Reforming Capitalism
Professor Michael Magill, USC, 10/22/2010

Abstract. Sounds radical in a sense it is: it argues from my earlier work on incomplete markets that applying the state of nature approach to describing uncertainty for corporations (the standard approach of finance) can be shown to be inappropriate, indeed largely meaningless. Instead we should adopt a more realistic statistical approach—i.e. think of the outcome of production as a random variable described by its probability distribution over the possible outputs (at date 1) where the distribution is influenced by the investment made by the firm at date 0. This apparently innocent change has a major impact on what the firm should do, since its investment decision now has an external effect on its employees and consumers. The paper shows in the simplest setting how stochastic general equilibrium theory with production has to be altered when we replace the standard Arrow-Debreu approach by this probability approach. It shows that we are led to a major revision of the theory of corporate governance, the standard theory of operating a corporation in the best interest of its shareholder by maximizing its profit, is replaced by a stakeholder theory of the corporation in which the firm must also take into account the interests of its workers and consumers.