Stakeholder Protection, Varieties of Capitalism, and Long-Term Unemployment

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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 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, specific kinds of legal provision 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 of the latter 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 rates and incidence, together with high degrees of employment protection.

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 of 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 the area of 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. Or, turning to labour law, the interest of actual employees not to be dismissed without verifiable justification is often considered and protected by the legal system, but usually not the interest of potential employees to be hired.[1]

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. 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 resort 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, as a modality of private enforcement.[3] In the case of corporations loss of reputation because of unethical behaviour can damage public image and goodwill, leading to loss of market value. Unethical behaviour can be sanctioned by the parties wronged, if they have the opportunity to react, and cost the firm the economic consequences of reduced trustworthiness. Of course the legal sanction, if provided, are probably more effective, potentially reinforcing the social ones. 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 proposes or implies. 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 judgment is that this kind of behaviour should be made illegal. But what would the economic consequences of this rule be? The first could be that the 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

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[1] Sometimes however even the latter interest is considered, in anti-discrimination and affirmative action policy measures.

[2] 'American Law Institute, 1992, quoted in Donaldson and Preston, 1995, p. 82.

[3] Cf. Kraakman et al., 2009, pp. 47-48. Moral norms are "'low powered' incentives of conscience, pride, and reputation" but not "less important in governing human behavior than are monetary incentives" (ibidem, p. 43).

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 is 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. Moreover 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.[4] 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, or that no interest payment is admissible, being tantamount to usury) may induce types of behaviour in contradiction with its thriving and progress. On the contrary general acceptance of some basic principles of functioning can enhance the economic performance of a market economy and lead, potentially at least, to "the greatest welfare of the greatest number". But in reality the basic rules of the game can vary a good deal, from American liberal capitalism to Scandinavian social-democracy, and to the German social market economy. In the latter case, for instance, 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[5], such as the employees, who are protected by the labour code, or the creditors, who are protected by the civil and commercial codes, in particular by the rules concerning the faithfulness and transparency of accounts, as "sunshine is the best disinfectant".[6] But the notion of stakeholders also implies some kind of consideration for interests that are outside specific legal protection but may find some specific form of protection in the institutions of corporate governance.[7] 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".[8] 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 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

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

[5] 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."

[6] The transparency rules are of particular relevance not only for creditors but for other stakeholders, such as minority shareholders or contractors. For the importance of the quality of accounting standards for investors see La Porta e al., 1998, p. 1140.

[7] 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.

[8] 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 "share owners, employees, customers, suppliers, lenders and society" (p.32), thus not much more restrictive, and very much in the perspective of strategic management.

be protected by the legal provisions concerning corporate governance, rather than by other specific pieces of legislation such as, for instance, in the case of employees, 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, as they are deprived in practice of decisional power, aside from entry and exit, in a context in which information is not only imperfect, and costly, but fundamentally asymmetric) lies traditionally at the very heart of the issue of corporate governance.[9]

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[10] 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[11]--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 rather the long-term value of the firm, as argued in Jensen, 2010). 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.[12]

4. Corporate Governance and the Varieties of Capitalism

An 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”, in particular the extent to which different rules and institutions aiming at the protection of stakeholders may be in a relationship of substitution or complementarity among themselves.[13] As shown in Hall and Soskice (2001), complementary prevails, in most cases probably as a consequence of the same social and political dynamics in the different legal areas rather than because of reciprocal enhancement in performance.[14] In particular the rules of corporate governance and the provisions of labour law tend to dovetail rather than alternate in the protection of perceived labour interests.[15] If consideration is given to

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

[10] By managers we intend here all those who have the responsibility of running the company, not only the top executives but also the directors.

[11] For an early eloquent statement see Friedman, 1970.

[12] 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).

[13] For the concept of institutional complementarity see for instance Armour et al. (2009).

[14] The first kind of complementary is called by Amable “structural isomorphism”, while institutional complementarity refers for him to the case “when the presence of one [institution] increases the efficiency of the other” (Amable, 2003, p. 6). Here we use the term complementarity simply to refer to the protection of the interest of stakeholders in different institutional domains, which, as noted by Amable, actually presents notable variations in the different countries.

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

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, we may arrive at 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 more specific varieties, and national characteristics, of the countries concerned.[16] 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".[17]

5. The Founders' and Financiers' Perspective and the Lump of Firms Fallacy

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. As a clear-cut example we may take Donaldson and Preston (1995), where the issue of stakeholder management is seen essentially as a static 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 first be established, and that the founders-owners are the original partners-shareholders. If the incentives they have for founding and financing the company are wanting, because, say, the law privileges the interest of stakeholders over those of shareholders, the company may not be founded and not exist at all, or it may attain a smaller dimension, because of the lesser incentives to organize and finance its growth. In the founders' perspective we can adopt different viewpoints: how would the founders best formulate the company charter in their own interest? And how should the legislator constrain the formulation of the charter from the perspective of the overall economic and social interests, taking into consideration the incentive structure that is created? In this the interests of stakeholders should be taken into account, but also how the imposed legal constraints may impact on the incentives of the founders, and thus on the supply of entrepreneurship.[18] Furthermore: 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, but also on its growth and further development? A related 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 the stakeholder interests 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. 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, which is by no means matched under European conditions, and that represents an important supply of crucial entrepreneurship, especially in technologically advanced and innovative firms.[19] 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 an institutional environment in which "employment at will"

[16] See Hall and Soskice (2001). For the quantitative aspects of the two main varieties and of their national variations see also Damiani (2011).

