapid growth with peaking revenue can mitigate the pernicious effects of profiteering. When incomes generally rise, it calms many burdens gathering upon the middle and lower strata. The endogenous costs of rent seeking seem less expensive when netted against robust growth. With tighter labor markets in the boom years, the unemployed feel far fewer with faster relief. As a result, during better times, it becomes less urgent to look inside the inner workings of the firm. In contrast, sharp downturns tend to loosen the reach of market mechanisms in their own way. The cumulative interaction of institutions and agents can no longer be explained as convincingly by market parameters. During bad times, theories reducing firm behavior to market dynamics fade in relevance, while other factors can more clearly be seen as key drivers of economic decisions. Markets become better understood as an open structure rather than a deterministic mechanism. This insight leads to the argument that firm governance structures matter more than ever in a recession.

In contrast, the conventional wisdom on downturns is that even if markets break down, competition will propel a robust recovery within reasonable time. Neoclassicals advise patience, because technological innovation will relentlessly create new jobs and raise standards of living.[1] The Keynesian approach urges government stimulus. They think that aggregate spending just needs a boost, and the new momentum will multiply into a major rebound.[2] However, if firm governance is rooted in a flawed distributional mechanism, neither technology nor fiscal spending guarantees anything. Throughout our latest recession, U.S. GDP per capita approached levels of around $200,000 for a family of four.[3] That already demonstrates a high degree of technological progress, without underdevelopment or productive scarcity. Additionally, the sizable national debt moving over $17.2 trillion makes clear that we have continued with significant spending stimulus.[4] That suggests that even if our $16.9 Trillion GDP multiplied ten times to become over $169 Trillion GDP, the same problems could persist.[5] Repeatedly, wealth and national output have not prevented recessions or unemployment. Many millions could still be out of work, on food stamps, and below the poverty line given the way distribution occurs in this economy. What I am suggesting is that the problems are more fundamental than either dominant approach, and require changes at the firm level.

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[1] In a Wall Street Journal opinion piece on December 23, 2013, Robert Grady, who is a chief advisor to New Jersey Governor Chris Christie, calls economic growth, "the defining challenge of our time" as the way to better lives for the majority.
[2] In the Economist, September 1, 2010, outgoing Chair of the President's Council of Economic Advisors, Christina Romer urges departing policy advice for, "the government to spend more and tax less."
[3] World Bank national accounts data showed 2012 U.S. GDP per capita as $49,965.
[4] U.S. Department of the Treasury, Bureau of the Public Debt showed $17,222 Billion as the National Debt as of December 4, 2013.
[5] Bureau of Economic Analysis, National Income and Product Accounts showed GDP of $16,890 Billion on its release December 5, 12/5/2013.

2. Evidence of Markets as an Open Structure

The breakdown of markets manifests at the firm level as undirected revenue. That is why it is so important to investigate firm governance. All forms of profit can expand due to recessionary conditions. In our latest downturn, we see many empirical anomalies that point to a relaxed impact of the market mechanism on firms, and enhanced profits in all forms. Those breakdowns occur across all kinds of markets whether they involve labor capital, or products.

Rising profit would be expected when a firm captures the advantages of a weak labor market. With higher unemployment during the recession, labor productivity has been shown to diverge noticeably from wages. For instance, since 2009 real hourly compensation has remained flat while over that same period output per hour rose 6%.[6] This suggests that employees are laboring longer and harder on the job. With evidence of greater profit being earned off workers, it could be imagined that combined effect of a multi-market mechanism will return the revenues back to those who produced it. Yet the evidence is that no market mechanism is available to do this. The extra profits are confirmed further by statistics that show workers losing their labor share of national income to their employer. Compensation to National Income moved from a 2007 pre-Recession level of 65.0% falling to 60.9% in 2012.[7] Additionally, compensation itself is increasingly stratified with a rising Income Gini Ratio. That increased from a measure of .432 in 2007 upwards to .452 in 2012. This suggests that executives may also be better positioned in recessions to take an increasing share of still dwindling wages and salaries.

[6] Data drawn from Bureau of Labor Statistics Productivity and Costs released November 14, 2013.
[7] Data drawn from Bureau of Labor Statistics National Income and Product Accounts released December 5, 2013.

