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Abstract: The economic theory of the corporation contends that corporations and their managers should maximize profits because this will lead to a socially optimal outcome. Theorists often object to this theory because it assumes ideal market conditions that do not exist in the real world. Although valid, I do not believe that the "ideal conditions" objection gets to the heard of what is wrong with the economic theory. In this paper, I develop a different objection, one that is based on the idea that the corporation belongs to a sphere of our lives that is shielded from the demands of social welfare—what I call the "sphere of partiality." I show how the economic theory leads to various counterintuitive results because it fails to acknowledge this important fact. Throughout my discussion, I focus on the version of the economic theory advocated by Michael Jensen.

A dominant strain of thinking about the corporation holds that corporations and their managers have a duty to maximize profits because this is the course of action that will lead to a socially optimal outcome. Call this the *economic theory of the corporation* (or the "economic theory" for short). The theory is "economic" in the sense that it appeals to modern economics to explain what sorts of consequences would follow from different patterns of behavior; however, it is fundamentally a normative theory because it attempts to justify claims about what corporations and managers *should* do, not just what they will do.

Theorists often attack the economic theory on the grounds that conditions in the real world are very different from the ideal conditions described in economic textbooks. Real markets are characterized by significant externalities (positive and negative), and economic agents are often not well informed or very rational. I accept this line of criticism, but I do not think that it gets at the heart of what is wrong with the economic theory. The economic theory has implications that are more counterintuitive than most people realize, and these implications have little to do with the assumption of ideal market conditions. The counterintuitive implications I have in mind flow from the fact that the economic theory does not acknowledge the important sense in which corporations belongs to a sphere of our lives in which we are permitted to show special concern for our personal plans, projects and relationships.

I begin my discussion in section 1 by setting out the main features of the economic theory of the corporation, focusing in particular on Michael Jensen's formulation of the argument. After introducing three simplifying assumptions in section 2, I draw out two counterintuitive implications of the economic theory in sections 3-5. I conclude by considering an objection to my argument.

1. The economic theory

The economic theory of the corporation is essentially a form of moral consequentialism. It claims that corporations and their managers have duty to maximize profits because acting this way will lead to the best outcome. From the standpoint of the economic theory, the best outcome is one that is “socially optimal” or “economically efficient.”[1] There are many ways of thinking about what makes an outcome “socially optimal” or “economically efficient,” but the conception of optimality that is most important for my purposes is what I will call the *wealth maximizing conception*.[2]

We can understand the intuitive idea behind the wealth maximizing conception in the following way. It is quite intuitive to think that we can determine how much a person values a certain resource by looking at the maximum amount of money that he would be willing to pay for that resource if he had to acquire it in the marketplace. So, for instance, imagine that A has an apple and an orange. If A did not have an apple, he would be willing to pay $100 (or the equivalent in goods and services) to buy one. If he did not have the orange, he would be willing to pay $50 (or the equivalent in goods and services) to buy one. Here it seems reasonable to think that A values the apple more than he values the orange, and therefore that the apple is worth more to him than the orange is.[3]

“Wealth” corresponds to a measure of how much an agent values his total bundle of resources. For the purposes of the wealth maximizing conception of optimality, an agent’s level of wealth corresponds to the maximum amount of money that he would be willing to pay in order to acquire the complete basket of resources he owns, if he had to buy these resources one by one. So suppose that A was willing to pay $100 for his apple

[1] Theorists often use the term “efficient” or “economically efficient” to refer to an optimal social state, but for the most part I will use the term “socially optimal” since it does not suggest any misleading parallels with our more commonsense notions of efficiency.

[2] My exposition of the wealth maximizing view in this paragraph and the next three follows Dworkin (1985).

