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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

In the literature the issue of the protection of stakeholder interests (of employees in particular) is usually considered in a static context: how should the institutions of corporate governance be shaped having regard to already existing firms, conforming in particular to some subjective criteria of fairness and fair play. It is remarkable that no attention is usually paid to the basic fact that a company in order to exist must first be established, and that the founders-owners are the original shareholders. Moreover not necessarily the most appropriate protection of stakeholder interests can be provided by the institutions and practice of corporate governance, other specific kinds of legal provisions may be more suitable. But rather than substitution complementarity prevails between different legal provisions protecting the interests of stakeholders (in particular employees) and the stakeholder protection afforded through the institutions of capital governance, conforming to the logic of the different "varieties of capitalism". An aspect that is emphasized in the paper, and is usually overlooked, are the much higher rates of long-term unemployment associated with the continental European variety as compared with the Liberal Market variety of the Anglo-Saxon tradition. But the Scandinavian Social-Democratic market model gives the best of both worlds: low long-term unemployment rate and incidence, together with high degrees of employment protection.

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1. 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, how 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 which are relevant from those that are not, and prescribes how 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 consequences 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 of the effects considered to be relevant? There are a number of possible alternative considerations, political, ethical, ideological etc. In the case of company law, the most relevant issue concerns the overall economic consequences of alternative regulations. But often considerations of morality and desert prop in, which should rather the domain of philosophers than of economists. Even aside from specific philosophical and ethical considerations it is obvious that those empowered to take decisions on behalf of the firm should be 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 puts it: "the absence of a legal obligation to follow ethical principles does not mean that corporate decision makers are not subject to the same ethical considerations as other members of society."[2] The sanction to unethical behaviour, when not provided by law, is the domain of social control. In the case of corporations loss of reputation because of unethical behaviour can lead to adverse publicity, damaging public image and goodwill. Unethical behaviour can be sanctioned by the parties wronged, if they have the opportunity to react, or cost the firm the economic consequences of reduced trustworthiness. Of course the legal sanction, if provided, would probably be more effective, potentially reinforcing the social one. But what is unethical behaviour is not always clear-cut and there are areas of uncertainty where moral and economic issues are blurred, and where the moral judgement cannot be taken independently of the perception of the economic consequences of the rule that the judgement implies or proposes. For instance, for some it is unfair and immoral to lay off some employees (seen as stakeholders) simply because their employment is not profitable any more. The implied consequence of this assumed moral judgement is that this kind of behaviour should be made illegal. But what would the economic consequences of this rule be? The first is that the

[2] "Principles of Corporate Governance: Analysis and Recommendations", Philadelphia, 1992, p. 82; quoted in Donaldson and Preston, 1995, p. 82

expected cost of hiring 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 not dismissing unprofitable employees would fall on the additional unemployed, what does not seem very ethical. If the burden of excessive employment leads to the demise of the firm, all employees are eventually laid off and the argument against the rule becomes 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 informed 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 examples of ethical rules based on religious beliefs that, even in our modern secular world, are hampering scientific and economic advance.[3] 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 induce types of behaviour in contradiction with its thriving and progress. On the contrary some forms of general acceptance of some basic principles of functioning can enhance the economic performance of a market economy and lead, potentially at least, to the "the greatest welfare of the greatest number". But the rules of the game can vary from those of American liberal capitalism to those of Scandinavian social-democracy and those of the German social market economy. In the latter case the collaborative attitude of the social partners founded on the acceptance of the basic tenets of the social market economy may contribute to explain Germany's economic success.

2. Who Are the Stakeholders and How Does the Legal System Take Into Account Their Interests?

But then, who concretely are the stakeholders? First of all those who have a contractual relation (either explicit or implicit) with the firm[4], such as the employees, who are protected by the labour code, or the creditors, who are protected by the civil and commercial codes and by the rules concerning the faithfulness and transparency of accounts.[5] 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.[6] 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".[7] At

[3] Such as in stem cell or family planning research.

[4] 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) "'contract' should be interpreted broadly to cover cases of 'implicit contracts'"; they "distinguish 'contract' from one-shot exchanges, and intend it to stand for 'multiple transactions' that require some governance mechanisms."

[5] The transparency rules are of particular relevance for creditors and for all sort of stakeholders, such as minority shareholders or contractors, 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").

[6] Thus it becomes rather vague. For a consideration of who could be seen as possible stakeholders see for instance Donaldson and Preston, 1995, pp. 85-86.