Further evidence suggests that capital markets do not perform reliably either. So, if labor markets offer an arbitrage opportunity I would argue that does not necessarily mean capital markets will direct revenue distribution in any helpful way. The record shows that corporate strategies have neglected both dividend distribution and productive use of those profits in many ways. One tendency is to accumulate cash hoards. This was well publicized by Bob Pisani of CNBC saying that corporate cash holding "set a record for 18 of the last 20 quarters."[8] Furthermore, firms that own our capital are making a decision that it is not profit maximizing to employ extra revenue productively, leaving their machinery sitting idle. Total Industry Capacity Utilization had a 2009 pre-recession high of 81% with a low of 67% in 2009. As of October 2013 that usage was still only 78%.[9] The firm makes the decision with profits to outsource their foreign direct investment, which continues as a spending leakage at an accelerated pace. Outflows of Foreign Direct Investment continue to far exceed inflows. In fact, that leakage has increased from a net outflow of $193 Billion in 2007 continuing at an elevated level to $222 Billion in 2012.[10]

In product markets, firms capture ever-larger markups on consumer spending with higher margins when there is growing market concentration. This would be expected with growing number of business bankruptcies. There were 19,695 business bankruptcies in 2006 but that reached up to 60,837 by 2009 and was still 40,075 in 2012.[11] With fewer firms, industry concentration increases with an expected payoff to surviving firms. The

[8] Bob Pisani on CNBC Trade Talk "Companies Sitting on Cash Piles over $1 Trillion." July 26, 2013.
[9] Data drawn from the Bureau of Labor Statistics Productivity and Costs released November 15, 2013.
[10] Data drawn from Bureau of Economic Analysis International Transactions.
[11] Data drawn from the American Bankruptcy Institute.

environment that encourages bailouts also discourages government regulation of consumer markets. Hence, the problems of asymmetric information should be exacerbated. That means less money spent on quality control and more frequent instances of price gouging. The lower quality products and price dispersion mean higher profit. Additionally, fiscal and monetary policies help existing companies cut costs. Corporations ransom more desperate cities, states and the federal government for support in the billions of dollars to enhance their profit. Furthermore, federal corporate income tax continues to shrink as a share of GDP. That relative share of GDP currently stands at a mere 1.5%. Also, the cost of capital has been lowered with increasing windfall profits. The bank prime loan interest rate has stayed pinned at a nominal low of 3.25%. That benchmark corporate cost of borrowing sits at the lowest since the mid 1950's.[12]

So what is the problem? What happens to all of these profits if the firm is making all of them? The payoff to market failure feeds through the firm. Everyone else is a loser. Those stakeholders include workers in addition to consumers, taxpayers, borrowers, citizens and communities. That is a social systemic problem, and economic theory already understands this, but has not integrated it into a new theory of the firm. It has only been handled piecemeal in separate fragmented analyses. In contrast, if our markets did indeed work in a way meaningfully close to a general equilibrium, then there would be no profits, and nothing extra would need to be distributed by the firm (Walras 1874). Distribution would go according to a version of product exhaustion, and each factor would receive according to its contribution (Wicksteed 1894). Laborers would receive a wage share according to their work. Wealth holders would be getting their share

[12] Data drawn from the Federal Reserve Board of Governors Historical Data released as of December 2, 2013.

according to the productivity of their resource contributions. But what happens if there are profits? That suggests that all of the mechanisms broke down. It also says that there remains no market mechanism left to impose a distribution upon that very same extra revenue. Slack in the system that creates profit suggests a coexisting slack in the system of distributing that profit. The concept of efficiency collapses (Pareto 1906). I am suggesting that this slack means that firm governance matters because it is the institutional mechanism that takes over from markets to direct revenue distributions.

3. Conceptualizing the Profit Distributing Firm

What is at stake is that firms impact the economy in a decisive way as much because they distribute revenue as because they earn it. Yet, in the basic theory of the firm, this distributive function is under theorized because the competitive firm is understood not to earn any profit. Market parameters are thought to direct revenue distributions according to product exhaustion theory in an unbiased and efficient way. Prices are competed down towards average cost per unit. That eliminates all profit. Hence, with that perspective there is no need to consider any other distributional process. But what if our economy does not actually work so tightly wound? Who would get the extra revenues? What would they do with that profit? How stable would that economy be?

To answer these questions, first we need some theory of firm revenue distribution. Firms ordinarily distribute their revenues to a variety of different groups. One group who receives distributions is laborers. Some work directly in the firm's profit making activity and others are only indirectly contributing through general and administrative functions. Other individuals receiving revenues are part of external groups like landlords getting rent, moneylenders receiving interest and the state collecting taxes. Finally, the firm has to decide how to spend any leftover funds. Those might be distributed back to property holders as dividends or retained for investment either financially or productively. The distribution of firm revenue is multifaceted and complex. When markets cannot strictly determine distribution, the resulting distributions filter through an array of political, cultural, economic, and other social forces.

For instance, if the wages in markets for direct laborers are depressed, the firm's gross profit should rise. It would also depend on capital goods markets for the costs of raw materials, and machinery and equipment. It will depend on prices for products to be sold to the extent markets determine the price of output. With a recession creating unemployed labor and capital, gross profit becomes a windfall across many firms. The resulting rise in gross profit does not necessarily go to owners of the firm. Many others can absorb some of the gain. Those extra revenues would be subject to the idiosyncrasies of firm governance rather than competitive mechanisms. In that way, firms contribute to growing wage inequality.

