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STAKEHOLDER PROTECTION IN CORPORATE GOVERNANCE AND IN THE LEGAL SYSTEM, THE FOUNDERS' PERSPECTIVE, AND THE VARIETIES OF CAPITALISM[1]

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Abstract

Not necessarily the most appropriate defence of stakeholder interests can be found in the institutions and practice of corporate governance, other specific kinds of legal provisions can be more suitable. In the literature the issue of protection of stakeholder interests (of employees in particular) is generally considered in a static context: how should corporate governance be shaped in relation to existing firms, according in particular to some subjective criteria of fairness and fair play. But in order to exist and to reach a given dimension the firm must be first founded and grow. Thus the propensity to found a firm and finance and manage its growth, and therefore the supply of entrepreneurship, depend, among others, on the extent of founders' and co-owners' rights, and thus on the institutions of corporate governance. As shown by Hall and Soskice (2001) the latter, together with the different legal setups, result in different varieties of capitalism, such as broadly speaking the Anglo-Saxon or the continental-European variety, with different characteristics, advantages and disadvantages. Among the disadvantages of the continental European model, not considered by Hall and Soskice, are much higher rates of long-run unemployment.

JEL Classification: P10, P48, G34, K22, K31

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1. Introduction and outline

The notion of stakeholder applies, according to the interpretations, to those having a contractual relation with the firm, to those affected by the externalities generated by the firm, to those from whom the performance of the firm is affected. To the rather broad and vague notion of stakeholders correspond somewhat hazy notions of stakeholder theory and of the pursuit of stakeholder value. According to the instrumental, and rather non controversial view of stakeholder theory attention has to be paid by managers to the interests and incentives of all from whose activity the success of the firm depends. Aside from this particular viewpoint, the notion of stakeholder theory acquires ethical or ideological connotations, and the picture becomes rather blurred. As often remarked in the literature, the alleged pursuit of stakeholder interest can justify in practice lack of managerial accountability and

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pathological interference by external organized interests (politicians in particular) in the actual running of the firm (what we may call at its worst the Alitalia syndrome). Moreover the issue of protection of stakeholder interests (of employees in particular) is generally considered in a static context: how should corporate governance be shaped in relation to existing firms (corporations in particular) and according to some subjective criteria of fairness and fair play. But in order to exist and to reach a given dimension the firm must be first founded and grow, and the propensity to found a firm and finance and manage its growth depends, among others, on the extent of founders' and co-owners' rights, and thus on the institutions of corporate governance (both in the legal system and in the practice of social interaction). The lesser those rights the lower will be presumably the founders' interest in creating the firm and managing its growth. Instead of relying on managers under pressure from the social environment to pay attention to stakeholder interests (the Japanese model), a different way can be to ensure the formal representation of selected stakeholder interests (in particular of employees) in corporate boards (the German way). In the German framework this solution is accompanied by better than elsewhere cooperation between the social partners. Otherwise stakeholder representation in company boards may provide some kind of restraint on managerial irresponsibility in public companies, but can also lead to a possible alliance between employees and managers or blockholders to the disadvantage of other stakeholders (such as minority shareholders). Broadening the perspective, not necessarily the most appropriate defence of stakeholder interests can be found in the institutions of corporate governance, but in other kinds of legal provisions, such, as in the case of employees, in the labour code. At the same time the institutions of corporate governance and the labour code, instead of being substitutes in the protection of employees' interests, in practice dovetail, leading to different varieties of capitalism, such as broadly speaking the Anglo-Saxon or the continental-European model. The different varieties have their overall advantages and disadvantages. In particular the protection of the interest of the employed insiders can be seen to be associated with a lower protection of the interest of the unemployed outsiders to be able to find an employment: the Anglo-Saxon model leads in fact to lower protection of the stability of employment, but at the same time to lower long- run unemployment. In the Anglo-Saxon model the institutions of corporate control by the market are more active, while in practice the enhanced powers of managers of public companies collude in bringing about what may be perceived as excessive remunerations, in particular in the USA. In the continental model instead of excessive open remunerations there are the hidden benefits of control. In the end the choice between the different varieties of capitalism is a matter of taste and depends on the social context, while, unsurprisingly, the practical consequences of the legal framework depend on the specific characteristics of the social framework.

2. Stakeholders, externalities and ethics

The operation of firms in general, and of corporations in particular, affects the interests of many, either by commission or by omission. The legal and conventional prescriptions on who is empowered to decide on behalf of a company, the rules of decision, the way in which the legal documents concerning the life of the company, such as budget accounts, product information, different types of disclosures are formed and publicized deeply affect the way in which the different interests influenced by the activities of the company are impacted. At the same time the incentive structure that is created by these rules and the manner in which stakeholder

