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Adam Smith Saw Through the Inherent Flaws in the Joint-Stock Company System

Shoji Otsuka
Senior Economist

When joint-stock companies grow bulky in scale, a large number of small shareholders with no genuine interest or concern in corporate management will emerge, with the owner of the business able to gradually control the company for the pursuit of personal profits.

The established theory is that this institutional fault was first pointed out by economic and legal scholars Adolph A. Berle Jr. and Gardiner C. Means. That theory dates from their 1932 publication *The Modern Corporation and Private Property* (Japanese translation by Tadao Kitajima, published by Bungado Shoten), which used corroborative research of companies in the United States to clarify that belief.

In reality, however, Adam Smith, considered by many to be the founding father of economics, saw through this defect over 150 years before the publication of that volume, supporting my conclusion that the joint-stock company system should be considered to have possessed inherent flaws from the start.

The Irresponsibility of Shareholders and Business Owners

To summarize Smith's view of the joint-stock company, the system for businesses in that category contains the two following flaws: (1) Failure by business owners to protect the assets of the company, and instead pursue their own profits (business owner irresponsibility); and (2) the absence of serious shareholder interest in the actions taken by company owners (shareholder irresponsibility). In this sense, the joint-stock company itself cannot be described as being a very desirable institution.

Within his assessment, Smith stated that the conditions required for the joint-stock company scheme to be utilized include the ability to manage a company under rigid regulations, while he held that such companies should also be limited to businesses characterized by high public benefit and which demand massive capital. In more specific terms, he proposed the following industrial categories: (1) Banking; (2) insurance providing coverage against fires, maritime accidents and wartime capture; (3) businesses engaged in the opening and/or maintenance of navigable waterways or canals; and (4) the supplying of water to big cities. According to Smith, using the joint-stock company mode for enterprises other than businesses in these categories would impede sound economic development.

Smith's ideas are the origin of "marketism," "small government" and other philosophies that comprise the mainstream of current-day economics. But with regard to the joint-stock company,

which had become a tool for the advancement of capitalism, he adopted a negative view based on his recognition of the inherent institutional flaws. Often cited within criticism of the “marketism” thinking, meanwhile, is Smith’s evaluation as presented in his signature work *The Wealth of Nations*.

Smith’s classical school approach to economics, which stemmed from his criticism of the mercantile system, treats a capitalistic economy as an autonomous reproduction system. He insisted that such economies adopt the laissez-faire principle of thorough rejection of government intervention, with the very reason that competition is private sector driven ensuring the effective function of the economy.

A term used by Smith to symbolize this state of affairs is the “invisible hand of God.” In short, when economic activity is consigned to free competition based on the self-interest of individuals seeking personal gain, the “invisible hand of God” will automatically function to guide the economy into conditions characterized by neither too much or too little “production and consumption,” thereby achieving profit for the society as a whole.

In the current day and age, when joint-stock companies engaged in economic activity are allowed to take over for individuals in advancing free competition targeting self-interest, economic growth continues. Action by governments in adding superfluous regulation will only have a negative impact. This is the thinking of advocates of “marketism.” Naturally, free activities by joint-stock companies are accepted under this approach. Opponents of this viewpoint, however, pursue the possibility that Smith was actually taking a negative view of the joint-stock company.

In *The Modern Corporation and Private Property*, Berle and Means also argue that when discussing the “company” as such, Smith was envisioning small-scale individual business as the typical corporate unit. Such owner-managed companies generally operated with several young apprentices or enlisted the help of workers, with the owner producing goods for market or engaging in commercial transactions. The authors held that Smith was extremely pronounced in his rejection of the joint-stock company as a business structure, and insisted that the dispersion of ownership rights would render effective operation impossible.

Smith’s Evaluation Targets were Chartered Companies

Smith, however, was not observing owner-managed businesses as we know them today. In fact, he was examining the chartered companies of the time that had been granted exclusive rights.

Smith was born in 1723 (soon after the South Sea Bubble stock crash of 1720), and passed away in 1790. He released *The Wealth of Nations* in 1776, directly after the outbreak of the American Revolutionary War. As such, the book was written on the premise of the English economy and society of the mid-18th century.

The England of that era had eclipsed Holland with its domination of maritime trade, and had begun to move down the road to economic prosperity. But even so, with the bitter memories of the South Sea Bubble remaining vividly etched in the minds of the English, the establishment of

joint-stock companies was not permitted under the operation what amounted to bubble company regulation.

The only such businesses allowed to be launched were chartered companies such as the East India Company. In terms of today's Japan, this would be the equivalent of the former Japan National Railways, Japan Public Highway Company or other special semi-government corporations with massive organizations. The East India Company, the first company to have a democratic general meeting of shareholders, also fell from grace in the Smith era, and became a hotbed of mismanagement aimed at generating personal gain. In his study of such chartered companies, Smith saw through their inherent flaws.

Yet why did Smith take a dim view of the corporate system itself? This would appear to lie in the fact that the book was written during the initial rise of the Industrial Revolution. Against the backdrop of that era, the rapid growth of railroads, steel and other heavy and chemical industries requiring large amounts of capital occurred from the early 19th century and on. Smith, therefore, was not around to witness this dynamic advance.

The driving force for England in seizing the reins of global leadership in the 18th century consisted of the woolen fabric, cotton and other textile industries – manufacturing sectors that did not require huge capital outlays to get off the ground and operate. This made it possible to operate businesses with funds furnished from a single financier, prompting the natural conclusion that there was no need to go out of the way to use the joint-stock company scheme (which by its very nature conjured up fears of “hotbeds of corporate crashes and scandals”).

Accordingly, in evaluating Smith's view of the joint-stock company, I would conclude that he took neither a positive nor a negative stand on judging the institution, and instead quickly saw through the inherent flaws in that approach to business endeavor. There has yet to be any means discovered or perfected to rectify these defects, with this area continuing to be the most essential theme in the quest to exercise effective corporate governance over joint-stock companies now and in the future.

Shoji Otsuka

Senior Economist, Research Service Department, specializing in corporate governance and related themes.

(Contact : 81-3-3639-2816)

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Japan Center for Economic Research (JCER)

Nikkei Kayabacho Bldg. 2-6-1 Nihombashi Kayabacho, Chuo-ku, Tokyo 103-0025, Japan

Phone:81-3-3639-2810 / FAX:81-3-3639-2839 / E-mail:jcernet@jcer.or.jp