While direct laborers could be receiving compensation based on their replacement cost rather than productivity, managers on salary or salespeople on commission might receive enlarged compensation. Meanwhile, margins increase and the metrics determining general and administrative salaries trigger bonuses and raises for indirect laborers. For instance, information technology that eliminated many jobs could emerge better off. With heightened unemployment, security concerns increase to levels justifying better paid guards and watchmen. Personnel departments who layoff workers can be seen as more crucial. No matter the market situation, gross profit still gets distributed to provide conditions of existence for production. However, the size of this gross profit to distribute is highly sensitive to market conditions. It is the indirect costs on general administration and infrastructure that makes it possible for firms to earn their gross profit. Still, these detailed distributions are typically overlooked because they are spent on indirect conditions of existence. However, these costs are important because such distributions may represent endogenous costs and thus inefficiency.

Even under normal conditions, the firm itself often devotes significant resources to creating private market infrastructure.[13] Coase (1937) and Williamson (1991) have written extensively about these firm costs as such expenditures on transaction costs and governance costs. Oddly, few have integrated the pervasive efficiency issue into their theory of the firm. In an environment with competition from other firms where gross profit itself can be threatened, those extra revenues must be deployed. In the long run, all the profit would be competed away with rising costs to secure and defend all of those gross profits.

However, matching expenditures never negate the distinction between productive costs and indirect costs. In *The Wealth of Nations*, Adam Smith himself confronted a similar notion of these firm costs when discussing his value theory. He writes:

> There is one sort of labour which adds to the value of the subject upon which it is bestowed: there is another which has no effect. The former, as it produces a value, may be called *productive*; the latter, *unproductive* labour.[14]

So Smith's work pinpoints this conceptual issue in terms of outlays for "productive and unproductive labour." Others might call them, "the costs of running the economic

[13] This is the pre-occupation of economic development and economic policy today that attempts to build/maintain a "business friendly" environment.
[14] This quote is from the beginning of book two, chapter III (Smith 1776).

system" (Arrow, 1969:48). Similarly, the Financial Accounting Standards Board and the Internal Revenue Service mandate a distinction between direct and indirect components of operations. Consequently, they all recognize gross profit distribution.

It is entirely possible that laborers of all kinds both direct and indirect suffer salary and wages declines. In those cases, external groups might become beneficiaries of the extra revenues. With inelastic demand for spatial continuity, many landlords can boost rents. Bankers can charge premiums in a credit constrained, de-leveraging environment. Governments more desperate to maintain budgets can demand more taxes. The atmosphere of economic decline rearranges economic and political relationships leading to new pressures as well as relief for firms. Redistributions can occur among many groups, and markets with greater slack like those for labor can become subordinate to other forms of industrial organization involving consumer items.

The returns paid to owners would be determined by capital markets. In a recession it is unclear how much will have to be paid out as dividends. Anything retained can be invested productively or financially. To the extent the funds lead to foreign direct investment, the economic recovery lags. If the disbursements are hoarded for financial speculation, then aggregate demand will be insufficient and firm governance contributes to rising unemployment and GDP declines. So, for many reasons, in a recession, revenue becomes freer and potentially moves in unpredictable directions throughout the economy.

4. Broader Stakeholder Governance and its Unique Tendencies

Another way to see how firm governance matters is to compare the performance of alternative models. In an environment of an open market structure, different firm governance will offer different potentials in healing recessions and their effects on individuals. Conventional governance has a tripartite top hierarchy comprised of shareholders, managers, and a board of directors (Berle and Means 1947, Penrose 1959, and Chandler 1977). It gives preferential treatment to property owners by allowing them to vote for board members who select management. Other stakeholders like workers, consumers, taxpayers, debtors, and communities must subordinate their interests to this type of firm's internal governance. Change in firm governance would require a shift from property-prioritized directorships to broader stakeholder governance. The justification for continuing to prioritize property holders is the reliability of the market mechanism. When there are no economic profits, the governance structure is considered to have neutral effects. Hence, the motivation for alternative governance has to do with the extent in which assumptions for pure market competition breakdown. The feasibility of alternative governance is based on two important insights. The first is that firms with different stakeholder governance compete successfully in many different market environments. They have many forms that are operational and spontaneous, and seem to be all around us. They have run themselves as going concerns on impressive scale without evidence that they weaken an economy. The second thing to notice is that they have their own unique tendencies. That means they lead to different results for all stakeholders both direct and indirect. They impact workers, owners, taxpayers, borrowers, communities, and national economies differently. To the extent that a broadened concept of stakeholder governance emerges, different macroeconomic outcomes would be experienced.