[17] Amable, 2009, p. 20.

[18] On the issue of the efficacy of the legal enforcement of shareholder rights for the advisability of constraining the formulation of the charter see La Porta et al. (1998, pp. 1121, 1126).

[19] Cf. OECD, 1998, pp. 18, 100. "Business angels", who are as a rule experienced older entrepreneurs, not only are sharing in the entrepreneurial function of risk taking, but are also 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). More in general "financial development may play a particularly beneficial role in the rise of new firms" (Rajan and Zingales, 1998, p. 584) and financial development is greater whenever outside investors (those not having a controlling share) are better protected (La Porta et al., 1997; cf. also La Porta et al., 1998, p. 1114), while "countries with poor investor protections indeed have significantly smaller debt and equity market" (La Porta et al., 1998, p. 1152).

prevails and the labour market is relatively unregulated.[20] In a different institutional context young innovative entrepreneurs would hardly have the same opportunities of creating and developing "gazelles". Outside of the North American institutional context, one would have hardly expected a Steven Jobs (or Jeff Bezos for that matter) to come out of his family garage to build in a short time a technological advanced and highly innovative large enterprise. [21] The same conditions make much easier the solution to the problem of how to deal, for instance, with the decision by the owners of a family firm 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. In general 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 appraise the rules that govern the life of the firm, in particular those that take into account the interests of 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. A pitfall to be avoided, which appears rather widespread instead, is a variety of the "lump of something fallacy" (found in the literature in the "lump of labour" version, as the idea that the amount of work to be done is given irrespective of circumstances), to assume, tacitly or explicitly, that the relevant data of a given situation will necessarily carry on in the future whatever the policy measures envisaged, which we may dub in our case the "lump of firms" fallacy. The number and types of firms and entrepreneurs at a given point of time is indeed given, but what happens later (and what happened before) depends on the incentives produced by the institutional setup, such as the regulations concerning the costs and timing of founding a firm, and the rules concerning corporate governance and the protection of stakeholder interest.

6. Haziness of the Concept of Stakeholder Value

The great disadvantage with stakeholder value (as the stakeholder approach is referred to in the literature)[22] as a guide to managerial behaviour, alternative to shareholder value, is the haziness of the concept, and of the basic concept of stakeholder itself. The consequence is, as Jensen (2010, p. 42) puts it, that "stakeholder theory plays into the hands of special interests that wish to use the resources of corporations for their own ends." 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",[23] which finds an actual legal counterpart "whenever corporate law mandates that the board act in the interest of the enterprise as a whole, a requirement which is of course open to multiple interpretations."[24] 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, as "a smokescreen for board discretion",[25] simply empowers managers to do what they think fit, independently of their agency or trustee relationships with the formal owners of the firm (the shareholders) pretending that they are pursuing stakeholders' interests.[26] If managers are left as the interpreters and guarantors of stakeholders rights this leads to a lot of haze in the assessment of

[20] According Ilmakunnas and Kanniainien (2001, p. 214) the rate of entrepreneurship (p. 208: " measured as the ratio of non-agricultural employers and people working on their own account...to the total labor force"), 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).

[21] Cf. The Economist (2012).

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

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

[24] Hopt, 2011, p. 6. As a matter of fact "the corporate law of many jurisdicions provides that directors owe their duty of loyalty to the company rather then to any of its constituencies" (Kraakman et al, p. 103).

[25] Kraakman et al., 2009, p. 103.

[26] As Jensen (2010, p. 34) aptly puts it "stakeholder theory politicizes the corporation and leaves its managers empowered to exercise their own preferences in spending the firm's resources."

managerial discretion and managerial results. This may increase the power to skim the value created by the company to managers' own benefit, while managers can always pretend to have sacrificed the interest of shareholders to stakeholders' interest.[27] 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.[28] 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, getting a return with the more successful ventures, repaying the losses on the least successful ones. The fact, that we have already emphasized, is that a company is established by the shareholders as partners. If the firm is supposed to pursue the interest of different parties (employees, local authorities, politicians etc.), rather than that 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.[29] The possible advantage of the idea that the purpose of the company should have some social dimension ("corporate social responsibility") rather than the creation of shareholder value, or that the company should be run "in the interest of the enterprise" rather than in the interest of shareholders could be in the area of psychology and social relations: Employees could be better motivated, and so more productive, industrial relations less antagonistic, public authorities and the public opinion better disposed and more cooperative, especially in cultural environments where profit creation tends to be considered tantamount with "exploitation" or "profiteering". In those environments, if the declared ideology of the firm is different and more socially acceptable than the creation of shareholder value this could serve well the creation of shareholder value itself. Show business is indeed an important part of business.

7. Who Owns the Company? Owners vs. Stakeholders

Against the concept of shareholder value it has been objected that dispersed shareholders usually do not offer much entrepreneurship, they perform as financiers rather than as entrepreneurs. According to a "politically correct" viewpoint, shareholders should not even be considered owners of the company, but only providers of finance capital alike banks or bondholders.[30] On the other hand shareholders are those who hold shares: shares of what, if not of the company? There are other situations of joint ownership where some of the owners are not playing an active role in the management of the common property, but are undoubtedly owners. Take for instance the undivided property of a family house, or of a business venture whose shares may be or may be not tradable according to contract and regulations. The larger the number of joint owners, the lesser their individual rights and interest in the management of the common property, and the greater the collective action problem, but they are owners nevertheless.