interests are affected influence the overall performance of firms and the economy. Among the different possible stakeholder interests that are impacted by what a firm does or omits to do the law distinguishes those that are relevant from those that are not, and prescribes the way the interests of the relevant stakeholders are to be considered and protected. This the law does implicitly, when it considers some external effects and ignores others. Indeed this is what the law does in general, since the effects of human behaviour are often numerous, far reaching and of diverse nature. For instance, turning to a very clear instance, albeit far from company law, modern Western family law ignores the external effects that the choice of a spouse produces for the rest of the family (parents, in particular). But in other legal systems the consideration of these external effects are paramount and the matching decision is attributed to the parents and not to the spouses themselves.
What are the criteria that guide the choice? There are a number of possible alternative considerations, political, ethical, ideological etc. However, turning back to company law, the most relevant issue concerns the overall economic consequences of alternative regulations, aside from the usual considerations of morality or desert, which would be mostly the domain of philosophers rather than economists. But even aside from any philosophical considerations it is obvious that those empowered to take decisions on behalf of the firm are expected, alike any other individual, not to pursue activities that run against widely shared moral principles (such as resorting to hold-ups or deceit--for instance it should be ethically inadmissible to knowingly deceive an employee about his effective career prospects just in order to extract greater effort from him--or, looking at more extreme possibilities, to murder, however perfect, or blackmail). As the American Law Institute ("Principles of Corporate Governance: Analysis and Recommendations", Philadelphia, 1992, p. 82; quoted in Donaldson and Preston, 1995, p. 82) puts it: "the absence of a legal obligation to follow ethical principles does not mean that corporate decisionmakers are not subject to the same ethical considerations as other members of society." Concretely, the sanction to unethical behaviour, when not sanctioned by law, could be provided by social control through informal social sanctions, leading to loss of reputation. In the case of corporations this could bring about adverse publicity that could be very damaging for their public image and goodwill. Of course the extent to which this takes place depends on the specific social and political context, as appraised by that elusive concept, of social capital. On the other hand there could be some areas of uncertainty where moral and economic issues are blurred. In this area the moral judgment cannot be taken independently of the economic consequences of the rule that the judgment implies or proposes. For instance, for some it could seem unfair and immoral for a firm to dismiss some employees (seen as stakeholders) only because their employment is not profitable any more. The implied consequence of this assumed moral rule would be that this kind of behaviour should be made illegal. But what would be the economic consequences? The first is that the expected cost of employment would increase and, ceteris paribus, the demand for labour decrease, leading to lower wages and/or higher unemployment: in the end part of the cost of such a measure could fall on the additional unemployed, what does not seem very ethical. Then, if the burden of excessive employment leads to the demise of the firm, everybody loses eventually his job and the argument is obviously even stronger. Secondly, a mechanism leading to the allocation of labour where it is most productive would be blocked, with possible adverse consequences on productivity, wages and, again, employment. It is in this kind of blurred area, where ethical and

economic considerations appear to collide that economic reasoning could prove to be the most useful, aiding to form an ethical judgement based on the acknowledgement of the economic consequences of some assumed ethical rule, as translated into corresponding legislation. Of course ethical rules vary according to epochs and civilizations. Ethical rules that run against technological and economic progress lead to lesser increase in productivity and living standards. We have various examples of ethical rules based on religious beliefs that, even in our modern secular world, are hampering scientific and economic progress. Above all ethical convictions that clash with the basic foundations of a market economy (for instance, that any return to capital and enterprise is ethically unjustified being the consequence of "exploitation", or that no employee should be ever dismissed) may bring about types of behaviour in contradiction with its thriving and progress. On the contrary some forms of general acceptance of its basic rules can enhance economic performance. But the rules of the game can vary from those of American liberal capitalism to those of the German social market economy. In the latter case the collaborative attitude of the social partners founded on the acceptance of the social market economy may contribute to explain the success of the German economy.

3. Who are the stakeholders and how does the legal system take into account their interests?

But then, who concretely are the stakeholders supposed to be? First of all those who have a contractual relation (either explicit or implicit) with the firm[2], such as the employees, who are protected by the labour code, or the creditors, whose interests are protected by the civil code, together with the legal discipline of bankruptcy, and by the rules concerning the faithfulness and transparency of accounts.[3] But the notion of stakeholders also implies some kind of consideration for interests that are outside specific legal protection and that should find some specific form of protection in the institutions of corporate governance.[4] According to Freeman (1984) the notion of stakeholder extends to include "any group or individual who can affect or is affected by the achievement of an organization's objectives"[5]. At the same time the externalities that the operation of the company generates on people (possible "stakeholders") who have no specific contractual relation with the firm enter in the scope of a number of legal provisions in defence of perceived public interests: such as environmental laws, public laws concerning the activities of the company relevant for local communities and public bodies, laws concerning the nature and quality of

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[2] This is the notion of stakeholder in Freeman and Evan (1990, p. 354): according to them "the firm is best conceptualized as a set of multilateral contracts among stakeholders" where (p. 355) for them "'contract' should be interpreted broadly to cover cases of 'implicit contracts'", and they "distinguish 'contract' from one-shot exchanges and intend it to stand for 'multiple transactions' that require some governance mechanisms."

[3] As "sunshine is the best disinfectant" (Djankov et al., 2008, p. 436, echoing the famous sentence by Brandeis, 1914, ch. V: "Sunlight is said to be the best of disinfectants"). The transparency rules are of specific relevance for creditors and for all sort of stakeholders, such as minority shareholders or contractors, and, obviously, for the fiscal authorities.