[3] For the sake of simplicity, I will assume that people are “rational” in the sense that they assign the same value to a resource whether they are going to buy it or sell it—i.e. if A were willing to buy the apple for $100, then he would also be willing to sell it for $100.

and $50 for his orange, and suppose that he has $150 in cash. His total wealth would amount to $300—that is, $100 for the apple, $50 for the orange, and $150 for his cash.[4]

The aggregate level of wealth in society corresponds to the total amount that each person would be willing to pay for the complete basket of resources he owns, if he had to buy these resources one by one. To compute the aggregate level of wealth in society, you simply add up the amount that each person would be willing to pay for his total basket of resources. A *wealth maximizing social state* is one in which the aggregate level of wealth in society is as high as it can be. In a wealth maximizing social state, we could add up the amount that each person would be willing to pay for his basket of resources, and the total would be higher than the total would be in any other feasible social state.[5]

Assuming now that a wealth-maximizing outcome is the best outcome, why do corporations and managers have a duty to maximize profits? According to the economic theory this is because a wealth-maximizing outcome is most likely to come about when corporations and managers attempt to maximize profits.[6] A version of this argument is

[4] Assuming that he would be willing to pay $150 in order to buy $150 in cash in the open market. For the sake of simplicity I will ignore any issues about the value of money and assume that agents value money purely because they can exchange money for goods and services.

[5] The wealth maximizing conception of optimality is not the only conception of optimality in welfare economics, but it is the one that figures most prominently in the work of proponents of the economic theory of the corporation, such as Michael Jensen. For a discussion of the relation between the "wealth maximizing" conception (or "Kaldor-Hicks" efficiency) and the more familiar Pareto conception of efficiency, see Coleman (1984) and Dworkin (1985).

[6] Assuming, of course, that the major elements of a market system are in place. The economic theory is best understood as a *contextual claim* about what market actors have a duty to do, that is, they have a duty to maximize profit *in the context of a market system*. If corporations and managers are operating under some other kind of system—say, a form of socialism—the economic theory does not claim that they should aim to maximize their profits.

sometimes attributed to Adam Smith, but I will focus on a contemporary formulation of the argument given by Michael Jensen.[7]

We can understand the activities of a firm as a process that takes goods and services out of the economy as factors of production, and then transforms these resources into new goods and services that get put back into the economy as products. Sometimes the activities of a firm will generate profits. This happens when customers are willing to pay more for the firm's products than the firm pays for the various factors that go into their production. But under the right conditions—where other people are not affected by transactions between the firm, customers, and suppliers—these profit-making activities will also "create value" in the sense of increasing social wealth. When the population as a whole is willing to pay more for the goods and services that a firm puts back into the economy than they were for the goods and services that it takes out, there is an increase in social wealth—the firm has transformed a less valued mix of goods and services into a more valued one (Jensen, 2001: 11). So, under the right conditions, firms that make a profit do more than generate revenue for themselves, they also push society towards a wealth maximizing social state.

Jensen appeals to this basic line of reasoning in order to argue that corporations and managers have a duty to maximize what he calls the "long-term market value of the firm."[8] The market value of the firm is simply "the sum of the market values of the equity, debt, and any other contingent claims outstanding on [it]" (Jensen, 2001: 12). This

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[7] Jensen (2001). Adam Smith describes the invisible hand in a famous passage of *The Wealth of Nations* (Smith 2000: 485). For a helpful discussion of how to interpret Smith's remarks in this passage, see Fleischacker (2004: 138-42).

[8] Jensen (2001: 8). I will sometimes refer to the "long-term market value" of the firm more simply as the "long run value of the firm."

value is ultimately determined by the market value of the stream of profits that the firm generates (Jensen, 2001:11). Now when a firm aims to maximize its long-term market value, it aims to balance the pursuit of opportunities to make a profit today with opportunities to make a profit tomorrow (discounted at the appropriate rate). The goal is to maximize the present market value of the whole temporarily extended stream of profits that the firm will produce. The reason that corporations and managers have a duty to pursue this goal is simply that their pursuing this goal will lead to a socially optimal outcome. In seeking to maximize their long run value, corporations will seek out all available opportunities to transform less valued goods and services into more valued ones, balancing the opportunity for improvements today with the opportunity for improvements tomorrow. Since these are effectively opportunities to transform the stock of goods and services in society so that people are more willing to pay for them, we see that a wealth-maximizing outcome is more likely to come about when corporations and managers aim to maximize the long run value of the firm.