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[27] Cf. Jensen, 2010, pp. 36-37. 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 interest of stakeholders, instead of being trusted to managers as is explicitly the case in a number of legislations (see Sjåfjell, 2009, pp. 50 f.), 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 (and of the discretion of strong blockholders), rather than to an enhancement.

[28] Alitalia is a good case in point. In the case of Alitalia however the pathological consequences of stakeholder management were compounded by state being the controlling stockholder. As Gugler (2001, 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". But the actual consequences of state ownership and control can be different in the different social and political contexts, and not always so disastrous as in the Italian case, where the cumulated past losses of state enterprises account for about half of the present huge public debt. (For a recent overview on the performance of state capitalism worldwide see The Economist, 2012.) For the relative worse performance of state owned in relation to private owned enterprises in mixed economies, see the empirical analyses reviewed in Megginson and Netter, 2001, sect. 3, pp. 328–338.

[29] 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.

[30] Cf. Aglietta and Reberioux, 2005; Sjåfjell, 2009, pp. 32-35 and 80-82, and the literature quoted there.

Analogous considerations can be put forward in relation to the viewpoint of Margaret Blair and Lynn Stout (2005) who concentrate, more than on the economic consequences, on the legal aspects of the issue.[31] According to them the fact that in practice the directors of public corporations are appointed by other directors ("corporate law gives shareholders a right to vote on a slate of directors that has normally been selected by the existing directors") rather than by shareholders (in particular dispersed shareholders have no influence) means that the shareholders are not the owners of a corporation and directors are not their agents, but only "'fiduciaries' with respect to the corporation and its stockholders" (quoted approvingly from a publication of Robert Clark, p. 13). This notion of directors being fiduciaries of stockholders is quite reasonable since shareholders are many, with different conceptions and interests, thus it would be difficult to see them collectively as a principal.[32] However even with fiduciaries the analogous moral hazard and asymmetric information issues as in the paradigm principal-agent apply. At the same time the notion of a fiduciary relationship between directors and stockholders seems to contradict the two authors' notion of directors as "'mediating hierarchs' who must balance the competing needs and demands of shareholders, creditors, customers, suppliers, executives, rank-and-file, and even the local community", a kind of variation on a Berle and Means' theme. Whatever the de facto behaviour of dispersed shareholders (who in practice behave as rentiers rather than as active owners), directors normally are elected by shareholders.[33] Moreover, unlike dispersed shareholders who are blocked by the collective action problem, shareholders with a controlling quota of the shares and important shareholders such as pension funds have actually a say or even a determining voice on the main strategic decisions of the company and the appointment of directors (the controlling shareholder may even appoints himself as CEO). Finally even minor shareholders have an impact on the running of the company through exit, even if they have no voice, by affecting the variations of its capitalization, and thus of the wealth of controlling shareholders and directors, as a consequence of shareholders' appreciation of how the company is run and its changing future prospects. In general, the evolution in the market capitalization of a company is an instrument of control through which shareholders, big and small (i.e. "the market"), may express their judgment on the way the company is run, judgment that management would duly take into consideration.

8. Shareholder value, stakeholder value, and the social function of profits

But the dispute on the nature of company ownership is in reality a red herring: the real issue is of what rights and legal protection should be assigned to shareholders (however defined in terms of ownership), and the economic consequences of the different legal disciplines. Whenever shareholders have lesser rights and are less guaranteed in the enjoyment of those rights 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. Furthermore the pursuit of shareholder value is tantamount to the pursuit of the profitability of the firm.[34] Profits, the difference of the value of what a firm produces and what is accounted for as costs, provide both a motivation and, directly or indirectly,

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[31] For a thorough critical discussion of a previous version of Blair and Stout ideas see Meese (2002).

[32] The possible variety of the interests of shareholders, not allowing to consider them as a homogeneous group with a common interest, is stressed by Sjåfjell. 2009, p. 85. In fact this obviously applies, even outside of the business company, to any situation of shared ownership, where the interest and objectives of the sharing owners can be quite different. But a possible common denominator could be the maintenance and enhancement of the market value of the shared good (think for instance to the case of the owners being the family members with joint ownership of an inherited estate or of a business venture). Analogous considerations apply to any collective body of interest (such as employees or pressure groups). The variety of positions does not usually prevent from considering what could be seen as the objective common interest of the group, such as, in case of shareholders, the viability and long-term profitability of the company.

[33] Usually through a majority voting rule, but in most cases through a plurality voting rule in the USA (Kraakman et al., 2009, pp. 58-59). But there are exceptions. The most relevant being that of employee representatives in the company boards (cf. Sjåfjell. 2009, p. 53). The most interesting case is that of the Netherlands between 1971 and 2004, where directors of some large corporations were legally selected by incumbent directors, with no shareholder participation (Kraakman et al., 2009, pp. 56, 94-95). In many other instances this may happen de facto, especially where share ownership is widely dispersed, as is the case in large American corporations (ibidem).

