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**Author**: Masouros, Pavlos  
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Chapter Two

Modeling Short-term Shareholdership’s Negative Impact on the Dynamics of Capital Accumulation:
The Post-Keynesian Theory of the Firm

Chapter One, particularly in Sections 3 to 6, presented several developments that took place at the international macroeconomic sphere and at the intellectual level that had as a result from the 1970s onwards a great reversal in the institutional logics of corporate governance, i.e. the reorientation of managers towards the maximization of shareholder value, and a great reversal in shareholdership, i.e. the shortening in non-controlling equity’s investment time-horizons.

To clear the way for the buttressing of this study’s First Hypothesis, i.e. that these two great reversals have cumulatively throughout a causality chain caused a slowdown in the rate of (physical) capital accumulation, I presented a series of empirical data and preliminary explanations in section 7. These data and explanations together provide a strong indication that the slow rates of economic growth that have been observed in the post-Bretton Woods era are caused by the slowdown in the growth of the business capital stock, which is in turn caused by the reduction in the corporate retention ratios and the concomitant increase in the equity payout ratios that in turn are caused by the heightened short-termism of shareholders that push towards the adoption of the ‘downsize and distribute’ corporate governance model and the shareholder value orientation of firms.

While the empirical data point towards the direction of the outcome that the post-Bretton Woods stagnation and the two great reversals cannot be independent to each other, no safe conclusion can be drawn that there is indeed a causality relationship between them without modeling the influence that short-term shareholders can have on a firm’s retention strategy. Indeed, a more stylized approach is needed to make the First Hypothesis appear plausible and thus I have chosen to complete the discussion started in Section 7 of Chapter One by presenting in this Chapter the Post-Keynesian theory of the firm that models the causality relationship implied to exist.

Post-Keynesians575 are not interested in the study of small firms in a perfectly competitive market, and prefer to study big businesses in oligopolistic

575 Post-Keynesian economics draw their inspiration by the work of John Maynard Keynes, but also by those who were instrumental in creating the Cambridge School in the 1950s and 1960s (Kaldor, Kalecki and Sraffa). Post-Keynesians are different than the new-Keynesians and the ‘neoclassical synthesis’ Keynesians, whose theories are structurally neoclassical (often with Austrian injections) with a minor Keynesian flair.
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markets. Thus, the setting of their analysis is more conducive to serve the goals of my effort, as I strive to show that it is what happened to those big corporations that are crucial for the (physical) capital accumulation in an economy that caused the prolonged economic stagnation Western economies were experiencing even before the 2008 financial meltdown.

1. The Post-Keynesian firm’s objective: power and growth

The intellectual roots of the Post-Keynesian theory of the firm were developed during the Golden Age of Capitalism, an era, which -viewed through the corporate governance lens- was also called the age of managerial capitalism. This was a time when managers were not so vulnerable to external pressures and could thus foster their Chandlerian instincts for expansion and growth (see Section 6.1. of Chapter One).

The Post-Keynesian and the Chandlerian theories of the firm share many things in common and eventually coincide in what they view as the firm’s objective. However, Post-Keynesians focus more on the endogenous constraints of the managerial pursuit of the firm’s objectives; an issue, with which the Chandlerian approach does not deal so rigorously, as it focuses mainly on how managers react and adapt to exogenous changes in the economic environment. Moreover, the Post-Keynesian theory is ideal for the modeling of the firm’s behavior in the era of post-Bretton Woods financialization, as it focuses more on how capital market constituents influence the managerial pursuit for growth, expansion and long-term productivity.

The Post-Keynesian theory of the firm starts with one of the presuppositions of Post-Keynesian economics -and perhaps of all heterodox economic theories-: organicism or holism. Organicism is premised on the Aristotelian axiom that ‘the whole is more than the sum of its parts’. In this light, Post-Keynesians view the firm as a semiautonomous economic agent able to develop a preference function of its own, which does not necessarily coincide with the preferences of one group of its stakeholders, as the neoclassical theory of the firm posits (see Section 6.2.1. of Chapter One).