It is worth emphasizing that Jensen's claim is *not* that corporations and their managers should pursue profits because they have a fundamental obligation to shareholders that they do so. We must distinguish his argument from various deontological arguments, such as the libertarian argument sometimes attributed to Milton Friedman (2004). According to the libertarian argument, corporations and their managers have an obligation to maximize profits because shareholders entrust their capital to the corporation with the understanding that this is what the corporation will do. In other words, corporations and managers have a special obligation to pursue the interests of their shareholders because they enter into a kind of tacit agreement with them. Jensen's argument, however, does not appeal to the idea that firms and their managers have a moral obligation to abide by the terms of a tacit agreement with shareholders—in fact, it does not appeal to any kind of moral relationship with shareholders at all. Jensen's argument appeals instead to the consequentialist idea that people have a fundamental duty to act in ways that will bring about a socially optimal state of affairs. From the standpoint of the economic theory, the reason that corporations and their managers should maximize profits is not because they *owe it to their shareholders* to do so, but because this is the best way to generate a wealth maximizing social state.

2. Three simplifying assumptions

To bring certain issues more clearly into focus, my examination of the economic theory in the rest of this paper will proceed under three important assumptions.

The first assumption has to do with market imperfections. Theorists often criticize the economic theory on the grounds that it does not have anything to say about the duties of corporations and managers in the real world because the circumstances in the real world are so different from the circumstances described in economics textbooks. The market in the real world is rife with externalities (both positive and negative), and market actors often act with incomplete information and less than perfect rationality. These facts imply that in many cases, the course of action that maximizes the long run value of the firm will not, in fact, lead to a socially optimal outcome. For example, if there are positive externalities associated with research and development, then at the margin, some firms will find it more profitable to engage in other activities besides research and development, even though engaging in these activities would be the course of action that would contribute most to social wealth. For the purposes of my discussion, however, I will assume that the circumstances in the real world closely approximate the ideal circumstances described in economics textbooks, that is, I will assume that there are no externalities in the market (positive or negative) and that market actors act with complete information and perfect rationality.

The second assumption has to do with the conception of social optimality. As it stands, the economic theory is open to a very serious objection. The theory contends that corporations and their managers have a duty to maximize the long run value of the firm because this is the best way to generate a wealth-maximizing social state. Now for the argument to be compelling, it must be true that wealth-maximizing social states are morally important and that people have a moral reason to bring these states about. Unfortunately, it seems pretty clear that this is not the case. To see the force of the point, consider the following example.

> Derek has a book Amartya wants. Derek would sell the book to Amartya for $2 and Amartya would pay $3 for it. T (the tyrant in charge) takes the book from Derek and gives it to Amartya with less waste in money or its equivalent than would be consumed in transaction costs if the two were to haggle over the distribution of the $1 surplus value. The forced transfer from Derek to Amartya produces a gain in social wealth, even though Derek has lost something he values with no compensation. (Dworkin, 1985: 242)

Call the state of affairs before the transfer "S1" and the state of affairs after the transfer "S2." Clearly S2 is wealth maximizing because the book is in Amartya's hands and he is willing to pay the most for the book. But is there really any sense in which S2 is a better state of affairs than S1? Set aside the fact that Derek was forced to give up the book and imagine that the book were secretly moved from Derek's house to Amartya's and all memories of the transfer were erased. What exactly is so important about the *mere* fact that the book is in the hands of the person who is willing to pay the most for it? The answer, it seems, is nothing. As Ronald Dworkin puts it, "the fact that goods are in the hands of those who would pay more to have them is as morally irrelevant as the book's being in the hands of the alphabetically prior party" (Dworkin 1985: 245).

For the purposes of my discussion, however, I will assume that the economic theory of the corporation does not hold that wealth-maximizing social states are intrinsically important from the moral point of view. As I will interpret the theory, what it contends is that we have a reason to bring wealth-maximizing social states about because the fact that a social state is wealth-maximizing tends to be strongly correlated with the fact that it is *welfare*-maximizing. Consider that it is quite natural to think that if Amartya is willing to pay more for the book in the previous example than Derek is, this is because he *wants* the book more or *needs* the book more. If it were true that he wants the book more or needs the book more, then overall welfare in society would be greater if the book were in Amartya's hands rather than Derek's. As I interpret the economic theory, it claims precisely that, in most cases, the fact that one person is willing to pay more for a certain resource than someone else means that he wants or needs the resource more, and therefore that social welfare would be maximized by giving him the resource. So, on my interpretation, the economic theory is a form of *welfare consequentialism* that contends that we should bring about wealth maximizing social states because these tend to be welfare maximizing social states.