[34] For the notion of shareholder value and its limitations see Chilosi and Damiani, 2007 and the literature quoted there.

the resources for continued existence and the long-term growth of the firm.[35] If the market values of inputs and outputs are taken as a proxy of social opportunity costs and benefits (admittedly quite a far-reaching assumption) the profitability of the firm measures not only private but also social value creation.[36] Probably no better proxy exists, while the degree of accuracy of the proxy depends on the institutions and regulations whereby issues such as externalities, market power and imperfect and asymmetric information are dealt with.[37] A troublesome issue is the time frame, as long as there may be contradiction between shareholder value in the long and in the short run.[38] The relevant notion of shareholder value should be for the longer run (what we may call sustainable shareholder value), but in practice a tendency to short-termism is lamented whenever the current stock exchange valuation is an overwhelming managerial concern (such as it is often reported to be the case in the USA). At the same time the issue of the time framework potentially weakens the efficacy of the shareholder value criterion: indeed any short-term fall in the market valuation of the firm can be justified as being in accord with longer-term value creation. But in the end it is for the market to judge what the long-term prospects of a company are.

An argument of the proponents of the stakeholder view,[39] is that enterprise costs are not social costs because they include variable amounts of stakeholder surplus (such as employees' surplus) that is created or destroyed by the firm in its multifarious activities, and it is not accounted for. For instance, when a firm scales or shuts down, the costs saved are not really equal to the social opportunity costs; only in the introductory textbook model of the perfectly competitive economy it is otherwise. In practice the local communities lose, and workers lose the difference between their actual wages and their reservation wages.[40] But concretely no better approximation to a firm's social costs and benefits than that provided by its accounts seems to be available. The idea that market values can be taken as the best practical approximation to social opportunity costs and benefits is the basic justification of a market economy, which, paraphrasing Churchill, is "the worst form of economic organization except all the others that have been tried". When proposing, explicitly or implicitly, alternative policy rules the implied structure of incentives and related overall economic consequences should be careful appraised. For instance, should employment maintained at all costs? Should a firm ever be allowed to close a plant or layoff workers? Should employees instead of shareholders be legally entitled to appoint directors and top executives? If some of these rules were accepted the negative consequences on aggregate productivity and employment could be far reaching.[41] If we are not ready to accept them in general they should not be invoked either

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[35] As Sjåfjell(209, p. 51) puts it, "The future life of the enterprise and the profit of the involved investors are generally interwined."

[36] Cf. Jensen, 2010, p. 34: "value is created—and when I say "value" I mean "social" value—whenever a firm produces an output, or set of outputs, that is valued by its customers at more than the value of the inputs it consumes (as valued by their suppliers) in the production of the outputs. Firm value is simply the long-term market value of this expected stream of benefits."

[37] Cf. Jensen, 2010, pp. 34-35.

[38] Cf. ibidem pp. 38-39.

[39] See for instance Charreaux and Desbrières (2001).

[40] In part the loss can be the consequence of sunk costs and of factor specificity whereby "a factor would lose part of its value if used" outside a given production arrangement (Caballero and Hammour, 2000, p. 5), and, more in general, of pecuniary externalities that are absent only in general equilibrium model of a perfectly competitive economy, but not in the real life of imperfectly competitive markets.

[41] Owing to overall budget constraints, if somewhere losses are covered, somewhere else resources that could be normally put to more productive use are distracted. In particular, labour mobility is an important factor enhancing productivity and growth (see on this Martin and Scarpetta, 2011). Moreover "In well-developed market economies, the evidence is overwhelming that the pattern of reallocation is productivity enhancing. Accounting exercises show that a large fraction of total factor productivity and labor productivity growth at the industry level is accounted for by the reallocation of outputs and inputs from less productive to more productive businesses" (Bartelsman et al., 2004, p. 4). As a consequence, if the process of resources reallocation is hindered the process of productivity and income growth can be thwarted. On the other hand some employment protection could be justified by imperfect information, externalities and lack of contractibility of employment insurance arguments, advanced by Belot et al. (2007) to explain an empirically derived (with the data from 17 OECD countries) inverse U-shaped relationship between employment protection and economic growth.

explicitly or implicitly in any single case, both for coherence and because the application in any single case validates the rules in the aggregate.

9. Stakeholder Management in the Japanese System

Probably there are no actual legal system where a rule empowering employees to appoint managers and top executives of companies formally exists. However, according to a view "employees' sovereignty" exists de facto in Japan while "shareholders' sovereignty" is simply a legal fiction (H. Itami, quoted by Koyama, 2010, p. 372). According to Itami this is the case in the complex system of cross ownership and control in the Japanese *keiretsu*, with the selection of managers among top employees through co-optation. For Tachibanaki (1998, pp. 20-22) the Japanese firm is a "labour managed firm", in the sense that "although it appears to be owned by the shareholders and monitored by debtholders, in reality the firm is owned by its employees", while "the stability of the firm, the safeguarding of jobs, and coordination for directorates are the most important goals for top executives." Such a system of governance can more easily apply to an already established structure of big interconnected firms reproducing and enlarging itself but it can be hardly compatible with the creation of new companies by individual innovative entrepreneurs. In the environment of an already existing industrial system of big companies, such as in post-war Japan, further firm growth and foundation of new firms by the existing ones could be ensured by the introduction of a managerial system neglecting the short-term interest of shareholders and privileging the interest of other stakeholders such as employees, whereby companies are chiefly financed through retained profits and the *keiretsu* bank. This can be a possible explanation of the peculiarities of the Japanese corporate governance system arising in the after war period with the demise of the *zaibatsu* and of older controlling shareholders, purged because of their relationships with the previous regime, and the formation of the *keiretsu*. But following the stagnation of the Japanese economy in the nineties a reform of the commercial code with the aim to put the Japanese governance system more in line with that of other OECD economies was undertaken in 2005 (cf. Koyama, 2010). At any rate, even in the case of de facto dominance by employees interests in corporate management, the interest of equity owners whould be considered to the extent that some equity financing is required and sought for, analogously to the case of corporate control by dominant self-interested blockholders in relation to dispersed shareholders. Otherwise the fact that profits are mostly retained appears not to be peculiar to Japan, part of value creation being captured elsewhere too by the increased value of shares accompanying the growth of corporate assets and expected profits.

