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The Modern Corporation and the Problem of Order

Analysts of the modern industrial corporation tell a remarkable story. In it, the invisible hand of the market has become cramped and atrophied, perhaps broken beyond repair. The damage has been inflicted by none other than the modern corporation, its visible hand clenched into a fist, pounding away at the fetters of the market, struggling to bring about a "managerial revolution in American business."[1] This story is told not by critics of modern capitalism, nor by those advocating a return to unencumbered free markets, but by analysts who see this managerial revolution as inevitable and desirable. Only with its success has capitalism come into its own, attaining previously unimagined levels of productivity and profit. In their account, the modern corporation emerges triumphant precisely because the visible hand of management is more efficient than market allocation. At the heart of this efficiency are new forms of organization that lower the cost of governing the business enterprise. The triumph of managerial capitalism has led to the dominance of a new type of business organization: the decentralized or multidivisional form (M-form) characterized by a number of distinct operating divisions and overseen by a hierarchy of professional managers.[2] Described as the "most significant organizational innovation of the twentieth century," the M-form has been perhaps the most important single factor underlying the success of the managerial revolution.[3]

The ascendance of the modern corporation is not the end of the story, for many of the enterprises that led the managerial revolution now face serious difficulties. They have been challenged by foreign competition and declining profit rates, while critics have asserted that they are plagued by wasteful and inefficient production, inept decision-making, and the practice of placing short-term profits ahead of the firm's

1 Chandler (1977).
2 The term "M-form" (for "multidivisional form") originated with Williamson (1975). I use the terms "M-form," "multidivisional structure," "decentralization," and "decentralized structure" interchangeably.
3 Williamson (1985, p. 279).

long-run interests. The efficiency of the M-form itself has been called into question by charges that it is ossified and bloated by bureaucracy, plagued by information-flow deficiencies, and too large and unwieldy to govern effectively. The situation has become so critical in some cases that long-dormant shareholders have intervened to take control of governing committees or replace top management, events that were nearly unthinkable in earlier decades. At least in some industries, the victory of the managerial revolution and the efficacy of the decentralized form appear to be in doubt.

Perhaps the foremost example of the modern corporation's triumph, as well as its decline, is General Motors. GM created and perfected one of the earliest multidivisional structures, during the 1920s, under the leadership of Alfred P. Sloan, Jr., and Pierre S. du Pont. Following the seminal work of Alfred Chandler, GM's organization, along with that of its largest shareholder, E. I. du Pont de Nemours, has been regarded as one of the paradigmatic examples of increased efficiency through decentralization.[4] After implementing the M-form, GM quickly became one of the most successful corporations in history, a position it held for nearly half a century. Surpassing Ford in the late 1920s to become the leader in the automobile industry, GM amassed a record of profitability that stretched unbroken into the 1970s; in some years, its share of automobile sales was over 50 percent of the North American market. The corporation became one of the most important institutions in the U.S. economy, single-handedly capable of having a serious impact on the country's economic well-being. By 1956, one government study concluded that "there is probably no company in the United States that affects the lives of the citizens of the country as much as General Motors."[5] Analysts inside and outside of GM attributed the corporation's incredible success in large part to the decentralized structure that it put into place in the 1920s. GM's organization was taken as a model of efficiency, and Alfred Sloan, who served as the corporation's president or chairman of the board for over thirty years, continues to be hailed as "an organizational genius" who was "relentlessly given to profit maximization."[6]

By the 1960s, GM's long record of success was beginning to show cracks. As early as the mid-1950s, GM began to lose market share to foreign competitors such as Volkswagen in the small market for economy cars. Because this market accounted for only a tiny fraction of GM's profits, the corporation was slow to react to the developing trend toward

4 Chandler (1962); Chandler and Salsbury (1971).
5 U.S. Senate, as quoted in Cray (1980, p. 10).
6 Williamson (1991b, p. 79, fn. 8).

smaller, more fuel efficient autos. When it finally decided to develop such a car, the result was the ill-fated Corvair. The car that Ralph Nader dubbed "unsafe at any speed" led to millions of dollars in lawsuits against GM and increased government regulation of the automobile industry. Perhaps more important, from GM's point of view, the corporation's reputation as a forward-looking producer of high-quality autos was called into question. But GM's problems ran even deeper than considerations of quality, safety, and customer relations. Between 1964 and 1969, the return on investment for the Chevrolet division, long the mainstay of GM's profit base, reportedly plummeted from 55.4 percent to 10.3 percent.[7] Following the 1973 oil embargo, GM's overall sales and profits fell dramatically, and its long dominance of the U.S. auto industry was shattered. The corporation that once had been hailed as the paradigm of efficiency was now charged with wasteful and inefficient production, failure to plan for the future, and inability to recognize emerging trends. Yet on paper, at least, GM's organization looked very much like the M-form that had been erected in the 1920s.