The last assumption has to do with the correlation between wealth-maximizing and welfare-maximizing social states. I will assume that wealth-maximizing social states tend to be welfare maximizing social states, that is, I will grant that there is a strong correlation in the real world between social states in which resources are in the hands of those who would pay the most for them and states in which resources are in the hands of those who want or need them the most.

The point of these three assumptions is to set aside certain well-known criticisms of the economic theory of the corporation in order to bring into focus a more fundamental objection. I accept that markets in the real world are very imperfect, and that wealth-maximizing social states are often not welfare maximizing.[9] But I intend to argue that *even if* we could remove all market imperfections and *even if* a wealth maximizing states were very closely correlated with welfare maximizing social states, there would still be a fundamental reason to reject the economic theory's claim that corporations and managers have a duty to maximize the long run value of the firm. The objection that I have in mind has to do with the idea of partiality.

3. Corporations and the sphere of impartiality

Most of us believe that there is some part of our lives in which it is permissible for us *not* to be guided by the demands of social welfare. Call this the *sphere of partiality*.[10] The

[9] A person's willingness to pay for a resource is not only a function not only of how much he wants or needs it, but also of his overall level of wealth. So a person with more money can afford to spend more on any given resource than a person with less money, even if they both want or need the resources in exactly the same degree.

The correlation between wealth maximization and welfare maximization is even weaker in the real world because of the incredibly wide range of factors that affect an individual's total level of wealth. Among these factors are whether the person has inherited wealth from his parents or ancestors, whether he was born with marketable talents, whether he was born into a fast-growing region of the country, and so on. All of these factors affect the amount of wealth that an individual has and will therefore affect his willingness to pay for a given resource. Since none of these factors is connected with how much an individual may want or need a certain resource, the correlation between wealth maximizing social states and welfare maximizing social states is not likely to be very strong, at least as things stand.

[10] The critique of utilitarianism on the grounds that it does not leave room for people to have a personal life is developed by Bernard Williams (Smart and Williams 1973). I take the idea of a "sphere of partiality" and a "moral prerogative" from Scheffler (1982).

sphere of partiality is that part of our lives where we do not have to respond impartially to the wants and needs of everyone in the world. Within this sphere, it is permissible for us to pursue our own particular goals, plans and projects, even if these would not be the goals, plans and projects that would be best from the standpoint of maximizing social welfare.

The fact that morality allows for a sphere of partiality becomes apparent when we think about just how overwhelming the demands of social welfare can be. In a famous article, Peter Singer (1982) offers a vivid illustration of this fact. Right now, as we speak, there are millions of people suffering with the AIDS virus in Africa and millions more suffering from starvation and malnutrition. Any amount of time or money that we spend in pursuit of personal objectives, such as making friends, getting a degree, or learning to play the piano, represents time and money that we could have spent satisfying the very real needs of people in Africa. But if we were to take seriously the demands of responding impartially to the needs of everyone in the world, it would seem that it was *wrong* of us to spend a minute or a dollar in pursuit of our personal plans and projects. After all, any minute or dollar that we spend in this way could have been spent effectively addressing a more urgent need in some other part of the world. Given the level of need in the world, it would seem that a thoroughgoing concern for human welfare would leave no aspect of our lives untouched, no place where we could simply pursue our own personal objectives. Yet this seems far too demanding as a conception of morality. The needs of others certainly make genuine claims on our time and money, but it does not seem wrong for a person to live his own life while giving the needs of others a certain amount of attention. The idea of what I am calling the "sphere of partiality" is meant to capture the idea that morality does not require us to devote all of our lives to the needs of others—this may be a noble thing to do, but it is not morally required.[11]