[4] The notion of stakeholders as such is rather vague. For a consideration of who could be considered as possible stakeholders see for instance Donaldson and Preston, 1995, pp. 85-86.

[5] Freeman, 1984, p. 46. It must be noted that the "affected" part was introduced by Freeman only because of the possibility that those affected by the organization would affect it in their turn. A previous definition by a 1963 memorandum of the Stanford Research Institute, quoted by Freeman (1984, p. 31) refers to "those groups without whose support the organization would cease to exist", such as "shareowners, employees, customers, suppliers, lenders and society" (p.32), thus not much more restrictive, and very much in the perspective of strategic management.

goods the company produces, anti-trust laws, and last but not least the criminal law, for preventing all sorts of criminal behaviour that can be committed in managing a corporation. Owing to the above, one may wonder whether there is any specific motive why the interest of stakeholders and of the public in general should be protected by the legal provisions concerning corporate governance, rather than other specific pieces of legislation such as, for instance, in the case of employees, the provisions of labour law. At the same time the protection of the interest of shareholders, especially minority shareholders, who can be considered as a kind of special stakeholders since they are deprived in practice of decisional power (aside from exit) in a context in which information is not only imperfect, but fundamentally asymmetric, traditionally lies at the very heart of the issue of corporate governance.[6]

4. The instrumental motive

A first, but least interesting, approach to the stakeholder issue is the instrumental one, in the standard optics of business administration. The fact that managers should take into account the interest of all whose behaviour is of consequence for the survival and growth of the firm is an obvious platitude, which lies at the core of the instrumental approach to stakeholder theory. The stakeholder view of enterprise management expounded in Freeman (1984), predating by two years the fortunate book by Rappoport (1986) popularizing the notion of shareholder value (according to which the corporation must be run in the interest of shareholders, creating value on their behalf), is not necessarily in contradiction with the notion of shareholder value, since it refers to the stakeholder perspective as a chapter of strategic management. According to Freeman (1984) for the most effective pursuit of the objectives of the organization managers should pay due attention to all those who may contribute to its success, whatever the success criteria are supposed to be (thus including shareholder value). For example, the efficiency wage theory itself can be looked at from the viewpoint of the instrumental stakeholder theory of the firm. Other aspects of personnel management theory, such as how to shape the structure of pay or careers, may be seen in the same perspective: obviously a good manager should take into account the interests and preferences of the different stakeholders and the consequences of stakeholders' behaviour on the attainment of the objectives of the firm (such as in particular profitability). But there is nothing particularly controversial about this. A more controversial and interesting aspect is the extent to which the various stakeholder interests should be taken into account **per se**, independently of their instrumental value.[7] A particularly interesting problem concerns the overall economic consequences of different legal rules relating to corporate governance, and the way in which alternative systems of corporate governance, variously taking into consideration "stakeholder interests", lead to different "varieties of capitalism", and in particular the extent to which different rules and institutions aiming to the protection of stakeholders may be in a relationship of substitution or complementarity among themselves. [8] As shown in Hall and Soskice (2001), complementary prevails. In particular the rules of corporate governance and the provisions of labour law dovetail rather than alternate in the defense of perceived labour rights. If one considers also other aspects of corporate governance such as

[6] On this see in particular Shleifer and Vishny, 1997.

[7] For the consideration of the different possible aspects of stakeholder theory (descriptive, instrumental, normative, and managerial) and many references to the literature considering the different aspects, see Donaldson and Preston (1995).

[8] For the concept of institutional complementarities see for instance Armour and Deakin (2009).

those concerning the protection of minority shareholders, the degree of contestability of managerial powers and the discipline of financial markets one may arrive to the perception of two broad varieties of capitalism, Liberal Market Capitalism (of the Anglo-Saxon tradition) and Coordinated Market Capitalism (the continental European + Japanese tradition), with different advantages and disadvantages and various concrete results which also very much depend on the specific varieties and national characteristics of the countries concerned.[9]

5. The founders' and financiers' perspective

Many discussions on stakeholders vs. shareholders concern how an already existing corporation should be best organized in order to take the interest of stakeholders into account.[10] But in order to function a company must first of all exist, and some measures which may appear to be justified having regard to the functioning of an already existing company can acquire a different perspective if the incentives and conditions relating to its founding are considered. A company arises from a contract between the partners. This is the consideration to start from. In the founders' perspective we may adopt different viewpoints: how would the founders best formulate the statutes in their own interest? And how should the legislator constrain the formulation of the statutes from the perspective of the overall economic and social interests? In this the consequences on stakeholders should be taken into account, but also how the imposed legal constraints may impact on the incentives of the founders, and thus on a crucial decision affecting the supply of entrepreneurship: the decision to found a firm and to put one's own invested resources at risk.[11] Also: how do the rules and objective conditions governing the subsequent life of a firm, in particular the degree of consideration of stakeholders' interests vs. the interest of shareholders, impact on the incentives to create the firm in the first place, and on the growth and further development of a firm? We may here provide an example: the relative abundance of venture capitalists and of so called "investment angels" in the USA, which is by no means matched under European conditions,[12] and which represents an important supply of crucial entrepreneurship,[13] especially in technologically advanced and innovative firms, depends to a great extent on the relative ease by which a successful initiative can be cashed in by going public in a stock market endowed with depth and a great deal of liquidity, and a partnership be

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9 See Hall and Soskice (2001). For the quantitative aspects of the two main varieties and of their national variations see also Damiani (2010).