10. Stakeholder Representation in the Governing Bodies[42]

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,[43] 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

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[42] For a synthetic overview of the various institutional varieties of employee representation in Europe see Sjåfjell, 2009, pp. 64-67.

[43] 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 directors take care informally of a bundle of complex stakeholders interests: "managers represent the company but never represent its shareholders or employees. It is the managers who represent 'the company itself'" (Koyama, 2010, p. 369). The Japanese articulate framework of strong social control may have been able to keep potentially arbitrary managerial power in check.

directors (for instance by giving a seat to bank representatives, as is often the case in the German governance system)[44], or be legally imposed.[45]

10.1. 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 be normally 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 could be reflected in goodwill, and thus in its net value.

10.2 Stakeholder Representation as a Control and Collaboration Device

Employees' representation in company boards could also 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.[46] The informational exchange that this 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.[47] This applies also to other kinds of employee representation such as works councils.[48] 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 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

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[44] For the literature debating the relevance of the presence of bank representatives in supervisory boards of German corporations see Fauver and Fuerst (2006), 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., 2005, p. 666). The role of banks in German corporate governance through vote delegation is downplayed by Hopt (2011, p. 51).

[45] 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. Indeed "many west European countries now mandate employee-appointed directors in at least some large companies" (Kraakman et al., 2009, p. 100). Cf. also Hopt, 2011, pp. 55-56.

[46] "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, 2006, 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.

[47] Cf. Fauver and Fuerst (2006), p. 673. On the other hand there are cases of labour representatives in the supervisory boards taking advantage of their position to organize strikes that were particularly damaging for the company (Kraakman et al, 2009, pp. 210-201).

[48] Kraakman et al, 2009, p. 102.

decentralization").[49] But there is also the possibility that insider workers and managers could collude against shareholder interests, especially of minority and disperse shareholders, in particular by blocking the working of the "market for corporate control" while defending existing employment levels even when this jeopardizes the long term profitability of the company.[50] 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).[51] 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,[52] to the advantage both of fairness, reduced inequalities, and even of efficiency since "lean cats may run faster than fat cats".[53] Without compulsion a single firm engaging in co-determination when the others do not could be negatively affected.[54] 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. In particular, the social compact implicit in the latter enhances the opportunities for macroeconomic collaboration between social partners. 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, in corporate governance could turn to the disadvantage of some weaker segments of

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[49] Ilsøe (2010), p. 40.

[50] Cf. Hopt, 2011, p. 57. 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. As argued by Kraakman et al. (2009, pp. 111-112) a disadvantage of employee representation (and one may extend this viewpoint to stakeholder representation in general) is that it complicates and makes more difficult the decision making process. As concluded by Hopt (2011, p. 58), " In the end, the impact of codetermination is an empirical question that still has to be conclusively answered." For a synthetic recent survey of the issue see Ginglinger et al., 2009, pp. 5 f.

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

[52] However Hopt (2011, p. 58) on this has a sobering note: "labor seems to be not really interested in whether there are higher or lower pay levels for directors". But this is actually changing, both for labour and for shareholders reacting to directors' excessive pay in the aftermath of the economic crisis.

[53] Chilosi, Damiani (2007), p. 10. The reason lies in the potentially negative income effect of higher incomes on managerial effort. Thus every measure for reigning in the high pay of top managers (such as making top executives remunerations subjected to a binding shareholder vote, as recently declared in the UK by the Cameron government; cf. Allen, 2012) could be defended not only in the name of equality and fairness but also in the name of productivity enhancement. Moreover "you wave enough money in front of people, and good people will do bad things" (Franklin D. Raines in Bloomberg 2003). 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 (Dyck and Zingales, 2004), whenever 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. (On the different legal protection of shareholder rights in the various legal systems, and its economic consequences, see La Porta et al., 1998; on the various extent of private benefits by controlling shareholders in the different jurisdictions and the reasons thereof see Krakman et al., 2009, pp. 107-111.)

[54] Fauver and Fuerst, 2006, p. 679.

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. Insiders are usually in much larger number than outsiders, as well as more vocal and organized, so it pays to legislators to stand in favour of their interest rather than for the interest of outsiders, unless at least the well-being of insiders is negatively affected by the precariousness of their position when there is a relevant chance to become outsiders (as we shall see in what follows).

11. Workers' Representation Vs. Labour Code Protection

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 protection of the interests of insider workers and of their firm-specific investment[55] through employees' representation in works councils or enterprise boards does not necessarily 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 theory at least, 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. The provisions of labour law may be in this respect a better instrument, since they guarantee everybody' rights in an employment contract. But codetermination may be the counterpart of a social bargain struck between the different social components 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 it could otherwise be expected from the protection of insider interests, as in the German social market model. Analogous considerations apply even more to the Scandinavian model of industrial relations. But one may speculate the extent to which