For the Post-Keynesians the firm’s preference function, i.e. its objective, is determined by Keynes’s axiom of fundamental uncertainty. Firms act in a world of fundamental uncertainty and they need to devise a way that procures some level of security to the organization pertaining to the future. The firm’s objective then is to have some degree of control over future events.

576 Thomas Dallery, Post-Keynesian Theories of the Firm under Financialization, 41 REVIEW OF RADICAL POLITICAL ECONOMICS 492, 494
577 LAVOIE, supra note 108, 8
578 Met. 106-1045a
579 James Crotty, Neoclassical and Keynesian Approaches to the Theory of Investment, 14 JOURNAL OF POST KEYNESIAN ECONOMICS 483, 486
580 MARC LAVOIE, FOUNDATIONS OF POST-FRISTESIAN ECONOMIC ANALYSIS (1992), 100
Thus, it seeks power over its environment, be it economic, social or political\textsuperscript{581}. Power seems to be the firm’s ultimate objective in the Post-Keynesian theory, although this is not accepted unequivocally by all Post-Keynesian economists as many have suggested that it might not be feasible to get a knock-down answer as to what exactly the firm’s objective is\textsuperscript{582}. But, powerful relations allow corporations to have access to scarce information, without which the firm would be immobilized and enter in the state of inaction that pervades uncertain situations, which Keynesian theory demonized. Indeed, power guarantees access to financial capital, increases the chances for the firm to survive in the long-run\textsuperscript{583} and allows it to control the quality of its labour force, its suppliers, the prices of the industry, the possibility of takeovers, the future of the industry and even government legislation (with power comes efficient lobbying).

To become powerful, firms must be big\textsuperscript{584}; to become big, firms must grow\textsuperscript{585}. The need to control environment encourages much greater size\textsuperscript{586}; the greater the size of the firm the greater the scope to plan the economic activity that will eventually fend off uncertainty\textsuperscript{587}. Consequently, to achieve its objective, the firm must seek to obtain growth in size measured in sales\textsuperscript{588}, assets, employment or real output\textsuperscript{589}. So, if firms are actually seeking to maximize something, then this is growth in the aforementioned sense\textsuperscript{580,591}. To make the connection to Chapter One, the central mechanism of capital accumulation is exactly the urge that firms have to grow\textsuperscript{592}; in this we can detect the Marxian roots of the Post-Keynesian theory of the firm, as in the Marxian

\textsuperscript{581} See Robert Dixon, Uncertainty, Unobstructedness, and Power, 8 JOURNAL OF POST KEYNESIAN ECONOMICS 585
\textsuperscript{582} JOHN KENNETH GALBRAITH, ECONOMICS AND THE PUBLIC PURPOSE (1975), 124; Joan Robinson, Michael Kalecki on the Economics of Capitalism, 39 OXFORD BULLETIN OF ECONOMICS AND STATISTICS 7, 11
\textsuperscript{583} Within the Keynesian line of thought the long-run survival of the firm was seen as a central objective: ‘For any organization, as for any organism, the goal or the objective that has a natural assumption of preeminence is the organization’s survival. This, plausibly, is true of the technostructure’; JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (1972), 170
\textsuperscript{584} Dallery, supra note 576, 495
\textsuperscript{585} ‘All the diverse objectives that can be pursued by managers are reduced to the single motive of sustainable long-run growth’; ROBIN MARRIS, MANAGERIAL CAPITALISM IN RETROSPECT (1998), 113
\textsuperscript{586} GALBRAITH, supra note 582, 125
\textsuperscript{587} EDITH PENROSE, THE THEORY OF THE GROWTH OF THE FIRM (1959), 15
\textsuperscript{588} For most Post-Keynesians growth was measured in terms of sales revenue; see GALBRAITH, supra note 600, 174; ADRIAN WOOD, THE THEORY OF PROFITS (1975), 4;
\textsuperscript{589} ROBIN MARRIS, THE ECONOMIC THEORY OF MANAGERIAL CAPITALISM (1964), Ch. 2
\textsuperscript{580} ‘The primary affirmative purpose of the technostructure is the growth of the firm’; GALBRAITH, supra note 599, 116
\textsuperscript{591} It will be shown in Section 2 below that profits are just the means to the end of maximizing growth. To be sure though, industrial economists have found that it is hard to distinguish empirically between growth measured in terms of sales revenue and growth measured in some other manner – e.g., in terms of profits over time [Peter Kenyon, Pricing, in A GUIDE TO POST-KENYANSIAN ECONOMICS (A. Eichner, ED.) (1979), 37]. But, however, measured, under the Post-Keynesian theory of the firm it is clearly growth that is the goal of the firm, in the sense that firms try to maximize something over time and for the long-run rather than eyeing for a short-run profit maximization to benefit the shareholders, as the neoclassical theory would tend to suggest; see LAVOIE, supra note 580, 107
\textsuperscript{592} JOAN ROBINSON, ESSAYS IN THE THEORY OF ECONOMIC GROWTH (1962), 38
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discourse on capitalism the firm must continue expanding in order to keep its share in the market (see Section 7.2 of Chapter One)\(^{593}\).