The form that alternative governance emerges can be both practical and political. Often stakeholders are an integrated component part of the firm for startup partnership ventures (Ackroyd 1995, Edwards 2000, Levin 2004). In those cases, all of the partners are both employer and employees together. It is collective employment. Examples are all around us from high-tech startups to professional services like legal and accounting practices, and can involve food preparation to basic manufacturing of many products. Sometimes a cooperative is formed. These would include celebrated examples like Mondragon in Spain and Evergreen of Cleveland, Ohio, among others (Tremlett 2013, and Schwartz 2009). In Germany, many large corporations include an important stakeholder dimension called codetermination (Gorton and Schmid 2004). In that case, a law requires significant level of worker representation on the board of directors of large companies. The logic of stakeholder governance can be expanded beyond an employer/employee axis to include significant public/private joint ventures (Bim, Jones, and Weisskopf 1993). In all of these cases, stakeholder models have already been proven to come into existence and succeed.

The tendencies of alternative governance in a recession are quite interesting and raise the promise of a very different economy if the stakeholder model were to prevail in dominance. The way such firms handle investment, unemployment, and inequality are all different from conventional corporations. The power structures are different. With the Mondragon cooperatives, there is the chance to focus on the seventh largest company in Spain, operating in an economy with severe unemployment over 20% for a sustained period. Mondragon has developed distinctive centralized bodies to minimize unemployment by moving workers from a weak enterprise to a stronger one. They also use funds to help their weaker enterprises. While these measures have not proven to be entirely fail safe, neither has conventional firm governance or state policy.[15] What is clear is that a firm level buffer to market decline can be achieved without entirely relying on monetary and fiscal policy. In Cleveland, Evergreen Cooperatives have emerged as the anchor enterprise model of redevelopment in contrast to the Detroit bankruptcy recovery models that are on the table. The thinking in Cleveland is that cooperatives help to resist outsourcing by placing worker/residents behind directorship decisions. In Germany, studies of codetermination with worker representatives on boards of directors suggest that profit maximization also includes a higher degree of job preservation than conventional governance. All of these examples suggest recession resistance of differing degrees from alternative governance.

5. Conclusion

Even though so many firms fail when markets breakdown, why is this issue of firm governance underestimated in a recession? Perhaps, it is because wage employment was the prevailing system that accompanied humanity while work moved from the fields to the mines and factories, and then into the offices and malls, and ultimately onto the Internet. That historical process included growth rates consistently high enough to raise U.S. real wages regularly from the early 1800's into the 1970's. But that trend has stagnated over the last four decades. Yet, what if hindsight tells us that such growth was largely harvested from the low hanging fruit of modernization? It would follow that faith in our current firm governance models is misled. If that has any truth, our current models

[15] In October 2013, Fagor Electrodomesticos became Mondragon's first big enterprise shutdown by bankruptcy. However, it needs to be noted that it was a "record-setting year of bankruptcies" in Spain. See "Recession Frays Ties at Spain's Co-ops," Wall Street Journal, December 26, 2013, page B3.

likely confront diminishing returns from modernization, and are now structurally dangerous. Couple that endgame with globalization and large external debts, and the United States economy faces significant sinks undermining growth. Constant incubators are the only things that keep people employed, but in this “new normal,” is it prudent to maintain our firm governance if they tend to be more of a drain than a fountain?

Yet, the totality of economic theory suggests that firm governance could matter even if there is no recession. I am talking about all of the profit opportunities due to market failures suggesting a high degree of slack in the market mechanism normally. Consider how profits can be made off of asymmetric information, market concentration, moral hazard, externalities, and public goods. For instance, we also know about transaction costs and incomplete markets for labor and capital (Bowles and Gintis 1990, and Stiglitz and Weiss 1981). Principal and agent problems matter along with products sold in “markets for lemons” and tourist trap models (Akerloff 1970). Spillover costs and benefits raise profits. Globalization also matters by creating a labor arbitrage opportunity (Bluestone and Harrison 1982). Additionally, monetary and fiscal policy open up enormous redistributive questions for stratification of both wealth and income. Consequently, many analytical issues triggered by profit making occur all of the time, even without a recession. My interest in highlighting a recession is that it is easier to consider as a special case with sharper implications. Things manifest more dramatically, and micro issues crystallize more clearly with a macroeconomic contraction.

Adopting a heterodox perspective of the business enterprise would mean embracing the notion that Property Directed Firms colliding with Private Market Decisions leads to economic displacement in three forms: inequality, inefficiency, and instability. Defending against these three themes are the pillars of modern economics. That would be Product Exhaustion (Wicksell), Efficiency (Pareto), and Equilibrium (Walras). If the world truly was as deterministic as Wicksell, Pareto, and Walras assumed, then firms should be understood to merely convert inputs into outputs. However, a heterodox analysis would have to say that when markets are understood as an open structure rather a deterministic mechanism, firm governance matters.

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