[55] 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 in the state administration (where the process of specific investment may start, with the perspective of entering the public internal market, already during the educational process), or in state railways, or in the IBM in its heydays. As remarked by Lazear (2003, p. 1) "it is difficult to generate convincing examples where the firm-specific component [of human capital investment] approaches the importance of the general component". Firm specific investment appears rather to be concentrated at the beginning of the employment relationship: for instance the cost of moving, of learning the rules and habits of the firm, to get knowing new colleagues, etc. It is unclear that its further building-up could be incentivated by employment protection, unless at least if accompanied by strong career motivation. Indeed, employment protection has been shown to be a factor hindering workprice training (Brunello, 2006). An additional related factor refers to the information about the employees that the firm acquires in the course of their employment and workers' investment in acquiring reputation inside the firm, which could not be easily transferable outside. The investment is reciprocal: the firm too invests in acquiring specific information as to the quality of its employees 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 is avoided not only if the fairness of the dismissal is legally verifiable but also in case it is simply observable by the employer and the workforce (even if not verifiable in court proceedings), allowing an extended leeway for firms to decide layoffs that are substantially, even if not verifiably, fair in case of absent legal protection, without enduring reputational losses. Finally, if insiders' protection leads to greater difficulties to find a job for outsiders (such as when it leads to the increase of long-term unemployment) the protected insiders (if the protection is not really watertight as it is in public employment in some countries) could be motivated to take advantage of their protection for concentrating on the accumulation of generic human capital as an insurance for having a better chance to find another job, in case of actual lay-offs. In case of lower protection (and higher probability to find another, albeit less satisfactory, job in case of dismissal because of lower long-term unemployment) insiders could be better motivated to cooperate in the accumulation of firm-specific capital in order to increase the probability of keeping their more satisfactory employment and career prospects, without risking really to become long-term unemployed in case of lay-offs. But in case of a system of dualistic labour contracts, where short time contracts are used as a buffer stock by the employers who are unable to get rid easily of long term employees, the expected reduced length of employment of short time workers may lead to lesser training and lesser human capital investment, both generic and specific. For a recent paper where the issue of firm-specific investment is considered, in relation to the productivity consequences of employment protection see Damiani et al. (2011).

this is the outcome of specific corporate governance and labour market institutions or of the specific social, political and national context that allows effective centralized wage bargaining to take place.[56]

12. 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). 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 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).[57] 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.[58] The countries are arranged in five different groups (according to Amable's, 2003 and 2009, classification)[59]: the first one corresponds to the the Anglo-Saxon Liberal Market Economies (LME), as defined in Hall and Soskice (2001), the second 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), the fifth, with scanty overall data, to the South-East Asian market variety. 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: an explanation may be found in a system of industrial relation akin to the Scandinavian social-democratic type.[60] 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.

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[56] The specific national context of Denmark, enhancing overall trust in industrial relations, is emphasized by Ilsøe (2010). For the Scandinavian social-democratic model in general see Andersen et al. (2007).

[57] 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.

[58] "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).

[59] Hall and Soskice (2001, p. 21) consider France, Italy, Spain, Portugal, Greece, and Turkey as belonging to a Mediterranean variety, which however is not dealt with by them in detail.

[60] Cf. Amable (2003), p. 138. And in fact according to Boyer (1997) classification (quoted in Amable, 2003, p. 83) Austria belongs, together with Sweden, to the social-democratic model. The relative small size and possibility greater internal social cohesion could be another factor making Austria's performance closer to that of the Scandinavian countries.

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 decision making, taking into consideration the overall consequences of wage policies on employment rather than defending the interest of insiders, bring about wage moderation. This, together with the pursuit of active labour market policies, make high levels of employment protection compatible with high levels of employment and low levels of long-term unemployment. But the Scandinavian recipe requires the fulfillment of a set of social and political conditions that are unlikely to be replicated elsewhere, especially in the Mediterranean countries, where usually more militant trade-unions undergo competition from rank and file anti-system trade union groups (such as the Italian COBAS). Trade union competition may in turn lead to a greater emphasis on employed workers' satisfaction and on achieving wage raises rather than high employment levels. As noted by Richard Freeman (1988, p. 65) "Economies at the extremes - with highly centralized or highly decentralized labour markets - had better employment records than those economies 'betwixt and between'". Even size could be a relevant factor, the smaller size of Scandinavian countries being better compatible with their centralized corporative institutions than it could be the case with larger economies (ibidem, p. 78). One may note from the data that in the USA, where "employment at will" is the rule 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.[61] The latter are different in the different countries considered (higher in Germany, but also in the UK, in relation to Italy, for instance, where 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, where the coordinated market economies appear to present on average lower unemployment levels in the period 1960-1998),[62] but it is long-term unemployment that represent the main source both of economic waste and of social suffering.[63] 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.[64] As argued by 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

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

[62] 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). The data on the incidence of long-term unemployment in the year 2000 of a set of OECD countries presented by Schmitt and Wadsworth (2005, p. 176) are in accord with the overall picture of Table 1. Their general remark that "other, less flexible arrangements can achieve" lower level of long-term unemployment (p. 177) may find comfort in the special case of the Scandinavian countries, as well from that of the Asian countries such as Japan of South Korea.

[63] "One should recognise that the experience of long-term unemployment is a horrid one for those unfortunate enough to experience it" (Machin and Manning, 1999, p. 3085). Moreover while *ceteris paribus* short-term unemployment may be instrumental for helding in check inflationary wage raises, in this respect long-term unemployment is pure waste: "long-term unemployment, in contrast to the short- term variety, contributes very little to holding down wage pressure and hence inflation … The long-term unemployed are far enough away from the active labor market that their presence has little influence on wages" (Nickell, 1997, p. 57).