[7] 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,

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 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 the labour code. 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.[8]

3. The Instrumental Motive

A first, but least interesting, approach to the stakeholder issue is the instrumental one, in the perspective of business administration. The fact that managers should take into account the interests 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 could 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 stakeholder behaviour on the attainment of the objectives assigned to the firm (such as profitability, or the long-term value of the firm, as argued in Jensen, 2001). 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.[9] 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", are associated 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

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lenders and society" (p.32), thus not much more restrictive, and very much in the perspective of strategic management.

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

[9] 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).

relationship of substitution or complementarity among themselves.[10] 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 defence of perceived labour rights. If one also considers other aspects of corporate governance, such as 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.[11] Taking those characteristics into account Amable presents a more articulate classification, distinguishing between five different types of varieties of capitalism, "neo-liberal or market-based capitalism; Continental European capitalism; social-democratic capitalism; 'Mediterranean' capitalism; and Asian capitalism".[12] Later on we shall deal with the issue of the protection employees' interests through labour market regulation, on the one hand, and through the institutions of corporate governance, on the other, and the likely consequences on long-term unemployment. In this respect Soskice and Hall's distinction between coordinated market economies and liberal market economies acquires paramount relevance.

4. 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.[13] 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 of the company 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.[14] Furthermore: how do the rules and objective conditions

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

[11]See Hall and Soskice (2001). As argued in Gatti et al. (2009) complementarity extends to the relation between the degree of coordination of the overall financial regime and the degree of labour market regulation as far as the consequences on the aggregate unemployment rate are concerned. For the quantitative aspects of the two main varieties and of their national variations see also Damiani (2010).

[12]Amable (2009, p. 20).

[13]As a clear-cut 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 inquiry 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 wanting, 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.

[14]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

governing the subsequent life of a firm, in particular the degree of consideration of stakeholders' interests vs. the interest of shareholders, impact not only on the incentives to create the firm in the first place, but also on the growth and further development of the firm? As an example of how the legal and environmental conditions affect the supply of entrepreneurship and the birth and growth of new firms we may refer to the relative abundance of venture capitalists and of so called "business angels" in the USA that is by no means matched under European conditions,[15] and which represents an important supply of crucial entrepreneurship, especially in technologically advanced and innovative firms.[16] The supply of venture capital and entrepreneurship is greatly favoured by the relative ease 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 established in the first place, in an institutional environment in which "employment at will" prevails and the labour market is relatively unregulated.[17] 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 setup 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. In this, as in other discussions, what we may call the fallacy of the still frame is often committed: the idea that a given apparent state of the word, such as captured in a still picture, should persist, independently of the manipulations which are applied to the setup. In the real world instead of a still picture we have a frame, part of a movie that is evolving: how the movie carries on depends on the way the setup is changed. This happens in particular with respect to the number and types of firms and entrepreneurs: at a given point of time they are given, but what happens later depends, among others, on incentives. 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 social and institutional framework, in particular by the rules that regulate the employment contract that in some way dovetail with the discipline of corporate governance itself.[18]

5. Haziness of the Concept of Stakeholder Value

The great disadvantage with stakeholder value (as the stakeholder approach is often referred to in the literature)[19] as a guide to managerial behaviour, alternative to shareholder value, is the haziness of the concept of stakeholder value, and of the basic concept of stakeholder itself.

entrepreneurship and risk capital.

[15]Cf. OECD, 1998, pp. 18, 100.

[16]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).

[17]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).

[18]On this see in particular Djankov, 2008.

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

This applies as well 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".[20] 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 indeterminable, just as the notion of the interest of the firm as such. This simply empowers the managers to do what they think fit independently of their agency relationships with the formal owners of the firm (the shareholders[21]), pretending that they are pursuing stakeholders' interests.[22] If 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.[23] At the same time politicians, as a particular category of stakeholders, can benefit from the quid-pro-quo allowed by opaque arrangements with firms that have unclear objectives and possibly hazy budget constraints.[24] 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 themselves, 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.[25] One could object that minority shareholders usually do not offer much entrepreneurship, they perform as financiers rather than as entrepreneurs.[26] 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 decreases. 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 cost, are the engine of the long-term

[20] Aglietta and Rebérioux, 2005, p. 46.

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

[22] 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."

[23] 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." However, if the consideration of the interest of stakeholders, instead of being trusted to managers, is taken care through some 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.

[24] 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 setups of corporate governance, "the evidence concerning state ownership is on the negative site".

[25] 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.