10 As a clearcut example see Donaldson and Preston (1995), where the issue of stakeholder management is seen essentially as an ethical issue, without paying attention to the economic consequences of the different possible arrangements, and to the ethical implications of those consequences. What is remarkable of their thorough enquiry is that they do not consider the basic fact that a company in order to exist must be first be established, and that the founders-owners are the original shareholders. If the incentives they have for founding the company are insufficient, because, say, the law privileges the interest of stakeholders over those of shareholders, the company will not be founded and therefore will not exist, or will have a smaller dimension.

11 An important aspect here is the extent of the complexity of the procedures needed to have a firm registered or a company incorporated. More exacting procedures can better guarantee some stakeholder interests that are affected by the company's very existence, but have a cost in terms of the propensity to found a company and supply entrepreneurship and risk capital.

12 Cf. OECD, 1998, pp. 18, 100.

13 In particular "business angels", who are as a rule experienced older entrepreneurs, not only are sharing in the USA in the entrepreneurial function of risk taking, but are involved in the assessment of entrepreneurial prospects and may variously affect the decisions relating to the running and development of the firm (cf. Chilosi, 2001, p. 329).

established in the first place, in an institutional environment in which "employment at will" prevails and the labour market is relatively unregulated.[14] The depth and extent of the financial markets depend on the discipline of corporate governance, and especially on the extent of the protection of minority shareholders, more far-reaching than elsewhere. The same conditions make much easier the solution to the problem of how to deal, for instance, with the time when the owners of a family firm decide that it is time to grow above or outside the family limits because of the momentum of the growth of the firm or because of demographic reasons. The legal constraints and the overall institutional environment affect the process through which a firm may be required to change its legal set-up in ways compatible with its growth, a process akin to molting in the natural world. So in order to determine the optimal setup of the rules that govern the life of the firm, in particular those that take into account the interests of the stakeholders, however defined, a dynamic approach should be taken, one that considers the possible development of the firm, from its birth and its growth, to its possible demise, without concentrating the attention on the static setup of an already existing firm, in particular a joint stock firm, at a certain moment of time, or even in a limited time span.[15] Obviously, entrepreneurial incentives are affected not only by the regulations influencing the costs and timing of entry and the rules concerning corporate governance, but also by the overall institutional framework, in particular by the rules that regulate the employment contract that in some way dovetail with the discipline of corporate governance itself.[16]

6. Haziness of the concept of stakeholder value

The great disadvantage with stakeholder value (as the stakeholder approach is often referred to in the literature)[17] as a guide to managerial behaviour, alternative to shareholder value, is the haziness of the concept, and of the basic concept of stakeholder itself. This applies also to the idea that the "management of the firm must be oriented to satisfying the interest of the entity itself, and not the interests of one of its constituents".[18] The idea that managers should be empowered and trusted to pursue stakeholder value (such as in Berle and Means'1932 approach, even if at the time the terminology was different) has the major flaw that stakeholders are many and their "values" indeterminate and undeterminable, just as the notion of the interest of the firm as such. This simply empowers the managers to do what they want independently of their agency relationships with the formal owners of the firm (the shareholders[19]), pretending that they are pursuing stakeholders' interests.[20] If

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14 According Ilmakunnas and others (1999, p. 1) the rate of entrepreneurship is negatively related to union power in the economy. Analogous considerations apply to the various forms of legal labour protection (cf. OECD, 1998, pp. 18–19). On the other hand stability of jobs engineered by labour protection could increase productivity by stimulating the accumulation of specific human capital and there could be some trade-off between job stability and remuneration (cf. Chilosi, 2001, p. 140).

15 The institutional constraints imposed on the companies are usually dependent on the dimension, and in particular may be shaped so as to favour the start-ups. (But this can bring about some threshold problems.)

16 On this see in particular Djankov, 2008.

17 See in particular Charreaux and Desbrières, 2001, where the notion of stakeholder value is defined.

18 Cf. Aglietta and Rebérioux, 2005, p. 46.

19 There are some (such as Aglietta and Rebérioux, 2005) who doubt that shareholders should be considered the real owners of the firm, but only as providers of finance capital alike banks or bondholders. One may note however that their legal role is that of partners in a partnership, and one may hardly dispute the fact that the partners are legal owners of a business, even if in the different