Nevertheless, one could assert that power and growth might indeed have been a firm’s objective in the era of managerial capitalism, when the divorce between control and ownership was more acute, since the floating population of shareholders, were acting as Veblenian abstentee owners\(^{594}\) and no signs of shareholder activism were present to change this picture. But, authors within the Post-Keynesian tradition have successfully—in my view—pointed to the fact that also in the era of entrepreneurial capitalism, in the 19\(^{th}\) century, family businesses were just as keen on growth as any modern corporation\(^{595}\). Anyone who is in business naturally wants to survive (particularly if her own heirs and successors are involved) and to survive it is necessary to grow\(^{596}\). Therefore, the claim that a firm’s objective is to grow can be seen as perennial.

To understand how different presuppositions and assumptions might result in the formulation of different theories, it is worth reminding here some facts about the neoclassical theory of the firm, which was presented in Section 6.2.1. of Chapter One. The neoclassicists posit that the objective of the firm is to maximize the present value of its future earnings (earnings being profits in the present sense minus interest payments, taxes and asset depreciation). Given the fact that one of the presuppositions of neoclassical economics is methodological individualism, organizations, such as firms, only hide the true intentions and preferences of individuals\(^{597}\). This means that if the firm’s intention is the maximization of profit, then the latter must be the objective of one group of individuals that belongs to the firm’s constituencies. This group could not be but the one of the residual claimants, i.e. of those that have an interest in the firm making the largest possible profit because they get to see money in their pockets only after everyone else is paid: the shareholders. Therefore, while the Post-Keynesian theory of the firm starts from the presupposition of holism and views the firm’s objective as being long-run growth, the neoclassical theory of the firm starts from the presupposition of methodological individualism and ends up viewing the firm’s objective as being aligned with one of the corporate constituencies’ objective.

2. The role of profits in the Post-Keynesian theory of the firm

Let us consider now a firm, which according to the Post-Keynesian assumption sets as its target to obtain a specific rate of growth. To move towards

\(^{593}\) NICHOLAS KALDOR, FURTHER ESSAYS ON ECONOMIC THEORY (1978), xvi

\(^{594}\) See THORSTEIN VEBLEN, ABSENTEE OWNERSHIP-BUSINESS ENTERPRISE IN RECENT TIMES: THE CASE OF AMERICA [1923] (1964)

\(^{595}\) See WOOD, supra note 588, 8; James Clifton, Competition and the Evolution of the Capitalist Mode of Production, 1 CAMBRIDGE JOURNAL OF ECONOMICS 137, 147-8; LAVOIE, supra note 580, 105

\(^{596}\) JOAN ROBINSON, ECONOMIC HERESIES: SOME OLD-FASHIONED QUESTIONS IN ECONOMIC THEORY (1971), 101

\(^{597}\) LAVOIE, supra note 108, 8
the realization of its target, the firm must accumulate capital; it must incur investment expenditures. Without investment in fixed assets and stocks the firm is unlikely to expand its productive capacity that will allow it to grow. To be able to meet the investment expenditures that have to be borne to obtain the desired rate of growth, a firm needs profits. This is because profits help the financing of the investment that needs to be undertaken; they release the financial constraint on capital accumulation. And they do so in two ways: (i) profits can be turned into retained earnings, so that the firm can internally finance the accumulation process; and (ii) profits facilitate the attainment of external finance as well, since they signal to rentiers of capital (creditors and shareholders) that the firm has a good performance record and thus it is solvent and creditworthy.