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

growth of the firm, which may be seen conforming both to the interest of shareholders as well as to 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.[27] The argument of proponents of the stakeholder view, 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 great deal of the surplus for its stakeholders that is created or destroyed by the firm in its multifarious activities 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 it 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 that is not accounted for in the decisions of the firm. To this it can be replied that concretely no better approximation to a firm's social costs and social contribution than that provided by its accountings seems to be possible and when proposing alternative rules of behaviour the implied structure of incentives and related economic consequences should be careful appraised. We have here what we may call the golden rule of rules: when a specific policy measure 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 be entitled to appoint managers instead of shareholders? If these rules 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 they should not be invoked either explicitly or implicitly in any single case, both for coherence and because the application in any single case validates the rules in the aggregate.

6. Stakeholder Representation in the Governing Bodies

A way for taking into consideration the interest of stakeholders (or rather of some of them) that is more plausible than to trust to managers the balancing of the different stakeholders' interests, à la Berle and Means,[28] 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 interest could be either spontaneously engineered by the controlling blockholders in choosing the board of directors (for instance by giving a seat to bank representatives, as is often the case in the German governance system)[29], or be legally imposed.[30]

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

[28]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 be seen to find an institutional counterpart in the traditional 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 potentially arbitrary managerial power in check.

[29]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. One may note that, owing to the German widely practiced system of vote delegation through banks by dispersed shareholders, bank representatives in corporate boards of theoretically wide held companies may be considered as representatives of the de facto controlling blockholders rather than of stakeholder interests as such (cf. Morck et al., p. 666).

[30]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.

6.1. Stakeholder representation and implicit contracts

A motive for having stakeholder interests represented in corporate governance could 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 by the different parties involved. Thus it may be difficult to realize whether and to what extent they are fulfilled or not. Stakeholder representation, such as in company boards or in works councils, could be seen as a guarantee for their implementation and as a vehicle for reaching some kind of general consensus on their interpretation through steady interaction and communication by the representatives of the parties involved. This kind of representation would not necessarily be adversary 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 could help in creating the expectation of implicit contracts compliance. The implicit assets and liabilities, and the relations of trust built up implicitly by the firm with its stakeholders should be reflected in goodwill, and thus in the net value of the firm.

6.2 Stakeholder representation as a control and collaboration device

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:[31] 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.[32] The credible sharing of information ensured by codetermination could make wage claims moderation and deterioration of working conditions acceptable in case of enterprise difficulties. Decentralized bargaining at the firm level in particular can 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 working hours at unchanged pay in exchange for 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").[33] But there is also the possibility that insider workers and managers could collude against shareholder interests, especially of minority and disperse shareholders.[34]

[31]"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.

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

[33]Ilsøe (2010), p. 40.

[34]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,

According to a number of inquiries considering governance systems where some employee representation in corporate boards is legally required, employee representation appears to be beneficial for the creation of firm value, provided it does not exceed some threshold (say, one third of seats).[35] One can wonder then why forms of employee representation have to be made compulsory at all; as long as they appear to be in the interest of shareholders one would expect to be present in the internal organization of companies, even without legal external compulsion. But as remarked long ago 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." The case for legally mandated codetermination can be made 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 other overall favourable consequences on the complex organization of society and the economy. Looking at the external effects a possible advantage of codetermination, as well as of profit participation remuneration schemes, is 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".[36] Without compulsion a single firm engaging in co-determination when the others do not could be negatively affected.[37] 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 inside stakeholders to the supervisory board is not too large. 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 (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 code.

7. 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. The defence of the interests of insider workers and of their firm-specific investment through employees' representation in works councils or enterprise boards does not guarantee any

appears to lead to complex and partially contradictory results. For a synthetic updated survey see Ginglinger et al., 2009, pp. 5 f.

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

[36] Cf. Chilosi, Damiani (2007), p. 10. The reason lies in the potentially negative income effect of higher salaries on effort. For the markedly higher remunerations 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 Damiani (2011), p. 224. According to a different view the high open remunerations of American top managers are matched elsewhere by the hidden advantages of control, as borne out by the much higher price associated to the transfers of control packets of shares (cf. Dyck and Zingales, 2004) in a context where blockholders can control the companies with a modicum of direct capital ownership, in particular through pyramid schemes (very widespread feature of capital market ouside USA and UK: see Morck, 2005), in a context of lower protection of minority shareholders, and lower contestability of corporate control.