managers are left as the interpreters and guarantors of stakeholders rights this can lead to a lot of haze in the assessment of managerial discretion and managerial results. In particular, enhancing managerial power may increase the power to skim the value created by the company to managers' own benefit, while they can always pretend to have sacrificed the interest of shareholders to stakeholders' interest.[21] At the same time politicians, as a particular category of stakeholders, can benefit from the qui-pro-quo allowed by opaque arrangements with firms that have unclear objectives and possibly hazy budget constraints.[22] And this can have a cost, in terms of lowering the interest of founders to found the company, of financiers to finance the company, of venture capitalists to launch venture capital initiatives with the prospect of being able to go public, and to have a return by going public for the more successful ventures, repaying the losses on the least successful. The fact, that we have already emphasized, is that the firm is established by the shareholders or partners. If the firm is supposed to pursue the interests of different parties (employees, local authorities, politicians etc.), rather than those of the partners, we may fairly assume that the interest in establishing and financing a firm assuming the relative risks is reduced and so is the potential supply of entrepreneurship.[23] One could object that minority shareholders usually do not offer much entrepreneurship, they perform as financiers rather than as entrepreneurs.[24] But whenever their rights are less guaranteed the depth of the financial market suffers, the extent to which firms are financed through bank credit rather than risk capital increases, the attractiveness of creating start-ups may decrease. Finally the formation of shareholder value is tantamount to the pursuit of the profitability of the firm. Profits, the difference of the value of what a firm produces and what is accounted as its cost, are the engine of the long-run growth of the firm, which may be seen both in the interest of shareholders as well as of the long interest of the economy, albeit with all the limitations and qualifications that are associated to the intrinsic imperfectly competitive nature of real market economies.[25] The argument of proponents of the stakeholder views such as Charreaux and Desbrières (2001) is that enterprise's costs are not social costs because they include variable amounts of surplus (such as employees' surplus) and therefore are different from opportunity costs, and that a

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partnerships and in the different legal systems the rights of the partners can be different, as well as the different partners' decisional power in the running and development of the business.

[20] As Jensen (2001, p. 10) aptly puts it "stakeholder theory politicizes the corporation and leaves its managers empowered to exercise their own preferences in spending the firm's resources."

[21] Donaldson and Preston (1995, p. 87) are dismissive on this point observing that "the conventional model of the corporation, in both legal and managerial forms, has failed to discipline self-serving managerial behavior." But if the consideration of the interest of stakeholders, instead of being trusted to managers' interpretation, is taken care through the provisions concerning stakeholder representation in governing bodies (as considered in the following section), this could lead to a reduction of managerial discretion, rather than to an enhancement.

[22] Alitalia is a good case in point. In the case of Alitalia however the pathological consequences of stakeholder management were compounded by public ownership of the controlling shares. As Gugler (p. 203) puts it, commenting a thorough review of the economic consequences of different set-ups of corporate governance, "the evidence concerning state ownership is on the negative site".

[23] This is bound to have an impact on the labour market since demand for labour is intrinsically derivative from the supply of entrepreneurship (the activity of launching as well as that of running a firm). Increasing the supply of entrepreneurship and its quality (which, among others, depends on the incentives for entrepreneurs to perform effectively) enhances the capability of the economy to create and maintain jobs. See on this Chilosi, 2001, p. 328.

[24] This is stressed for instance by Aglietta e Rebérioux (2005).

[25] For the notion of shareholder value and its limitations see Chilosi, Damiani, 2007.

great deal of the surplus that is created or destroyed by the firm in its multifarious activities for its stakeholders is not accounted for. For instance, when a firm scales or shuts down, the costs saved are not really equal to the opportunity costs; only in the textbook model of the perfectly competitive economy is otherwise. In practice the local communities lose and workers lose the difference between their wages and their reservation wages. There in general a definitive surplus loss. This is not accounted for in its decision by the firm. What can be replied then is that concretely no better approximation to a firm's social costs and contributions than that provided by its accounting seems to be possible and when proposing alternative rules of behaviour in society the implied structure of incentives and related economic consequences should be careful appraised. We may here propose what we may call the golden rule of rules: when a policy intervention is envisaged attention should be focused on the economic consequences of the rule that is implicitly asserted. For instance, should employment maintained at all costs? Should a firm ever be allowed to close a plant or layoff workers? Should employees entitled to appoint managers instead of shareholders? If these rule were accepted the negative consequences on productivity and employment could be far reaching. But if we are not ready to accept these rules in general should they be invoked either explicitly or implicitly in any single case? We may here also refer to the fallacy of composition.

7. Stakeholder representation in the governing bodies

A way for taking into consideration the interest of stakeholders (or rather of some of them), more plausible than to trust to managers the balancing of the different stakeholders' interests, à la Berle and Means,[26] is to have stakeholders' (in particular employees') interests to be represented in the governing bodies, and the balancing of some of the different shareholder and stakeholder interests to be the result of the internal organizational dynamics of the firm. The representation of stakeholder interests could be either spontaneously engineered by the controlling blockholders in choosing the board of directors (for instance by giving a seat to bank representatives, such as is often the case in the German governance system)[27], or legally imposed.[28]

7.1 Stakeholder representation and implicit contracts

A motive for having stakeholder interests represented in corporate governance can be to provide a kind of guarantee for implicit contracts stipulated with the workforce, but also with other stakeholders, such as customers or suppliers (including banks, as credit and financial services suppliers), or local authorities and the state. By their very nature implicit contracts cannot normally be enforced through the courts. Moreover, since they are not explicit their content may be unclear, and assumed to be different

[26] According to Berle and Means (1932, p. 356), managers should become "a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity". For them "public policy" would be the outcome of a program set forth by "corporate leaders", "for example … comprising fair wages, security to employees, reasonable service to their public, and stabilization of business" (p. 356). This conception could find an institutional counterpart in the Japanese corporate governance system, where there is no formal legally prescribed stakeholder interest representation, but informally directors are bound to take care of a bundle of complex stakeholders interests. The Japanese articulate framework of strong social control may have been able to keep arbitrary managerial power in check.