People will disagree about the precise nature of the sphere of partiality and its proper boundaries. Some may think that this sphere is larger and others may think that it is smaller. Some will reject the idea that social welfare makes any sort of demand on us at all, in which case the sphere of partiality will take up the whole of our lives. But for my purposes, the general question of the proper boundary of the sphere of partiality is not important. I am interested in a more limited question. It seems intuitively that some forms of human association belong to the sphere of partiality, while others do not. The family, for instance, seems to belong to the sphere of partiality. Morality allows parents to spend a certain amount of time and money on their children, even if doing so means that people who are in greater need in other parts of the world would be deprived of these resources. Children too are allowed to spend a certain amount of time and money on their parents, even if doing so means that people in other parts of the world are deprived of these resources. These facts suggest that the family is a form of association that belongs to the sphere of partiality: the association belongs to a part of our lives in which we are not morally required to respond impartially to the needs of everyone in the world. The question I want to ask is, where does the corporation belong? Does it belong in the

[11] Notice that the problem here applies equally to those forms of welfare consequentialism that reject the possibility of interpersonal comparisons of welfare. For example, suppose that you take the view that we cannot make interpersonal comparisons of welfare, so one social state is better than another if and only if it is Pareto superior to that state, but no Pareto optimal social state is superior to any other Pareto optimal social state. This means that one social state is better than another if and only if there is one person better off in that state and no one is worse off. This view is impersonal in the sense that it says that you have reason to take steps to bring about a certain social state, so long as there is one person who does better in that state and no one does any worse. It does not matter whether the person doing better is you or someone else. A view like this raises the question of partiality because it may turn out that bringing about the Pareto optimal social state would require that you forego the pursuit of your personal plans and projects in order to enable others to pursue theirs.

part of our lives that is shielded from the demands of social welfare? Or does it belong to the part of our lives that is, in principle, available for the promotion of social welfare?

The economic theory of the corporation essentially places the corporation in the sphere of impartiality, that is, in the part of our lives that is available for the promotion of social welfare. Corporations and their managers have a duty to maximize the long-run value of the firm because this is the strategy that is most likely to lead to a wealth-maximizing outcome. So the corporation is, according to this view, an entity whose basic purpose is to play a role in a process that promotes social welfare.

On reflection, however, we can see that the economic theory is mistaken on this point: the corporation does not belong to the sphere of impartiality. The corporation may not belong completely to the sphere of partiality either, but it is clearly a mistake to think that it belongs solely in the sphere of impartiality.

The fact that the corporation does not belong in the sphere of impartiality comes out most clearly in the following type of case. Imagine that I want to set up a firm on the model of *Ben and Jerry's* or *Patagonia*, where the firm will pursue the goal of making a profit, but it will do so while also pursuing other important social objectives. So, for instance, suppose that I want the company to pursue profits, but I want it to give preference to profit making opportunities that also promote goals such as supporting minority owned businesses and protecting the environment. Here it seems that the economic theory would say that I am doing something *wrong*. Even if I announce clearly to potential shareholders before going public that my intention is for the firm to operate with profit as only one among a number of objectives, and even if I get the approval of my employees, the economic theory says that I would *still* be doing something wrong. Not only would I be acting wrongly, but the firm would be violating its duties in its day-to-day operations, and the firm's managers would be acting wrongly in operating the firm according to these standards.

Why does the economic theory have these implications? The theory says that corporations and their managers have a duty to act in ways that would lead to a wealth maximizing social state. The best way to do this is to maximize the long run value of the firm, so the theory says that corporations and their managers must do this. Their obligation to act this way has nothing to do with the desires of shareholders, employees and others, so the fact that these parties want the corporation to pursue some other objective has no bearing on what corporations and their managers are obligated to do. By the same token, when I attempt to establish a company that pursues other objectives, I am essentially trying to establish an organization that violates the fundamental duty to maximize social wealth, so my actions also violate the fundamental moral requirement.

It seems, however, that these results are quite at odds with our moral intuition: though it may not be ideal from the standpoint of social welfare for us to establish and operate a company that pursues other objectives, it certainly falls within our moral prerogative as market actors to do so.

4. Distinctions between corporations of different kinds

A second set of counterintuitive implications has to do with the distinction between different types of corporations. Some corporations in our society are for-profit and some are not-for-profit: *Coca-Cola* and *Microsoft* are for-profit corporations, while *Amnesty International* and the *Metropolitan Museum of Art* are not-for-profit corporations. It seems intuitively that the moral duties in each case are quite different; however the logic of the economic theory seems to apply equally to both types of corporation.