Why did the decentralized structure that served Alfred Sloan and his successors so well prove to be so ineffective later in GM's life? To address this question, I set out to examine the changes in GM's organization over time. Initially, I expected that my research would focus primarily on the latter stages of GM's history, for the period prior to 1960 seemed well documented. Chandler's pathbreaking work focused extensively on the period from 1920 to 1925, when the M-form was created. Arthur Kuhn's comparison of GM and Ford extended the analysis through 1938, one year after the corporation's first formal reorganization.[8] Decades before these works were published, Peter Drucker had written about his experiences in GM during the 1940s, providing a less systematic description of the decentralized structure that nonetheless seemed consistent with Chandler's analysis.[9] Finally, Alfred Sloan's best-selling autobiography provided a firsthand account of the development of GM's organization over the years.[10] Sloan's account emphasized that the GM structure had changed little between 1925 and 1960, and, like Chandler, he attributed the corporation's success to that organization.[11] While a few reviewers noted inconsistencies in Sloan's story, there appeared to be no reason to doubt that the M-form had changed only minimally prior to 1960.[12] Nonetheless, I set out to examine the primary historical documents that were available – internal memos and reports disgorged by the

7 Wright (1979, p. 100). 8 Kuhn (1986). 9 Drucker (1972).
10 Sloan (1964). 11 Chandler served as a research assistant for Sloan's book.
12 See Wolff (1964).

U.S. government's 1949 antitrust suit against GM and E. I. du Pont de Nemours, and the business papers of various Du Pont and GM executives, many of which had been unavailable to earlier researchers.[13]

These historical documents told a surprising story. According to prevailing views of the modern corporation – accounts that had been constructed using GM as a key source of evidence – the most important factor behind the M-form's ability to lower costs was the fact that it created a firm separation between long-range planning and daily operations. The M-form decomposed the corporation into operating divisions (like Buick and Chevrolet) and a general office or corporate headquarters.[14] Executives at headquarters were responsible for making long-term policy and entrepreneurial decisions that affected "the allocation . . . of resources for the enterprise as a whole."[15] This reduced the possibility that operating men would attempt to divert resources to their own units by promulgating and pursuing self-interested policies. Division management was responsible for making daily operating decisions utilizing resources allocated by the general office. This ensured that operating decisions would be carried out by the men closest to the facts, rather than being made by top executives who lacked detailed information and knowledge about operating issues. The division of labor between strategic planning and daily operations was thus seen as a fundamental prerequisite for the success of the M-form; an organization that failed to separate these functions would be inefficient.[16] Yet at GM, the textbook M-form described in the literature had existed for only a brief time. Soon after its inception, top executives deliberately introduced changes that conflated strategic and tactical planning. During its decades of phenomenal success, GM had thus been governed by an organization that, according to organization theory, violated the fundamental principles of efficient decentralization.

Nor was that the end of the story, for historical documents revealed a number of other surprises. First, the changes in GM's organization had by no means been uncontested. Owners favored an M-form like that described in organization theory, and representatives of E. I. du Pont de Nemours, which owned about 25 percent of GM's voting stock during most of the period under study, sought constantly to impose such a

13 Throughout this book, the name "Du Pont," with initial capital letters, refers to E. I. du Pont de Nemours, which owned about 25 percent of GM's voting stock during the period under study. The use of "du Pont," with initial lowercase *d*, refers to individual members of the du Pont family, several of whom played key roles in GM's history.
14 The terms "general office," "headquarters," and "corporate headquarters" are used interchangeably throughout this book.
15 Chandler (1962, p. 11).
16 Williamson (1975, pp. 148–154; 1983, pp. 352–356).