Regarding the importance of the transformation of profits into retained earnings enough have been said already in Chapter One, especially under the light of the empirical data presented in Figures 21 to 24 that showed the dominant role of retained earnings in the financing of fixed capital formation. As it has been stated ‘finance raised externally – whether in the form of loans or equity capital- is complementary to, not a substitute for, retained earnings’.

Regarding the second function of profits, as a lure for external finance, Post-Keynesian theory rests firmly on Kalecki’s principle of increasing risk, which posits that the funds that can be obtained through external finance by a firm are a multiple of its current level of retained earnings (a.k.a. undistributed profits). Kalecki’s principle of increasing risk is based on the Keynesian notion of fundamental uncertainty. In a world where there is uncertainty about the future, external financiers seek to limit their own risks, when extending financing to firms. Thus, they are more likely to rely on the firm’s profitability record of the past in order to ascertain whether the firm is creditworthy enough to receive their funds.

It follows, that as opposed to the neoclassical theory of the firm, profit for Post-Keynesians is not an end to itself, but it’s the means to effectuate the accumulation process and further to realize the objective of growth. So, although profit is not the ultimate maximand for Post-Keynesians, you still need to maximize it to get financing for your investment plans, which will then allow you to grow. One would fairly wonder then: is there a practical difference between the post-Keynesian hypothesis of maximizing growth and the

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596 Wood, supra note 588, 4
599 Lavoie, supra note 580, 106
600 Dallery, supra note 576, 495
601 Lavoie, supra note 108, 37
602 Kaldor, supra note 593, xvi
604 Lavoie, supra note 108, 37
605 Lavoie, supra note 580, 106
606 Dallery, supra note 576, 495
neoclassical hypothesis of profit maximization. Neoclassicists would claim that you can focus on profits and still get growth as a side-effect, if this is what you ultimately want; it does not make a difference where you want to go to, as in both cases profits are still a maximand, whether intermediate or ultimate.

Still though from a normative point of view the ultimate focus in a firm’s activities makes a difference. Because when profit maximization is the ‘holy grail’ of corporate governance this will inevitably be reflected in the dividend and investment policies of the firm. Eyeing profit means having a ‘fetish’ for liquidity (to put it in the words of Keynes himself), so when liquidity will be available for those that are entitled to enjoy it (i.e. the shareholders) it won’t be refused to them. In other words, if profit maximization is the ultimate maximand, then once free cash flows will be available, they will be distributed instead of retained. A profit-maximizing firm calls for contributions by investors that are seeking to complement their portfolio with a riskier and highly liquid investment; investors that are unlikely to then have the patience to wait for remoter gains, when gains are immediately available. A profit-maximizing firm calls for impatient investors that have a peculiar zest in making money quickly. In brief, profit-maximization means aiming at short-run profit maximization, while growth maximization means aiming intermediately at long-run maximization of profit, which by its very nature is a different goal, as investors will know beforehand that their investment plan will be served only if profits are made and retained for a certain amount of time. As a side note here then, we could add that this is why the rise to dominance of the neoclassical theory of the firm has promoted short-term shareholdership.

3. The growth-profit tradeoff in corporate governance

We now turn to the analysis of the relationship between profit goals and growth objectives, which is crucial in order to understand the role that shareholders play in the Post-Keynesian firm and especially the influence that the shareholder value orientation may exert on the firm’s strive to grow through capital accumulation, as suggested in the previous section.

Again let’s consider a firm that has selected to pursue a certain growth rate. It will necessarily have to make some investments to obtain its goal. According to the Post-Keynesian line of thought the firm faces two constraints in its investment plans. I will try below to present these two constraints by using an oversimplified math model to make my case, hopefully understandable by any social scientist.