[64] There are three possible reasons why the LMEs can present higher levels of short-term unemployment in relation to CMEs: 1. Higher rates of discouraged workers in the CMEs because of the lower probability of finding a job associated to higher rates of long-term unemployment in a more rigid labour market (resulting in lower participation rates: see the third column of Table 1). 2. Higher rates of entrapment of employed workers who, in case of a more flexible labour market, would leave their current employment in order to find a more satisfactory job. 3. Firms may have a greater propensity to lay off workers as the costs and hassle of layoffs are lower. As a matter of fact "In countries such as the United States and the United Kingdom gross job and worker flows are almost twice as large than in most continental European countries" (OECD, 2009, p. 6).

such a regulation, whether positively or negatively, is relatively weak" (ibidem).[65] But in a given rate of aggregate unemployment quite different rates of long-term and short-run unemployment can be hidden (see the different rates of incidence of long-term unemployment in Table 1). 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.[66]

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 (or at least long-term) 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 who are 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;[67] the other is what we may call the entrapment factor:[68] 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)[69] through which workers tend to be allocated to jobs that they relatively prefer and where they are relatively more productive.

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[65] See also Bassanini and Duval, 2006, p. 9: "In line with a number of previous studies, no significant impact of employment protection legislation (EPL) on aggregate unemployment is found."

[66] Obviously there are other criteria for comparing the performance of economic systems that are of paramount relevance, such as the capability to generate technical progress and growth. Calmors and Driffil (1988) consider the way in which the degree of centralization in wage settings affect macroeconomic performance, arriving to the conclusion that the extremes (either fully centralized wage setting or complete decentralization) work the best. This is compatible with the data of table 1, as far as long-term unemployment is concerned. For a broad consideration of the institutional factors affecting a composite index of labour market performance see Pieroni and Signorelli (2002). On the negative consequences of employment protection on labour mobility and productivity growth see Martin and Scarpetta, 2011.

[67] The empirical studies surveyed by Skedinger "indicate that employees with permanent jobs perceive less security in countries with stricter legislation" (p. 118). In Clark and Postel-Vinay (2009) while "workers feel less secure in countries where jobs are more protected" this does not apply to "permanent public jobs, suggesting that such jobs are perceived to be by and large insulated from labor market fluctuations".

[68] Skedinger (2010, p. 116) refers to "locking-in effects" induced by employment protection. In case of entrapment, and the overall market conditions that may lead to it, it would much more risky to heed the exhortation by Steven Jobs: "the only way to do great work is to love what you do. If you haven't found it yet, keep looking. Don't settle."

[69] Cf. Rosen, 1986.

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

Country	Long-term unemployment rate	Long-term unemployment incidence	Unemployment rate	Participation rate	Employment protection index
USA	0.52	9.45	5.4	66.1	0.21
UK	2.24	31.09	6.7	61.4	0.66
Canada	1.03	12.21	8.4	65.6	0.75
Australia	2.05	26.01	7.4	63.5	1.05
Ireland	4.54	47.33	8.4	57.4	0.98
Average	**1.73**	**25.2**	**7.26**	**62.8**	**0.73**
Germany	4.21	48.25	8.6	58.5	2.54
France	3.8	39.66	10.3	55.3	3.01
Belgium	4.48	55.91	8.2	51.1	2.52
Netherland	2.15	42.97	4.8	61.4	2.4
Austria	1.23	25.75	4.1	58.3	2.13
Average	**3.17**	**42.51**	**7.2**	**56.92**	**2.52**
Italy	5.8	59.34	9.8	48.1	2.69
Spain	7.34	45.76	15.5	52.4	3.31
Greece	5.08	53.25	9.6	52.1	3.27
Portugal	2.47	43.66	5.9	60.7	*3.67*
Average	**5.17**	**50.5**	**10.2**	**53.33**	**3.24**
Denmark	1.52	24.36	6	66.1	1.71
Finland	2.9	26.61	10.8	61.7	2.08
Sweden	1.71	22.7	7.1	64	2.44
Norway	0.6	13.62	4.3	65.6	2.69
Average	**1.68**	**21.82**	**7.05**	**64.35**	**2.23**
Japan	1	24.5	3.9	62.4	1.58
Korea	0.1	2.6	3.5	61.2	2.32
Taiwan	NA	NA	3.1	NA	NA
Singapore	NA	NA	3.7	65.4	NA
Hong Kong	NA	NA	4.3	61.4	NA
Average			**3.7**	**62.6**	

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

12.1 The Dual Employment Solution

There is a possible mixed dual solution whereby labour protection is restricted to a section only of the labour force. This kind of solution may be pursued de facto with 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 is created depends concretely on the perspective of temporary employment to become permanent, which may be slight if employers prefer to avoid incurring the costs of more permanent labour contracts even for workers they would otherwise prefer retaining, bringing about termination of the employment whenever the maximum legal length of temporary employment is reached. This can have negative productive consequences if only because of the lower propensity of temporary employees and employers to invest in the employment relationship.[70] Of course much would depend on how more onerous are the regular contracts in relation to a sequence of temporary ones.[71]

The postwar Japanese economy presents a clear-cut case of a dualistic labour market where a core part of the labour force enjoys lifetime (or rather long-term)[72] employment (with associated incentives to undergo specific investment as provided by the career motive) while the residual part is subjected to more precarious temporary employment with larger labour turnover.[73] This institutional setup has made compatible the lifetime (or rather long-term) employment model with low levels of unemployment, but also with high inequality in the distribution of earnings.[74] Another factor is provided by the residual component of married women employed in precarious and lesser paid employment and discouraged from taking part in the labour market in periods of lower labour demand. Other relevant features are more stable employment relationships, and thus relatively low labour turnover, adjustment in the number of hours rather than in the number of employees in case of reduced sales, and a relatively high share of self-employed.[75]

13. 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, by 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. Recent instances are the

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[70] On the possible negative productivity consequences of short-term contracts see in particular Damiani, Pompei (2010). A reason can be in particular the lower interest of the employers in training employees whose permanence prospects in the firm are seen to be low.