[27] For the literature debating the relevance of the presence of bank representatives in supervisory boards of German corporations see Fauver and Fuerst, pp. 680-81.

[28] For a synthetic survey of the way in which concretely these kinds of arrangements are produced not only in Germany, but in a number of other countries see Allen et al. (2009), pp. 7-8.

by the different parties involved. Thus it may be difficult to realize whether and to what extent they are fulfilled or not. Thus it may be appropriate that they may be protected through stakeholder representation such as in company boards or works councils, where some kind of general consensus on interpretation and implementation may be reached through communications by the representatives of the parties involved. This kind of representation would not necessarily be contrary to the interest of the owners in general, and of the founders in particular, because it could save on the cost and time of building trust, and expectation of implicit contracts compliance. The implicit assets and liabilities in relation to stakeholders and the way in which they are expected to be honoured should be reflected to some extent in goodwill, and thus in the net value of the firm.

7.2 Stakeholder representation as a control and collaboration device

On the positive side employees' representation in company boards could bring about some additional supervision of managerial behaviour that, because of the specific information that employees have on the running of the companies, may also turn out to the advantage of non controlling shareholders, especially in case the employees who are represented are also shareholders:[29] the informational exchange that employees' representation may bring about could be to shareholders' advantage because it could favour better informed managerial decisions and a more collaborative climate of industrial relations reducing the probability of industrial actions.[30] The credible sharing of information ensured by codetermination could make wage claims reductions and worse working conditions acceptable in case of enterprise difficulties. Thus decentralized bargaining at the firm level in particular could take place in an atmosphere of greater trust, and Pareto improving agreements can be struck more easily. This has been recently the case in Germany's metal industry, where workers have accepted increases in work hours at unchanged pay in exchange for continuous employment guarantees following the Pforzheim agreement of 2004 ("mainly targeted at reducing costs at company level, for instance, through an increase in the duration of working hours while freezing or cutting wages", leading to "controlled decentralization").[31] But there is also the possibility that insider workers and managers could collude against shareholder interests, especially of minority and disperse shareholders.[32] According to a number of inquiries considering governance systems where some employee representation in corporate boards is legally required, unless it does not exceed some threshold (say, one third of seats)

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[29] "Labor representation introduces a highly informed monitor to the board that reduces managerial agency costs (such as shirking, perk-taking, and excessive salaries) and private benefits of blockholder control" (Faver and Fuerst, p. 680). As a matter of fact, according to the inquiry of Ginglinger et al. (2009) on French companies "directors elected by employee shareholders unambiguously increase firm valuation and profitability". There are some studies (cf. Coles et al. 2008), that show that insider directors may be beneficial to value creation, especially in high tech firms. But these refer to directors who are freely appointed rather than appointed on the basis of outside legal compulsion.

[30] Cf. Fauver and Fuerst (2006), p. 673.

[31] Ilsøe (2010).

[32] In the case of the German *Mitbestimmung* the power of insiders finds a limit in the countervailing power of strong blockholders. The theoretical and empirical literature on the overall economic consequences of the German *Mitbestimmung* in particular, and of codetermination and of employee stock ownership and "voice" in general appears to lead to complex and partially contradictory results. For a synthetic updated survey see Ginglinger et al., 2009, pp.5 f.

employee representation appears to be beneficial for the creation of firm value.[33] We can wonder then why forms of employee representation have to be made compulsory at all, as they appear to be in the interest of shareholders too, and thus one would expect to be included in the internal organization of companies even without legal external compulsion. But as remarked by Jensen and Meckling (1979, p. 473), "A striking fact about industrial democracy is that it cannot be effected on any significant scale voluntarily. Without fiat, codetermination would be virtually nonexistent." This makes the case for legally mandated codetermination if it can be shown that through its favourable external effects social partners could avoid being stuck in otherwise sub-optimal Nash equilibria, or because of some presumed overall favourable consequences on the complex organization of society and the economy. One of the possible advantages of codetermination, as well as of profit participation remuneration schemes, could be to have an additional party interested in the publicity and faithfulness of the accounts, and in reigning in top managers' compensation, to the advantage both of fairness, reduced inequalities, and even of efficiency, since "lean cats may run faster than fat cats".[34] At the same time a single firm engaging in co-determination when the others do not could be negatively affected.[35] Among the externalities that systems of employee representation generate we could consider the pursuit of overall macroeconomic social and economic objectives such as in the architecture of the German social market system. The social compact implicit in the latter enhances the opportunities for macroeconomic collaboration between social partners, while at the same time microeconomic efficiency objectives are on the whole not jeopardized in the process, at least in firms where participation of insiders to the supervisory board is not too large. But, depending on the social and economic setup there is always the possibility that at the macroeconomic level the enhancement of the protection of the interest of represented stakeholders, insiders in particular, could turn to the disadvantage of some weaker segments of society, such as consumers, or the unemployed, as a consequence of the enhancement of the interest of the insiders in relation to outsiders (for instance by pushing for higher wages and better working conditions, reducing the opportunities for increasing employment). But this kind of outcome could be also the consequence of any other measure aimed at the protection of insiders, such as that provided in particular by the labour law.