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607 LAVOIE, supra note 580, 107
608 The analysis followed is heavily based on LAVOIE, supra note 580, 109ff.
3.1. The finance constraint of the corporate accumulation process

The first constraint is called the finance constraint. The firm’s investment, which will allow it to obtain the desired growth rate, needs to be financed somehow. Finance may be internal or external. In both cases, as it was noted above in Section 2, retained earnings play a central role in the financing opportunities the firm will have; they are themselves the means of internal finance, but also function as a determinant of the external finance funds the firm will be able to secure according to Kalecki’s principle of increasing risk. Especially with regard to external finance, retained earnings determine not only the amount that external financiers will be willing to provide the firm with, but also the amount of external finance that the firm itself will want to take on; management will self-impose stricter limits on itself than the suppliers of funds will and these limits will be based on some multiple of the firm’s retained earnings.

Let’s denote a firm’s contributed capital with the symbol $K_S$ and the capital borrowed through loans or bond issues with the symbol $K_B$. Let $\pi$ be the firm’s gross earnings, i.e. the firm’s revenues before dividends and interest are paid out. With $i_s$ we denote the rate of returns on shares (taking under account both the dividend payments and the cash flows used for stock repurchases) and with $i_b$ the rate of interest on borrowed capital. Then the retained earnings, which are practically additions to the contributed capital, are equal to the firm’s gross earnings minus the amount that has been paid out in dividends and stock repurchases minus the amount that has been paid back to lenders in interest:

$$\Delta K_S = \pi - i_s K_S - i_b K_B$$ (1)

We may now assume that the rate of return on contributed capital and the rate of return on borrowed capital are identical. This is an assumption that Post-Keynesians defend as not being too unrealistic. The basis for it is that since the promise to equityholders does not represent some fixed obligation for the firm, managers will adopt a dividend policy that is simply adjusted to the market conventions, one of which is the yield of fixed-income financial assets of a similar class. This is based on the fundamental premise of the Post-Keynesians that dividend payments, like interest payments, are for the managers a cost of autonomy from capital market constituents; the management will pay


610 WOOD, supra note 588, 31; PAUL DAVIDSON, MONEY AND THE REAL WORLD (1972), 348

611 The sum of the par value of the firm’s capital plus the capital contributed by the shareholders in excess of the par value; CLYDE STICKNEY, ROMAN WEIL & KATHERINE SCHIPPER, FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS AND USES (2009), 852

612 LAVOIE, supra note 580, 110

613 Id.

as a return on the share just as much as it is required to keep the shareholders passive, so this amount is not likely in the long-run to be considerably greater from what a bondholder would make. Under this assumption equation (1) looks the following way:

$$\Delta K = \pi - IK$$  \hspace{1cm} (2)

So far we’ve got the variables that determine the firm’s internal finance. We now turn to Kalecki’s principle of increasing risk (see Section 2 above), which views a firm’s external finance as a multiple of the current level of retained earnings, which we gave just above under (2). Thus, a firm’s external finance is given by the function:

$$\Delta K = \rho(\pi - IK)$$  \hspace{1cm} (3)

The firm now has gathered funds both from internal and external sources and may use them in order to realize the investment, which will be necessary to obtain the desired growth rate. The firm’s investment expenditure (I) will necessarily be (smaller or) equal to the funds obtained from retained earnings and from external sources:

$$I = (\pi - K) + (\rho K)$$  \hspace{1cm} (4)

Equation (4) above shows us that one of the determinants of investment is the firm’s profits. Thus, we gradually start to understand what was said above about the role of the profits in the Post-Keynesian theory of the firm; that profits are a means to the firm’s end. In the above equation we see clearly that the more profits a firm makes the higher the investment expenditures (I) incurred will be.

But, when we are trying to identify the finance constraint the firm faces in its effort to obtain a specific growth rate, we need to formulate an equation, where one of the variables will be this growth rate (g). The rate of growth is the objective, whose attainment depends on the amount of finance a firm will be

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615 James Crotty, Owner-Manager Conflict and Financial Theories of Investment Instability: A Critical Assessment of Keynes, Tobin and Minsky, 12 JOURNAL OF POST KEYNESIAN ECONOMICS 519, 534.

