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Pierre-Yves Gomez and Harry Korine
Excerpt
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Introduction

'*What* gives the right to direct a corporation?' This question is at the heart of corporate governance. It is also of central concern to the millions of citizens whose lives depend upon the fate of business corporations. The rules, institutions, and practices of corporate governance define the limits of the power to direct and determine under what conditions this power is acceptable. In our sense, to direct means to exercise an entrepreneurial force that impacts the entire corporation, giving it an orientation and laying the foundations for its long-term survival. The legitimacy of exercising this force in the name of the corporation is not automatically assured, but is rather a subject of rules and limits. Corporate governance is the definition of these constraints.

As befits a subject with implications for many spheres of human activity, the study of corporate governance draws on a wide variety of disciplines. In spite of, or perhaps precisely because of its broad grounding, the field, in our view, lacks a coherent, holistic vision that would make it possible to pull together the different strands of inquiry. The more research is done, the stronger this impression becomes, because the three principal disciplinary axes along which research is moving – economics, history, and political philosophy – do not speak to each other and are not compatible in terms of approach and methodology.

However erroneously, the primary voice in the study of corporate governance is often considered, today, to be economics, more particularly financial economics. The contemporary articulation of the 'governance problem' in economics emerges in the 1970s, with the reactivation of agency theory and renewed attention to property rights. Neo-liberal scholars[1] refocus research on the right to direct from the

[1] In this book, the terms 'liberal' and its corollaries (neo-liberal; anti-liberal) refer to a definition that is consistent with how the terms are understood in the history of thought: 'liberalism is distinguished by the importance it attaches to the civil and political rights of individuals. Liberals demand a substantial realm of personal freedom . . . which the state should not intrude upon, except to protect

point of view of the divergence of individual economic interests, pointing out that the interests of management are naturally opposed to the interests of shareholders. After decades of very widespread faith in managerialism, that is to say an a priori faith in management as disinterested, technocratic experts in the service of the corporation, this represents a complete reversal of point of view; now, management is also considered to be made up of rational, self-interested individuals, and it is recognized that management self-interest can conflict with the interests of the shareholders. The theory which is inspired by neo-liberalism defines corporate governance as a game of opposing forces to orient the corporation, between those who hold power and those who hold information, an agency problem which needs to be regulated by the institutions of the corporation and, more generally, by the financial markets. This is why financial economics reduces corporate governance to the financial dimension and economic calculation plays such a critical role. If financial markets are efficient and the price of the share accurately reflects the *performance* of the corporation, then shareholders are effectively in control. In order to answer the question '*What* gives the right to direct a corporation?' contemporary economics focuses on financial performance, as verified and acted upon by the shareholders.

Agency theory holds pride of place in corporate governance. Thousands of articles and books have been published on this theoretical basis, demonstrating in considerable detail how the study of the relationship between principal and agent sheds light on and can, in some but not all cases, resolve the conflict of forces between management and shareholders. Since agency relationships can be found almost everywhere, this focus has led to an ever greater array of different, partial solutions, with no end in sight. Nonetheless, the lack of realism that arises from the dogmatic insistence on efficient financial markets upon which the entire theoretical edifice is based has led to vigorous questioning, both from inside and from outside of economics. Criticism

others from harm; today, particularly after the decline of communism, it is the dominant ideology in many parts of the world' (Ted Honderich (ed.), *Oxford Companion to Philosophy*, Oxford: Oxford University Press, 1995, p. 483). As we will show, economic liberalism is a dimension of the liberal ideology (see also M. Blaug, *The History of Economic Thought*, Aldershot: Edward Elgar, 1990). We will not, in this book, distinguish between the different branches of liberal thought – liberalism, libertarianism, etc. For our purposes liberalism is to be considered as the ideological reference of modern Western society and capitalism.

has also arisen based on the fact that the vast majority of corporations are not quoted on the financial markets and are of necessity ignored by agency theory. Other theoretical currents have been thrown into the breach more recently to address these concerns – for example, stakeholder theory[2] that proposes a redefinition of the function of management, or resource based assessments that seek to understand corporate governance in terms of an optimal allocation of competence.[3] These well-articulated criticisms aside, there is no way around acknowledging that agency theory is the basis for economic reflection on corporate governance – including critical reflection – and that this approach has produced an important and sophisticated corpus of analysis that influences the whole range of contemporary thought in corporate governance.