[71] On the consequences of liberalizing short-term employment see Skedinger, 2010, pp. 63-64, 107, 125-26.

[72] Even in the paramount Japanese case we have long-term rather than life-long emloyment, as "there are only about 10-15 per cent of male employees who have never changed employers during their careers" (Tachibanaki and Taki, 2000, p. 10).

[73] In Japan "the majority of employees such as female employees, part-time workers and workers in smaller firms are not covered" by the long-term employment system reserved to men employees in big enterprises (Tachibanaki, 2000, p. 11). The coexistence of a core section of protected workers with a relatively large one of temporary less paid employees can be found also in the case of Korea, where the recorded incidence of long-term unemployment is minimal. Cf. Grubb, Lee and Tergeist (2007), p. 12.

[74] Japan's Gini is relatively high among OECD countries at 37.6 (in 2008; source CIA Factbook 2011).

[75] Cf. Tachibanaki and Taki, 2000, p. 12.

encroachment by the German government on the destiny of the Opel GM subsidiary during the 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 its 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 quite damaging. Moreover we have here an obvious case of 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. This may be particularly damaging in case by case ad hoc interventions, outside the constraints of a general legal framework. Here too there may be exceptions. During the recent economic crisis keeping the automotive industry afloat in the USA by ad hoc interventions has been vindicated by the subsequent return to profitability showing long-run viability. In exceptional times, where the normal working of capital markets is paralyzed, exceptional interventions in the public interest may be justified.

14. Minority Shareholders as Stakeholders

Minority and dispersed shareholders could be perceived as kind of stakeholders whose interest is impacted by the decisions of controlling blockholders 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 at protecting non-controlling shareholders. The same applies to the mandatory bid rule that allows non-controlling shareholders to share in the control premium. More generally, the law provides guarantees for the co-owners of a business each towards the others. Thus its constraints may not be adverse, but rather favourable to the forming of agreements establishing a company, by reducing transaction costs through standardization, while disciplining and preventing ex-post opportunistic behaviour and protecting the interest of other types of stakeholders such as creditors, or the inland revenue and taxpayers. At the same time the advantages of standardization should be balanced against those of subsidiarity, by granting to the partners the autonomy of deciding how best to pursue their own interest in drafting the charters, as long as this is not contrary to the protection of a perceived public interest. Contestability of corporate control provides some guarantee for non-controlling shareholders against misuse of corporate resources, and may work as an instrument leading to a better allocation of productive resources overall. It appears the more effective in the Liberal Market Economies, where the protection of investors is also overall greater·.[76] The mandatory bid rule makes bids to acquire a controlling share more onerous, reducing the potential challenge to established positions.[77] At the same time it may reduce the potential instability in corporate control, and the tendency towards excessive short-termism when managers are all too dependent on the changing moods of the stock exchange instead of planning for the long term. In constituencies where the overall protection of dispersed shareholders is lower the mandatory bid rule can increase the interest of savers to participate to the stock market, as it

[76] In particular "the United States and the United Kingdom still have by far the most takeovers of any country in the world" (La Porta et al., 1998, p. 1120).

[77] Cf. Kraakman et al., 2009, p. 124; Schuster, 2010, p. 8.

increases the probability even for non controlling shareholders to collect eventually the real value of their shares, without expropriation of part of it by the controlling blockholders.[78] But it may also hinder value enhancing transfers of corporate control, while preventing some value decreasing transfers.[79] As often is the case, there are no clear-cut answers, only trade-offs. But on the whole better protection of shareholder rights may lead to better economic performance.[80]

15. Conclusion

In the end we should always be aware that the economic consequences in the different institutional and social contexts of alternative legal disciplines may be quite different. 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.[81] In particular "Russia's negative experience during the mid-1990s is a cautionary reminder that 'self-enforcing' governance strategies still require an honest judiciary and a strong securities regulator to be effective".[82] 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 is apparently in the Scandinavian case) turn against workers' living standards and opportunities of employment. Or, going to a hypothetical extreme, a legal rule empowering employees instead of shareholders to appoint a controlling majority of directors would probably be to the disadvantage of workers in general: it may well correspond to the ethical principles of someone, but can be nefarious for the category the rule itself would aim to protect, considering its possible impact on the propensity to invest, innovate, and create firms and jobs. At the same time the approach to stakeholder theory privileging the protection of stakeholder interests as opposed to value creation may work as a powerful ideological instrument for favouring special interests, such as of managers or controlling shareholders wishing to escape the constraints of the market for corporate control, or of politicians wishing to wield 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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[78] For the worldwide diffusion of the mandatory bid rule see Schuster, 2010, p. 3.

[79] Such as in the case of acquisition of control by "looters". See Schuster, 2010.

[80] Cf. Core et al. (2006).

[81] See on this Black et al. (2000).

[82] Kraakman(2009), p. 55

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