616 While dividend yields relative to bond yields will rarely be on a par to each other in the case of an individual firm, it has indeed been observed that in aggregate the two yields are not too remote to each other. For instance, empirical data for S&P 500 companies have shown that the dividend yield is on average 97% the yield on AAA bonds over the period from 1870 to 2000; but there have been eras, during which there was a high divergence between the two yields (see http://www.capital-flow-analysis.com/investment-theory/dividend-yield.html). Justifiably, there might be concerns about adopting this assumption and indeed there are many studies in the Post-Keynesian realm that do not incorporate it; but still in the end the same conclusion is drawn regarding the impact of shareholder value orientation on the firm. In light of this, it wouldn’t harm if for the sake of simplicity we choose to adopt this assumption at this point, as others have done.

617 Dallery, supra note 576, 496
able to secure on the first hand. Since as we explained a firm’s finance, internal or external, is determined by its undistributable profits (a.k.a. retained earnings) we need to rearrange the equation in such a way, so as it can give us the relationship between the firm’s growth rate and the firm’s profits, the latter also being expressed in dynamic terms (i.e. being measured as a ‘rate’ rather than as an absolute number). The dynamic version of profitability is the profit rate \( r \). What we need to identify then is what profit rate a firm must reach in order to be able to get the growth rate it aspires. This rate of profit is the finance constraint the firm needs to struggle with in its effort to obtain the growth it wants.\(^6\)

Profit rate \( r \) is given by the ratio of \( \pi/K \). Growth rate \( g \) is given by the ratio of \( i/K \). So, in equation (4) above we divide \( I \) by \( K \) to get \( g \); we divide \( \pi \) by \( K \) to get \( r \) and then we rearrange and isolate \( r \) on the one side, which will enable us to see the variables the profit rate depends on. Thus, we break down the finance constraint to its determinant factors. After some manipulation we get:

\[
 r = i + g/(1 + \rho) \tag{5}
\]

Equation (5) is the firm’s finance constraint for the attainment of a specific rate of growth.

What we need to focus on in equation (5) for the purposes of our analysis, is the fact that the rate of return on shares and the rate of interest on borrowed capital \( i \) is located in the numerator. That effectively means that the higher the rate of return on shares and the rate of interest on borrowed capital \( i \) is, the higher the profit rate \( r \) a firm must achieve in order to finance the effort to move towards a specific growth rate. Therefore, if a firm has to pay large amount of its earnings in dividends and stock repurchases to its shareholders, then it will have to strive for a greater profit (as measured by return on capital, which is essentially what the profit rate \( r \) is) in order to meet its growth targets. The more profits are squeezed out of the company to the benefit of equityholders, the lower is then the possibility that the firm will actually end up having the money that is necessary to effectuate the accumulation process that is instrumental for its aspired rate of growth. Accordingly, the lower the dividends paid to shareholders, the lower the profit rate a firm needs to achieve in order to realize its investment plan.\(^6\) So, a stronger shareholder value orientation, materializing in the form of higher equity payout ratios, functions as a counterforce to growth.\(^6\) The equity’s preference for profit affects the inherent in the firm growth-profit tradeoff in a way detrimental to growth.\(^6\) The more then the institutional logics of corporate governance favor the promotion of shareholder value, the less investment/capital accumulation firms will be able to

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\(^6\) _Id._, at 497


\(^6\) Engelbert Stockhammer, _Shareholder Value Orientation and the Investment Profit-Puzzle_, 28 _JOURNAL OF POST KEYNESIAN ECONOMICS_ 193, 211
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effect and thus the less growth we should expect in this economy’s business sector.

Even without the fore stated algebraic representations, we could conclude from the mere discursive description of the way internal and external finance works in the Post-Keynesian theory that the higher the orientation of a firm towards shareholder value is, the more dividends will be paid out of the realized profits and thus the lower the firm’s retention ratio will be, which determines the magnitude of the firm’s internal and external financing. Thus, firms that really want to meet their investment and hence growth goals have to struggle to make higher profits, so that even after the squeeze dictated by the strive to keep the share price up, there can still be some free cash flows that can go for the finance of the firm’s investment plans. Shareholder value orientation makes the finance constraint more difficult to surpass.