8. Workers' representation vs. labour code protection

Indeed, not necessarily the best protection of the legitimate interests of stakeholders may be sought in the architecture of corporate governance, some other legal provisions could be more suitable. For instance if the defense of the interests of insider workers and of their firm-specific investment[36] is sought through employees'

[33] Cf. Allen et al. (2009), pp. 26-27.

[34] Cf. Chilosi, Damiani (2007), p. 10. The reason is in the potentially negative income effect of higher salaries on effort. For the markedly higher remuneration of top managers in relation to that of manual workers in the UK and especially in the USA in relation to Germany and Japan where forms of stakeholder control formally or informally apply see Towers Perrin (2005). According to a different view the high open remuneration of American top managers are matched elsewhere by the hidden advantages of control obtained through fraudulent means, and allowed by the lower protection of minority shareholders, as borne out by the much higher price associated to the transfers of control packets of shares (cf. Dyck and Zingales, 2004).

[35] Cf. Fauver and Fuerst, 2006, p. 679.

[36] The issue of firm specific investment is often emphasized to justify employees' legal protection and internal labour markets. However the argument is not entirely persuasive. It is difficult to envisage

representation in works councils or enterprise boards instead than through the protection of the labour code this does not guarantee any given employee since, even omitting the possibility that the representatives be "captured" by the interest of management or of the owners, employees' representatives may well act in defense of a subset of the work force rather than of the work force as a whole. Labour law may be in this respect a better instrument, since it protects everybody' rights in an employment contract.. Co-determination on the other hand can be the counterpart of a social bargain struck between the different social components (in particular trade unions and employers) at the political level towards exchangin some institutional protection of insiders (which could also favourably affect employment stability and overall working conditions), with some overall political and social consensus and wage moderation, reducing the restrictive consequences on employment that one could otherwise expect from the protection of insider interests. This may be the essence of the German social market system enhancing collaborative rather than conflictual social propensities between the different social partners, with overall better macroeconomic results than in other, more conflictual, environments. But one may speculate the extent to which this is the outcome of specific corporate governance institutions or instead of the specific social, political and national context.[37]

9. Insiders, outsiders and long-term unemployment

Privileging the interest of entrenched insiders, such as blockholders and existing employees, through the institutions of corporate governance and through the labour code, can go against the interest of outsiders, such as would-be employees and minority shareholders. Protection of the interest of insider workers limits the mechanism that in a market economy, however very imperfectly, tends to shift labour wherever in the economy its productivity is higher. The countries (such as Italy, Germany or France) where the protection of insiders is higher are also characterized by a markedly higher rate of long-run unemployment than the UK or USA, where protection of insiders is lower.[38] On the other hand some workers, even

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any acquired skills that could not be used at least in some other firms of the same industry, except in the case of monopoly or strong market power, such as specific skills required by the state administration, or in state railways, or in IBM in its heydays. Firm specific investment appears rather to be concentrated at the beginning of the employment relationship: for instanced the cost of moving, of learning the rules and habits of the firm, to get knowing one's new colleagues, etc. An additional investment could be related to imperfect information, and the information about the employees that the firm acquires in the course of employment. Thus the worker can invest in acquiring goodwill and reputation inside the firm which could not be easily transferable outside. But the investment is reciprocal: the firm too invests in acquiring specific information as to the quality of the worker and has an interest in protecting this specific investment as well as past investment in training. This is a protection against unfair dismissals that occurs even without any specific legal protection. Moreover as long as moving to another firm is costly for the worker, some degree of investment by the firm in generic training is justified.

[37] The specific national context of Denmark enhancing overall trust in industrial relations is emphasized by Ilsøe (2010).

[38] For the data on long-run unemployment in the different countries the reader is referred to the OECD data included in the ILO database, such as reported in the KILM 6th edition, freely accessible and downloadable from the ILO Internet site. In the ten years 1999-2008, for instance, the average long run rates of unemployment (where long-run unemployment is defined as unemployment of one year or longer) were as follows: USA 0.5; UK 1.3; Germany 4.7; France 3.4; Italy 4.7. One may note from the data that in the USA, where the labour market is particularly flexible and "employment at will" prevails both the rate and the incidence of long run unemployment are particularly low, much lower than in European countries such as Germany, France, and Italy where the rigidities of the

the unemployed, if given the choice, may prefer a setup where the labour market is more rigid, unemployment higher and the probability for the unemployed to find a job lower, possibly labour productivity and average wages lower, but once a job is found employees enjoy legal protection and a lifetime employment prospect, and thus greater peace of mind. [39]