structure on GM.[17] Top GM executives, led by Alfred Sloan, resisted Du Pont's version of the M-form and sought to introduce variations that, according to both owners and organization theory, were inefficient. Owners and managers struggled over the issue of organizational form for decades, creating intense debate and frequent organizational change. A second surprise was that although Alfred Sloan and his colleagues fought passionately to preserve "corrupted" versions of the M-form, their public pronouncements belied this fact. In his autobiography, for instance, Sloan explicitly endorsed the idea that operating executives should be kept off of governing committees responsible for planning and resource allocation, and he insisted that any departures from this principle at GM had been "exceptions" to the rule of good organization.[18] But internal memos revealed a very different Sloan. In 1945, for instance, he described GM's Administration Committee, which at that time was responsible for approving policy, authorizing appropriations, and reviewing divisional performance:

> Every division . . . is represented directly or indirectly on the Administration Committee. The five car divisions – the biggest part of the corporation – are represented directly. Frankly, I can not conceive how any . . . organization could[,] in a more scientific way, bring to bear on an important problem the concerted ability of the organization as a whole.[19]

17 Throughout this book, I use the term "owners" to refer to the coalition of E. I. du Pont de Nemours and J. P. Morgan, who together controlled more than 25 percent of GM's voting stock and a significant number of the positions on GM's board. I use this term more out of convenience than analytic specificity. These shareholders dominated GM's board in a way that others could not. Nonetheless, it is important to remember that Du Pont and Morgan remained minority owners; we should not confuse their preferences or actions with those of all shareholders.

It is also important to note that a number of top management executives at GM, including Alfred Sloan, were large individual shareholders. In 1940, for instance, Sloan owned some 3.8 million shares of GM common – less than one percent of corporation stock outstanding, but still sufficient to constitute a considerable financial incentive. To speak of such executives as managers rather than owners may therefore seem odd. As the empirical evidence will clearly show, however, the interests of these men were driven first and foremost by their structural positions as managers. Differences between outside owners like the du Ponts and management men like Sloan broke down along remarkably consistent lines. Moreover, as I show later, when Sloan and others withdrew from management but continued to serve on GM's board and its subcommittees, they suddenly found themselves agreeing with outside owners on policy issues, even to the point of repudiating positions they had taken when they were managers. Positions within the governance structure do matter, it seems, in shaping one's interests and point of view on a variety of issues. On Sloan's holdings of GM common, see United States Congress (1956, pp. 3567–3575).

18 Sloan (1964, p. 113).

19 Alfred P. Sloan, Jr., to Walter S. Carpenter, Jr., June 14, 1945, Accession 542, Box 837.

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The inclusion of division managers hardly sounded like an exception to the rule here. Indeed, for most of his tenure as GM's chief executive, Sloan fought passionately for an organization that incorporated division managers into the planning and resource allocation process. Either Sloan's thinking on the M-form had changed over the years, or there was a serious discrepancy between the ideology and practice of decentralization at General Motors.

The biggest surprise, however, was that GM's long decline began only after it reintroduced a textbook M-form in 1958, following the most profitable and successful decade in its history. For most of its corporate life, GM was governed by an M-form that violated the principles of efficient organization and, according to prevailing theories, should have failed miserably. Yet during those periods, GM succeeded magnificently, becoming one of the largest, most profitable corporations in the world. In 1958, following decades of struggle between owners and managers, GM finally implemented an M-form that established a firm distinction between strategic planning and daily operations. The new organization kept division managers out of planning by putting executives at headquarters firmly in control of top committees responsible for strategy formulation. But the new structure created internal dissension and contestation that played a key role in GM's eventual economic decline. Not only had GM's success defied the prescriptions of organization theory, so too did its failure. Faced with these unexpected and puzzling findings, I set out to understand and explain the changes that had occurred in GM's organization over time.

The main thesis of this book is that the variations in GM's organizational form are easily accounted for when corporate governance is understood as a social and political process rather than a simply economic one. The primary imperative facing governance mechanisms is to establish and maintain social order within the firm by creating cooperation between different levels of the firm and by motivating subordinates to carry out corporate goals. Drawing on economic models, existing theories of the firm contend that order and cooperation are effected through incentive alignment that rewards compliance to organizational goals and punishes malfeasance, thereby aligning the interests of individual actors with that of the firm. Within this context, top executives govern through fiat and authority, issuing orders that subordinates obey out of self-interest. I argue that this Hobbesian view of order is untenable, particularly given the conditions of complex interdependence and imperfect information that characterize the modern corporation. Order within complex organizations cannot be maintained by fiat and sanctions because it always entails an element of consent or voluntary acceptance on the part of those who are governed. Yet the creation of consent often requires a departure from principles of efficiency. Indeed, I argue that the same factors that give rise to technical efficiency in the modern corporation have unintended social consequences that disrupt consent, creating constant tension between efficiency and internal order. For this reason, a strict adherence to the textbook M-form often undermines consent, leading not to effective governance, but to organizational decline.