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

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 defence of a subset of the work force (such as those endowed with lower human capital and lower remuneration, in case of an egalitarian viewpoint, or the reverse, in case of a more hierarchical perspective) rather than of the work force as a whole.[38] The provisions of labour law may be in this respect a better instrument, since they apply to the protection of everybody' rights in an employment contract. But co-determination 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 exchanging some institutional protection of insiders (which could also favourably affect employment stability and overall working conditions), against 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. In this may lie the essence of the German social market model enhancing collaborative rather than conflictual social attitudes between the different social partners, with overall better macroeconomic results than in other, more conflictual, environments. Analogous considerations apply to the Scandinavian model of industrial relations. But one may speculate the extent to which this is the outcome of specific corporate governance and labour market institutions or rather of the specific social, political and national context.[39]

8. Insiders, Outsiders and Long-Term Unemployment

Privileging through the institutions of corporate governance and the labour code the interest of entrenched insiders, such as blockholders and existing employees, 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. This, together with "decreased work intensity among the employed" and "increased worker absenteeism" can affect negatively overall productivity (Skedinger, 2010, p. 7, see also p. 14). Moreover the studies surveyed by Skedinger, in his thorough review of the existing literature on the employment protection legislation and its economic consequences, "indicate that stringent employment protection leads to less dynamics in the economy" because "employee turnover is reduced by fewer firings and hirings, while structural change also goes more slowly due to less job creation and destruction, while exits and start-ups of firms are also reduced" (ibidem p. 14). At

[38]The issue of firm specific investment is often emphasized to justify employees' legal protection and the existence of internal labour markets. However the argument is not entirely persuasive. It is difficult to envisage 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 new colleagues, etc. Therefore there may be no need to incentivate its further building-up. An additional related factor refers to the information about the employees that the firm acquires in the course of their employment. Thus the worker can invest in acquiring 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. To that it could be added the loss of reputation endured by a firm among its own workforce in case of unfair dismissals; this loss of reputation does not occur not only if the unfairness of the dismissal is verifiable (such as in the case of legal protection against unjustified dismissals) but also in case it is simply observable (and not verifiable in court proceedings), allowing an extended leeway to firms to decide layoffs that are substantially, even if not verifiably, fair.

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

the same time protection enhances "employment prospects … for those who already are securely placed in the labour market, while the opposite holds for vulnerable groups, especially the youth. Employment protection therefore works as a regressive redistribution mechanism on the labour market" (ibidem, p. 7). The countries (such as Italy, Germany or France) where the protection of insiders is higher are also characterized by a markedly higher rate and incidence of long-term unemployment than the countries, such as the UK or USA, where protection of insiders is lower (with the notable exception of the Scandinavian countries).[40] In the ten years 1999-2008, for instance, the average long-term rates of unemployment (where long-term 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. More extensive data averaged over the seventeen years 1991-2007 are reported in Table 1, together with the OECD employment protection index, averaged over the same years, in the last column.[41] The countries are arranged in four different groups (according to Amable's, 2009, classification): the first one corresponds the the Anglo-Saxon Liberal Market Economies (LME), as defined in Hall and Soskice (2001), the second corresponds to Continental Europe coordinated market economies (CME), the third to Mediterranean Europe market economies (MME), the fourth to the Scandinavian social-democrat market economies (SME). From an inspection of the data it is immediately obvious (as one would expect) the association of employment protection with higher level and incidence of long-term unemployment. With two exceptions. First of all there are two outliers: Ireland presents relatively high long-term unemployment rate and incidence together with low employment protection (but in more recent years the performance becomes more in line with that of the other LME), and Austria, where the reverse applies. But the most remarkable case is that of the Scandinavian countries where low long-term unemployment rate and incidence are associated with high degrees of employment protection. Their exceptional labour market performance could be attributed to specific institutional factors such as "high unionization, highly coordinated wage bargaining geared to wage compression, active labour market policies ... More specifically, the institutional system, based on coordinated negotiations between strong partners and supporting policies by the government, may be seen as a way of offering security to workers without some of the drawbacks of tight legislative labour market regulation" (Andersen et al., 2007, p. 40). In other terms social cohesion and centralized decisions bring about wage moderation to the extent of rendering high levels of employment protection compatible with low levels of unemployment. At the same time the notoriously very efficient active labour market policies result in low levels of the incidence of long-term unemployment. One may note from the data that in the USA, where "employment at will" prevails and the Employment Protection Index is the lowest, both the rate and the incidence of long-term unemployment are the lowest. Of course other factors could be relevant here, such as the extent and duration of unemployment benefits.[42] 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 between different countries is made in terms of overall unemployment rates (such as in Hall and Soskice, 2001, p. 20),[43] but it is

[40]For the data on long-term unemployment in the different countries the reader is referred to the ILO database, in the KILM (*Key Indicators of the Labour Market*), 6th edition, freely accessible and downloadable from the ILO Internet site. Some aggregate data are reported in Table 1.