10. Politicians as carers for stakeholders' interests[40]

Another view of stakeholder governance can be to entrust stakeholder interests to the protection of the political establishment and public powers, formally (such as through golden shares) or informally, through political influence exerted, for instance, through the leverage of publicly owned banks, or through public regulatory capacity. The record on this account does not seem on the whole brilliant. Often, even when not directed to milking resources for the pursuit of petty political interests, government interventions for defending the interest of stakeholders aim, in continental Europe in particular, to stimulate those decisions by firms that lead to higher employment, but especially to restrain the decisions that bring about employment reductions. Instances are the recent of encroachment by the German government on the destiny of the Opel GM subsidiary and that of the Italian government on Fiat's decision to close the Termini Imerese production plant, or the pluriannual Italian costly drama concerning the destiny of Alitalia. Interferences of this kind may have negative consequences both on the allocation of scarce financial and human resources and on entrepreneurial incentives, even if prima facie they may seem to be justified by serious social and public order concerns and by the consideration of the short run difference between private and social costs. In appraising this kind of policy actions one should take into account, as argued above, the overall consequences of the general rules that are implicitly asserted, such as: <<the closure of any given plant, however unprofitable, should not be permitted>>, or <<the government should always do whatever it is in its power to avoid layoffs, even at the cost of covering the losses>>. The consequences of following such kind of rules on the propensity to invest in new initiatives, to hire, and to open new plants, to maintain profitability, and on the use of scarce budgetary resources can be

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labour market are higher and, in the case of Germany and France, insider representation in corporate boards is mandated. The UK, while having a long-run unemployment rate higher than in the USA presents a much lower rate than in the three continental countries. Of course other factors could be relevant here, such as the extent of unemployment benefits. But the latter are different in the different countries considered (higher in Germany, but also in the UK, in relation to Italy, for instance, were they are particularly low). In general the comparison (such as in Hall and Soskice, 2001, p. 20) is made in terms of overall unemployment rates, but it is long run unemployment that represent the main source both of economic waste and of social suffering. Moreover if, as in the LMEs, there is greater flexibility in the labour market and greater propensity to change jobs, this leads to higher rates of frictional employment, which can be seen as functional to the greater dynamism of the labour market. The greater capability of the LMEs to create jobs (albeit on average less durable and with greater income inequalities) may be reflected in the higher full-time equivalent employment rate in relation to the CMEs (as shown in Hall and Soskice, 2001, p. 22). The above however does not apply to Japan, which has both a very high full-time equivalent employment rate and a very low long-run unemployment rate. But Japan in many respects is a case apart.

[39] A possible downside of such a setup from workers' viewpoint may be the danger to end up trapped in a less preferred and less rewarding job than under an alternative, more flexible and less legally constrained system, owing to the greater risk of leaving one's job and the difficulty in finding, once unemployed, a different, more suitable, job. More generally, labour market regulation weakens the allocative mechanism expounded by the hedonic theory of wages.

[40] On the political determinants of the degree of shareholder and employment protection, according to the nature of the electoral system, see Pagano, Volpin (2005).

easily guessed. Moreover we have here an obvious case where there is contradiction between the protection of insiders and the interest of outsiders, such as workers whose opportunities of finding an employment is thwarted by the misallocation of economic resources and the reduction of entrepreneurial incentives, taxpayers who are financing the subsidies for loss-making plants, recipients of social expenditure or social services whose supply is curtailed because of the alternative use of financial resources, etc. But in these cases the insiders are known, the outsiders are undetermined, and this, psychologically and politically makes a lot of difference. Moreover there is the well known fact that politicians are often prone to be captured by organized interests rather than be guided by the long term consequences of their policy actions.
As an instance of the fallacy of composition, rules apparently in favour of some stakeholders do not necessarily have favourable consequences on the category to which the stakeholders belong. For instance, security of tenure in employment may have important productivity consequences (by limiting incentives and blocking an important mechanism for reallocating resources where they may be more productive) that may turn against workers' living standards and opportunities of employments. Or, going to a theoretical extreme, a rule empowering employees instead of shareholders to appoint a controlling majority of directors would go to the disadvantage of workers in general: such a rule could respond to the ethical principles of someone, but would be disastrous for the category the rule itself would seem to protect. Who would invest, create firms and jobs under those circumstances?
At the same time the diffusion and approval itself of stakeholder theory aiming at the defence of stakeholder interests as opposed to value creation may work as a powerful ideological instrument for favouring special interests, such as of managers wishing to escape the constraints of the market for corporate control, or of politicians wishing to exert political power and influence though their interference in the running of firms, to the detriment of the general interest.

11. Conclusion

In the end one should be always aware that the economic consequences of alternative legal disciplines in the different institutional and social contexts may be quite different.[41] In particular this applies to the mix of formal rules affecting corporate governance and those affecting stakeholder interests, in particular those regulating the labour market, in their interaction with the informal rules characterizing the social framework.

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[41] One may refer here as an extreme case to the disastrous consequences of the introduction of some capitalist market institutions, especially in the corporate and financial area, in Russia after the demise of the URSS.

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