In parallel with economics, the field of history has also built up a body of research in corporate governance. Work in business history and economic history focuses on understanding how the governance of the corporation has evolved over time. More often than not, the research is built around the detailed analysis of a single country or the comparison of national singularities.[4] National studies of this type show how specific cultural, economic, and political characteristics have shaped the path followed in the development of corporate governance. Static analyses typically based on the shareholding structure have helped consolidate the partial results of country specific longitudinal work, providing evidence of several major governance types: the Anglo-Saxon, the Rhine River (France/Germany), or the Japanese, etc. Historical research has sought to show how, since the origins of capitalism, each country has produced its own institutions and rules, creating systems of corporate governance that are in line with systems of political

[2] See E. Freeman, *Strategic Management: A Stakeholder Approach*, Marshfield, MA: Pitman Press, 1983; E. Freeman and D. Reed, ‘Stockholders and stakeholders: a new perspective on corporate governance’, *California Management Review* 25 (3) (1983), 88–106; T. Donaldson and L. Preston, ‘A stakeholder theory of the corporation: concepts, evidence, and implications’, *Academy of Management Review* 20 (1) (1995), 65–91.

[3] For a recent and complete overview, M. Huse, *Boards, Governance and Value Creation: The Human Side of Corporate Governance*, Cambridge: Cambridge University Press, 2006.

[4] For examples, M. J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Princeton, NJ: Princeton University Press, 1994; M. Levy-Leboyer, ‘Le patronat a-t-il échappé à la loi des trois générations?’, *Le Mouvement Social* 132 (1985), 3–7; A. Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism*, Cambridge, MA: Harvard University Press, 1990.

governance in each country: laws of incorporation, rules and rights of business, stock market and trading regulation, etc.[5] The great question faced by historical research concerns the influence of globalization – does globalization lead to the convergence of all the different national types towards one global interpretation of corporate governance, or, on the contrary, is globalization compatible with multiple types of governance, either region or ownership specific (i.e. for family owned, for cooperatives, for public companies, etc.)? Without a more general theory to understand whether or not all societies are converging – after all, corporate governance is just one dimension of society – the questions posed by globalization cannot be definitely answered. Such a general theory of societal convergence does not yet exist.

The historical approach to the study of corporate governance contrasts distinctively with the austere purity of financial economic theory. Whereas economics reduces corporate governance to rational calculation and a principal agent problem, history describes a multiplicity of particular cases, almost as many as there are different national cultures. Each country, even each region, if it is of sufficient cultural differentiation, can give rise to its own type of governance. Of course, at the highest level of analysis, all of these different interpretations revolve around shareholders, management, and entrepreneurs. However, local history has such a determining influence on how the institutions of corporate governance are understood and interpreted, that each case seems special. In contrast to the extreme homogenization proposed by economic theory, the historical approach offers extreme heterogeneity. The historical approach has the great advantage of being able to demonstrate that corporate governance is closely tied to the *evolution* of mentalities and interpretations, indeed that corporate governance is anchored in the societies in which it is exercised and therefore cannot be studied in isolation. For the historian, corporate governance is often idiosyncratic and in continuous evolution. In answer to the question '*What* gives the right to direct?', history points to the multiple paths whereby different interpretations of corporate governance become locally established.

[5] D. North, *Institutions, Institutional Change, and Economic Performance*, Cambridge: Cambridge University Press, 1990; M. Aoki, *Towards a Comparative Institutional Analysis*, Cambridge, MA: MIT Press, 2001; P. Frentrop, *A History of Corporate Governance*, Amsterdam: Deminor, 2003.