[41]"Unweighted average of version 1 sub-indicators for regular contracts (EPR_v1) and temporary contracts (EPT_v1)", where EPR_v1 is "sub-indicator for dismissal of employees on regular contracts" and EPT_v1 is "sub-indicator for strictness of regulation on temporary contracts" (OECD 2010).

[42]For the issue of omitted variables affecting the way in which employment protection impacts on employment and unemployment, see Skedinger, 2010, p. 88.

[43]This applies to various other studies that purport to determine the consequences of alternative institutional setups on unemployment, such as, recently, Amable (2009) or Gatti et al. (2009).

long-term unemployment that represent the main source both of economic waste and of social suffering. As Machin and Manning (1999, p. 3085) put it "one should recognise that the experience of long-term unemployment is a horrid one for those unfortunate enough to experience it". Wherever, as in the LME, there is greater flexibility in the labour market and greater propensity to change jobs, this leads to higher labour mobility and hence to higher rates of frictional employment, which can be seen as functional to the greater dynamism of the labour market. As argued by Per Skedinger (2010, p. 7), "there is a great deal of evidence which indicates that both dismissals and hirings decrease at approximately the same rate" as a consequence of employment protection. At the same time "the evidence that aggregate employment and unemployment are affected by such a regulation, whether positively or negatively, is relatively weak" (ibidem). But in a given rate of aggregate unemployment quite different rates of long-term and short-run unemployment could be hidden (see the different rates of incidence of long-term unemployment in Table 1). Analogous considerations could be made with respect to the unemployment rates of disadvantaged categories, such as in particular youth unemployment. According to Hall and Soskice, (2001, p. 22) the greater capability of the LME 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 CME.

Even if on the whole labour market flexibility is associated with lower long-term unemployment rates, it could be argued that some workers, even if unemployed, may prefer, if given the choice, 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. However inquiries in the satisfaction provided by different contractual arrangements in different normative setups do not surprisingly report greater degrees of satisfaction and feeling of security for workers taking advantage of strong legal protection of their permanent employment contract (Skedinger, 2010, pp. 8, 15). Here two circumstances can be relevant: the first is the awareness of the greater difficulty to find another job in case of layoffs;[44] the other is what we may call the entrapment factor:[45] the danger to end up trapped in a less preferred and less rewarding job than under an alternative, more flexible and less legally constrained labour relations system, owing to the greater risk of leaving one's job and the difficulty in finding, once unemployed, a different, more suitable, one. More generally, labour market regulation weakens the allocative mechanism (such as expounded by the hedonic theory of wages) through which workers tend to be allocated to jobs that they relatively prefer and where they are relatively more productive.

[44] The empirical studies surveyed by Skedinger "indicate that employees with permanent jobs perceive less security in countries with stricter legislation" (p. 118).

[45] Skedinger (2020, p. 116) refers to "locking-effects" induced by employment protection.

Table 1. Long-term unemployment, employment protection, and the varieties of capitalism.

Country	Long-term unemployment rate[a]	Long-term unemployment incidence[a]	Employment protection index[a]
USA	0.52	9.45	0.21
UK	2.24	31.09	0.66
Canada	1.03	12.21	0.75
Australia	2.05	26.01	1.05
Ireland	4.54	47.33	0.98
Average	1.73	25.2	0.73
Germany	4.21	48.25	2.54
France	3.8	39.66	3.01
Belgium	4.48	55.91	2.52
Netherland	2.15	42.97	2.4
Austria	1.23	*25.75*	2.13
Average	3.17	42.51	2.52
Italy	5.8	59.34	2.69
Spain	7.34	45.76	3.31
Greece	5.08	53.25	3.27
Portugal	2.47	43.66	*3.67*
Average	5.17	50.5	3.24
Denmark	1.52	24.36	1.71
Finland	2.9	26.61	2.08
Sweden	1.71	22.7	2.44
Norway	0.6	13.62	2.69
Average	1.68	15.73	2.23

[a]Country **a**verages for the 17 years 1991-2007. Source: ILO (2009);. last column: Oecd (2010).