This thesis may seem unremarkable. Anybody who has spent time inside large firms knows that political machinations are common and that managers do not govern merely by issuing orders. Yet these simple facts, when understood through the proper conceptual lens, have profound consequences for existing theories of the firm and for our understanding of corporate governance. To understand why this so, and to grasp the revolutionary implications of the GM case for organization theory, it is helpful to have a deeper understanding of prevailing accounts of the modern corporation.

Efficiency Views of the Modern Corporation

The story of organizational form at General Motors is a story of corporate governance. Governance centers on the question of how cooperation and order are created and maintained within the firm. As Oliver Williamson puts it, governance involves the creation of "good order and workable arrangements."[20] Efficiency views of the firm contend that new types of organization like the multidivisional form arise and persist because they are more efficient than alternative methods of organizing the firm, and such views hold that their efficiency derives primarily from their governance attributes. New forms of organization succeed, that is, because they help establish "good order and workable arrangements" within the firm, thereby lowering the cost of running the enterprise. In this view, the creation of order reduces the cost of running the firm, market mechanisms favor lower-cost forms of organization, and firms with superior governance arrangements are therefore more likely to survive and prosper.[21] Efficiency analyses of the M-form focus primarily on relations between top executives and lower-level management in the

20 Williamson (1996, p. 11), quoting Fuller.
21 Strictly speaking, successful firms are those that lower the sum total of production and governance costs. Efficiency theories of the firm tend to assume that the action is on the governance side of the equation; production costs are seen as largely independent of organization. *Ceteris paribus*, the firm with the lower governance costs prevails.

firm, and they ask how cooperation and coordination are achieved between these levels. They also consider a second level of governance, the division of labor between owners and managers that has come to be known as the separation of ownership and control. Here, the question is how owners can ensure that the firm will continue to be run in shareholders' interests once they delegate significant decision-making power to professional managers. The M-form literature suggests that these two aspects of corporate governance are interrelated and that problems at both levels are alleviated through internal reorganization. In this section, I outline both of these arguments in more detail, with an eye to showing why the GM case proves problematic for each.

The claim that the multidivisional form emerges and succeeds because it is more efficient than existing alternatives arises in the historical work of Alfred Chandler, who shows that the growth of the modern corporation took place in two stages.[22] In the first, firms expanded to serve national and international markets, entering and sometimes creating new markets for mass-produced goods. As they grew, these firms internalized previously independent steps in the production process, taking over functions formerly carried out by independent suppliers and distributors. This resulted in the creation of large, vertically integrated firms with enormous investments in plant and equipment. Growth through vertical integration led to increased profits in the short run, for it created enormous economies of scale and scope that reduced production and distribution costs. But over the longer run, the new firms repeatedly found that growth through integration eventually led to internal chaos, causing initial profits to turn suddenly into huge losses. These difficulties occurred because the increased size and complexity of integrated firms overwhelmed the governance capabilities of traditional, centralized enterprises organized along functional lines. As firms grew and internalized diverse activities across different markets, there was a rapid increase in complexity and in the types of decisions that needed to be made. Eventually, the costs of governing and coordinating activities within the firm increased so substantially that they outweighed the economies created by integration. Intelligent decision-making in the face of complexity hinged on a second stage of development – structural reorganization of the firm. In the long run, growth without reorganization of the governance process led "only to economic inefficiency."[23] The success of the modern corporation was achieved only with the creation of the decentralized or multidivisional form.

22 See Chandler (1962; 1977; 1979; 1990); Chandler and Salsbury (1971); Chandler and Daems (1980).
23 Chandler (1962, p. 16).