The analysis of the finance constraint leads us to the conclusion that there is indeed a growth-profit tradeoff within firms and thus shareholder value-improving mechanisms of corporate governance, such as stock option remuneration packages, are likely to negatively affect the growth prospects of a firm due to their implicit impetus for distribution rather than reinvestment of profits.

3.3. The expansion frontier

According to the Post-Keynesian theory of the firm the second obstacle firms face in their effort to accumulate capital and obtain their selected growth rate is the so-called expansion frontier. It is valid then according to equation (5) to suggest that the Great Reversal in Corporate Governance, which has prompted managers to cater more for shareholders’ interests by adopting more generous equity payout policies, has actually hampered the accumulation process inside corporations, which means that this study’s First Hypothesis is in this respect confirmed.

The Great Reversal in Corporate Governance and the Financing of the Capital Accumulation Process

According to equation (5) for a given profit rate \( r \) managers can finance a higher accumulation rate, the lower the dividend payments are. It is valid then according to equation (5) to suggest that the Great Reversal in Corporate Governance, which has prompted managers to cater more for shareholders’ interests by adopting more generous equity payout policies, has actually hampered the accumulation process inside corporations, which means that this study’s First Hypothesis is in this respect confirmed.

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The general rule is that there is an increasing relation between growth/accumulation rate and profit rate. The bigger you get the greater your return on capital. Neoclassical economics call this ‘economies of scale’. Since

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622 Also known as the ‘opportunity frontier’; WOOD, supra note 588, 62
623 Dallery, supra note 576, 497
growth comes with greater investment in capital stock, it is natural that the latter provides the firm with the extra capacity needed to supply for any given increase in demand. Increased investment expenditure also improves the firm’s efficiency since it renders it able to integrate the latest technologies, thus reducing the costs of production and therefore attain a higher profit margin.

However, the increasing relation between the capital accumulation or growth rates and profit rate is not infinite. There is a rate of growth, called the expansion frontier, beyond which accumulation rate and profit rate are negatively related. This means that beyond this point growth has a negative effect on profits due to a series of difficulties the rapidly expanding firm faces. The student of the discourse of neoclassical economics on the ideal firm size might think that this axiom of the Post-Keynesian theory of the firm is what neoclassicists call ‘diseconomies of scale’. However, there is a difference in that neoclassical economics believe that the frontier is related to a firm’s absolute size, while Post-Keynesians view the frontier as being determined by the rate of expansion, by how rapidly a firm grows. Post-Keynesians believe that there is no optimal size for a given firm and that it is indeed feasible for managers to coordinate activities within organizations that have an infinite size (at least up to the size they are allowed by national competition authorities depending on the market share they obtain). What causes the problem in the Post-Keynesian theory of the firm is the speed, with which a firm changes and grows; this is what may cause problems to the managerial factor of production.

The negative relationship between growth and profit beyond the expansion frontier is due to a series of reasons such as: (i) the large amount of money that the firm needs to expend in order to increase the demand for its products (e.g. extra advertising, promotion, product innovation and quality improvement) will cause its unit costs and prices to rise and thus the firm’s profit margin will go down; (ii) growing firms must integrate new managers and train them to handle the complexities of the business, but this integration is time consuming and costly to the firm (this difficulty is known as the ‘Penrose effect’); (iii) expanding firms tend to diversify in new markets and new products, of which management lacks knowledge.