Consider that *Amnesty International* and the *Metropolitan Museum of Art* both enter into the market to make exchanges with other market actors; they both take resources out of the economy as factors of production, and they both put new goods and services back into the economy as products. Why should the duty to maximize the long run value of the corporation not extend equally to them? Suppose, for example, that the *Met* could turn a profit by charging its patrons for admission. What would make the *Met's* failure to charge admission any different from any other business enterprise that decides to give some of its services away for free? In both cases, we might argue that the best strategy from the point of view of generating a wealth-maximizing outcome would be for these corporations to maximize their long run value, and so they both have a similar duty to pursue this strategy.

But clearly this runs counter to our intuitions. We do not think that the *Metropolitan Museum of Art* or its managers have a duty to maximize the long run value of the corporation. I take it that this is because the museum belongs to the sphere of partiality. It represents a choice made by various donors, curators, and patrons to devote a certain amount of their time and energy to a personal project. This project belongs to the part of each person's life that is not available for the promotion of social welfare. So even if it were true that social welfare would be greater overall if the *Met* charged admission, the fact that this project belongs in the sphere of partiality means that this has no bearing on what the *Met* or its donors, curators, and patrons have a duty to do. More generally, we might say that the economic theory places all corporations, whether they are for-profit or not-for-profit, in the sphere of impartiality. It offers no basis for drawing a principled distinction between different types of corporation, so it offers no basis for saying that some corporations have a duty to maximize their long run value while others do not. The result is that the theory seems to be committed to the idea that nonprofit corporations have a duty to maximize their long run value, and it seems intuitively that no such duties exist.

5. Diagnosing the problem

I take it that both of the problems I have discussed relate to the same feature of the economic theory, namely that it does not adequately acknowledge our moral sovereignty. Other people's desires and needs are certainly important, and we have a duty to take reasonable steps to help them to satisfy their desires and needs, if we are in a position to do so. But at a certain point, we are independent persons who have a moral prerogative to pursue our own personal plans and projects, even if these are not ideal from the standpoint of satisfying everyone's desires and needs as much as possible—we have a moral right to be inefficient. To say that we must *always* respond impartially to the desires and needs of everyone is to understand ourselves as mere servants of social welfare.

The corporation is also a part of our lives: it represents a set of choices that employees, managers, shareholders, and others, have made about how they will spend their time and money. When a theory takes the corporation to belong completely to the sphere of impartiality, it says that in this aspect of our lives, we *are*, in fact, rightly understood as the servants of social welfare. This fails to recognize an important aspect of our sovereignty, namely our right to live our own lives as we wish, even if the choices we make are not ideal from the point of a socially optimal outcome.

6. A defense of the economic theory

Some may object that my argument only applies to the economic theory understood as a form of *act* consequentialism, not to the theory understood as a form of *rule* consequentialism. To test the objection, suppose that we reinterpret the economic theory in the following way. According to the revised theory, corporations and their managers have a duty to pursue the course of action that follows from the system of rules that would be legislated by an ideal legislator whose only goal was to maximize social wealth. Would the revised theory avoid the counterintuitive results suggested above?

I think not. Consider the first set of results. Jensen's argument shows that social wealth would be maximized if corporations and their managers maximize the long run value of the firm. It follows from this that an ideal legislator would want to encourage this kind of behavior: he would probably legislate a rule requiring corporations and their managers to maximize the long run value of the firm, as well as a rule that prohibits people from establishing corporations that aim to pursue other objectives. It follows that when a corporation pursues objectives other than profit maximization, the corporation and its managers would be violating one of the rules that would be legislated by the ideal, wealth-maximizing legislator. Similarly, someone would also be violating one of these rules if he tried to establish a corporation that pursues other objectives.

What about the second set of results? Given Jensen's reasoning, it seems that both for-profit and not-for-profit corporations contribute most to generating a wealth-maximizing outcome when they each attempt to maximize their own long run value. It follows that an ideal legislator attempting to design a system of rules that generates wealth maximizing outcomes would include in this system of rules both a rule that says that both types of corporation should pursue profits and a rule that says that no one should establish corporations that pursue other objectives besides this. And it follows that organizations such as *Amnesty* and the *Metropolitan Museum* violate the rules that would be legislated by the ideal, wealth-maximizing legislator. I conclude that the move from act consequentialism to rule consequentialism would not address any of the issues raised in this paper.

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