The M-form is characterized by two features, *both* of which must be present for decentralization proper to exist.[24] The first is divisionalization, or the decomposition of the firm into a number of distinct operating units dedicated to specific product markets and functioning as independent profit centers.[25] Each division administers a specific product line and is responsible for generating its own profits. Divisional management is responsible for making decisions regarding a single product line and for administering day-to-day operations. The second defining feature of the M-form is the creation of a general office or corporate headquarters to oversee the corporation. Rather than focusing on a specific division or product line, headquarters executives are responsible for monitoring, evaluating, and coordinating the activities of the various divisions and for carrying out long-range planning for the corporation as a whole. To assist them in these functions, the general office relies on financial and technical staffs that oversee and audit divisional activities, making corporate headquarters "less the captive of its operating organizations."[26] The result is an administrative hierarchy in which the general office oversees long-range strategic planning, while the divisions take charge of making operating decisions for specific product lines. The task of making operating decisions is thus decentralized, while that of long-range planning and coordination is centralized (Figure 1.1). This organization improves efficiency by rationalizing information flows, creating clearer lines of authority, and removing "the executives responsible for the destiny of the entire enterprise from the more routine operational activities," giving them "the time, information, and even psychological commitment for long-term planning and appraisal."[27]

The efficiency view of the M-form is formalized in the transaction cost economics (TCE) of Oliver Williamson.[28] TCE brings governance to

24 Some analysts imply that divisionalization alone is sufficient to achieve effective decentralization (e.g., Stinchcombe 1990, pp. 150–151). Chandler (1962; 1991a) clearly argues that divisionalization must be accompanied by coordinated control through a general office before we can speak of a decentralized structure. This is apparent in his treatment of GM, for GM created divisions early on in its history. Yet Chandler argues that GM achieved efficient governance only when divisionalization was accompanied by the creation of a general office and its attendant control mechanisms. A company that is divisionalized yet has no general office (or a very weak general office) constitutes a holding company. As we will see later, Williamson is even more explicit on this point.

25 In Chandler's analysis, divisions can also arise to serve geographical regions rather than product markets proper. This formulation has been the source of some controversy (Stinchcombe 1990). Because GM's (and Du Pont's) divisions are organized along product lines, I stick to the narrower definition.

26 Chandler (1962, p. 310).

27 Chandler (1962, p. 309).

28 See Williamson (1975; 1985; 1996). There are many scholars who adopt a general focus on transaction cost analysis. Williamson's work is the best-known version

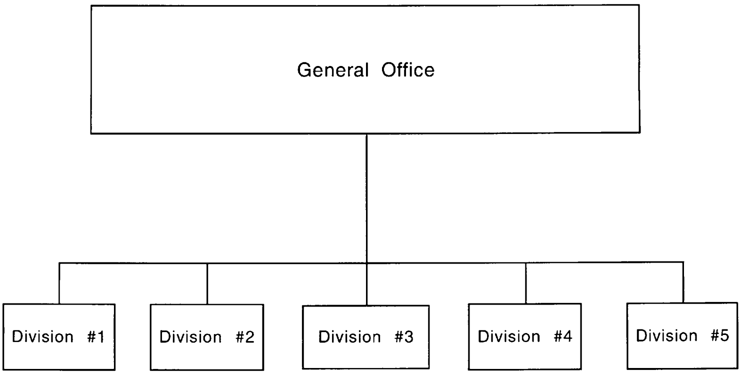

Figure 1.1. The multidivisional form. (Adapted from Alfred D. Chandler, Jr., *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*. Cambridge, MA: MIT Press, 1962, p. 10.)

center stage in organizational analysis by focusing on transaction costs – the costs involved in devising, monitoring, and carrying out transactions within and between firms. Traditional economic accounts treat the firm as a frictionless production function in which actors possess perfect information about the world around them and subordinates follow orders from above without resistance. TCE, on the other hand, assumes that economic actors are characterized by bounded rationality and opportunism. The former refers to the fact that while these actors are intendedly rational, they possess incomplete information and have cognitive constraints that often prevent them from reaching optimal solutions to complex problems.[29] Opportunism denotes "self-interest seeking with guile," reflecting the fact that actors may pursue their own goals at the expense of the larger organization, and may use deception in doing so.[30] Once assumptions of perfect information and unquestioned compliance are replaced with those of bounded rationality and opportunism, transactions are no longer costless. The process of identifying and controlling opportunism and bounded rationality takes time and money, and the primary imperative facing economic organizations is to "devise . . . governance structures that have the purpose and effect of economizing

among organizational analysts, and it has been by far the most concerned with issues of internal organization.

29 Simon (1976). I use the terms "bounded rationality" and "imperfect information" interchangeably.

30 Williamson (1975, p. 26).