When the firm moves in the area below the expansion frontier then both growth and profits are at suboptimal levels. The firm would like to grow more, since this is its objective, while the shareholders would like to make more profits. When the firm reaches the expansion frontier, profits are at their peak and this is the optimal situation from the shareholder point of view. But the Post-Keynesian firm that tries to maximize growth is not satisfied yet, as it knows it can grow even more. But, since the relationship between profits and growth is an inverted U-shape, if the firm wants to go beyond the expansion frontier
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frontier it won’t be so profitable anymore, so the shareholders will be unhappy. So, if the firm has a strong shareholder value orientation, it won’t grow beyond the expansion frontier. This analysis is better understood with the following graph (Figure 28):
On the horizontal line we measure the firm's growth rate. On the vertical we measure the firm's profit rate. Let's assume that the firm wants and is able to pursue pure profit maximization under the influence that the shareholder value orientation generates. Its desire will be to realize profits at a rate, which is the maximum possible profit rate the firm can achieve. The
rate leads to point $R$, which is associated with a suboptimal growth rate $g_r$. If the firm is Post-Keynesian and is completely insulated by shareholder pressure, so that it can maximize autonomously its own preference function, which is the pursuit of growth as a maximand, then the firm would be able to reach growth rate $g_s$, which leads to point $G$ in the graph, which is in turn associated with a suboptimal profit rate $r_s$ that is however sufficient for the firms in order to finance their objectives.

The analysis of the expansion frontier with the help of Figure 28 confirms the existence of the growth-profit tradeoff and shows how shareholder value orientation with its inherent ‘fetish for liquidity’ may enter the top management’s decision function at the expense of the firm’s real growth prospects.

3.4. Integrating the parameter of shareholdership’s short-termism in the Post-Keynesian theory of the firm

The Post-Keynesian theory of the firm offers a more solid foundation than the explanations in Section 7 of Chapter One for the backing of this study’s First Hypothesis. However, so far in Chapter Two what has been shown is that the slowdown in capital accumulation may plausibly be suggested to having been caused by the Great Reversal in Corporate Governance. The question to be asked at this point then is whether this stylized negative influence of the shareholderist thought on fixed investment that the Post-Keynesian model suggests would still be there, even in the absence of the Great Reversal in Shareholdership. In other words, is shareholder value orientation alone capable of hampering the growth aspirations of the firm regardless of the time-horizons of the shareholders?

The short answer is no. Shareholder value orientation alone does not make or break a company. Shareholder value orientation has a derivative content; the influence that it generates depends on something exogenous: on the character of shareholdership. The content of the preferences of the shareholders
makes a big difference for the results that the orientation towards the satisfaction of those preferences will produce. Therefore, whenever any theory or line of thought suggests that the dominance of the shareholder value approach in corporate governance leads to the production of a specific set of results, it makes implicitly some assumptions regarding the equity’s preferences and appetite.

So, in light of this analysis, the crucial question to be posed is what is the assumption that the Post-Keynesian theory of the firm makes regarding shareholdership? The answer is that the Post-Keynesian model in setting the preference function of the shareholders, as profit maximization, assumes implicitly that shareholders are short-termists. The shareholder value orientation is conducive to produce these negative results on the efforts of the firm to surpass the finance constraint and move beyond the expansion frontier, because it is implicitly assumed by Post-Keynesians to be an orientation towards the delivery of short-term profits. If shareholders were interested in the intermediate to long-term prospects of the enterprise, then it would be plausible to suggest that they would be concerned with the firm’s investment policy and would not seek to hamper the firm’s efforts to accumulate capital. The premise that short-termist shareholders have this negative stance towards capital accumulation is backed by empirical data presented in Section 7.5. of Chapter One. If shareholders were observed in reality to be long-termists, then the Post-Keynesians would not lend to shareholder value orientation the content of orientation towards the distribution rather than the retention of profits. Why else would the Post-Keynesian theory of the firm stylize the influences flowing from the equity towards the firm as hostile to fixed investment, if it didn’t view shareholders as having a, typical for myopic horizons, ‘fetish for liquidity’ and hence a distaste for the irreversible and illiquid nature of fixed capital formation? Since in Chapter One it was shown (Figures 25-27) that shareholders only have a fleeting relation with any particular enterprise, then the implicit assumption of the Post-Keynesians cannot be blamed as unrealistic and hence it is plausible to suggest that the Post-Keynesian modeling backs the claim that short-term shareholdership coupled with shareholder value orientation is responsible for negative accumulation dynamics in firms.