There is a possible mixed solution:whereby labour protection is restricted to a section only of the labour force. This kind of solution may be pursued de facto in the underground economy, where all sorts of legal provisions are not observed, or de jure whenever different labour contracts, in particular temporary employment contracts with lower legal protection, are allowed. The advantage in relation to complete flexibility lies in the fact that the social and economic costs of long-term unemployment could be lessened while maintaining for the lesser protected section of the labour force some prospects of being promoted to more stable and guaranteed employment. The structure of incentives that are created depends concretely on the perspective of temporary employment to become permanent. This is slight in case of the prevalence of gross substitution between temporary and permanent jobs, as employers may prefer to avoid incurring the costs of more permanent labour contracts, even for temporary employees they would have otherwise preferred to continue to hire, leading to their dismissal when the maximum legal length of temporary employment is reached. This may have negative productive consequences if only because of the lower propensity of temporary employees to invest in the employment relationship.[46] Of course much would depend on how more onerous are the regular contracts in relation to a sequence of temporary ones.[47]

[46] On the negative productivity consequences of short-term contracts see in particular Damiani, Pompei (2010).
[47]On the consequences of liberalizing short-term employment see Skedinger (2010), pp. 63-64, 107, 125-26.

9. Politicians as Carers for Stakeholders' Interests

A further approach to the defence of stakeholder interests is to have them trusted to the political establishment and public powers through intervention on a case by case basis, formally (such as through golden shares) or informally, through the political influence exerted, for instance, with the leverage of publicly owned or controlled banks, or through the public regulatory capacity, or with the instruments of power twisting the rule of law (the Russian way). The record on this account does not look on the whole brilliant. Often, even when not directed towards milking resources for the pursuit of petty political interests, government interventions, allegedly 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 encroachment by the German government on the destiny of the Opel GM subsidiary during the recent crisis, or that of the Italian government on the Fiat decision to close the Termini Imerese production plant, or the pluriannual Italian costly drama concerning the destiny of Alitalia. Interferences of this sort are bound to 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 his power to avoid layoffs, even at the cost of covering the losses». The consequences of following this kind of rules on the propensity to invest in new initiatives, to hire, to open new plants, to maintain profitability, and on the use of scarce budgetary resources can be 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 are 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 to be guided by the long term consequences of their policy actions.

10. Minority Shareholders as Stakeholders

Minority and dispersed shareholders could be perceived as kind of stakeholders, rather than owners outright, whose interests are impacted by the decisions of controlling shareholders and top management. Indeed, as remarked above, part of the legal provisions affecting corporate governance, such as those concerning the publicity and fidelity of accounts, are aimed in particular at protecting non-controlling shareholders (as well as creditors). More generally, the law provides guarantees for the co-owners each towards the others, and so its constraints may not be adverse, but rather favourable, to the forming of agreements establishing a company, as they may discipline and prevent ex-post opportunistic behaviour, whilst also protecting other types of stakeholders, such as creditors or the inland revenue and taxpayers. Contestability of corporate control is seen, for well known reasons, as a guarantee for non-controlling shareholders, as well as an instrument leading to a better allocation of productive resources. As well known, the rules

for enabling the non-controlling shareholders to benefit of the potential profitability of the firm by selling their shares to a bidder in public tender offers are devised on the one hand to allow the totality of shareholders to be in the position to take advantage of the bid, and thus of the premium of control, and on the other to render the bids more onerous, avoiding an excessive instability in corporate administration and a tendency towards excessive short-termism (such as having managers to be all too dependent on the continuously changing moods of the stock exchange instead of planning for the long term), but it may throw in prohibitive obstacles towards the challenging of consolidated positions. As often is the case, there are no clear-cut answers, only trade-offs.

11. Conclusion

In the end one should always be aware that the economic consequences of alternative legal disciplines in the different institutional and social contexts may be quite different.[48] In particular this applies to the mix of formal rules affecting corporate governance and stakeholder interests, in their interaction with the informal rules characterizing the social framework. As an instance of the fallacy of composition, rules apparently in favour of some stakeholders do not necessarily have unambiguous 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 (or may not, as in the Scandinavian case) turn against workers' living standards and opportunities of employment. Or, going to a hypothetical extreme, a rule empowering employees instead of shareholders to appoint a controlling majority of directors would certainly be 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 approach to stakeholder theory privileging 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 through their interference in the running of firms, to the detriment of what could be perceived as the general interest.

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[48]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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