From its vantage point, and since the beginnings of capitalism, political philosophy has also been interested in the question '*What* gives the right to direct?' Liberal political philosophy, in particular, has sought to establish the principles upon which a society composed of free individuals can be based: at its core, liberal thought has asked how it is possible to build a stable political organization on the autonomy of its constituent members. The corporation and its governance were not left out of this inquiry; rather the corporation has itself been the subject of extensive liberal reflection, in the specific context of the productive organization. It was not necessary to wait until the term 'corporate governance' was coined, for philosophers interested in politics and law to discuss the nature of power exercised in the corporation and inquire about the source of the authority to direct. The preoccupation of philosophers in the field of corporate governance was and is the *legitimacy* of power. From the earliest days of liberal thinking, philosophy had to develop a theory of legitimate private entrepreneurial action that was legally and politically compatible with the acceptable exercise of power over others. The notion of private property was advanced as the basis for sovereignty over things and hence for the freedom to act. This foundational principle of the modern liberal society was then extended to the corporation, which, when looked at in terms of the social capital it represents, could be considered to be an object of private property.

Of course, the extension of the notion of private property ownership to an *organization* has given rise to great deal of criticism and debate. It is one thing to own the physical objects, such as machines or buildings, quite another to affirm that the person who owns the objects *therefore* has the authority to direct the organization, a social space made up of free individuals. Basing corporate governance on private property ownership has met two principal objections, vigorously articulated over the last two centuries. The first objection concerns the relationship between the individual interest of property owners and the collective interest of society. The corporation concentrates the means of production, often at a very large scale, and the effects of this concentration are felt, more generally, far beyond the sphere of the owner: how to make sure that society does not suffer from self-interested profit seeking on the part of owners. The second major objection to basing corporate governance on private property has focused on the nature of this property. What, really, is the owner the owner of? If a corporation concentrates machines and tools under one (legal) roof, it also mobilizes the competences, experiences, and networks of people; it relies on collective infrastructure (education, justice, etc.) and consumes resources that may or may not be renewable and thus diminishes the potential for action of future generations. These important criticisms have given rise to a great deal of debate, but they have not managed to break the ideological dominance of the liberal political project upon which modern Western societies are based. Still today – perhaps even more so than in the past – reflections on corporate governance start with the liberal model.

In sum, the question '*What* gives the right to direct a corporation?' is answered by economics from the point of view of *performance*, by history from the point of view of the *evolution* of governance, and by liberal political philosophy from the point of view of the foundations of *legitimacy*. However, the lack of bridges between the different disciplines, a state of affairs encouraged by narrow specialization, makes it difficult to keep the essential question(s) of corporate governance in focus.[6] What with corporate governance also being the subject of a considerable amount of descriptive work detailing its institutions (boards, board committees, general meetings, etc.) and its practices (selection of board members, remuneration of management, role of employee shareholders, etc.), the field is starting to look like a giant puzzle, with the pieces in clear view, but the whole only vaguely discernible. And yet, both the researcher and the practitioner sense that there must be a way of pulling together the different approaches. Indeed, how can one deny that the performance, the evolution, and the legitimacy of corporate governance are interlinked and that the economic, historical, and political approaches provide complementary responses to the same question?

This book is motivated by our conviction that the time is now ripe to present a holistic vision of corporate governance. We insist that ours is a vision of the whole and not a synthesis of everything and everyone that has gone before us. It is not our intention to embark upon the unrealistic task of building a general theory of corporate governance

[6] Comments along these same lines can be found in R. Monks and N. Minow, *Corporate Governance* (2nd edition), Oxford: Blackwell, 2001, in Freeman, *Strategic Management*, and also, in a more partial manner, in Frentrop, *History of Corporate Governance*, or M. Roe, *Political Determinants of Corporate Governance*, Oxford: Oxford University Press, 2003.

that would replace all existing theories: the diversity of motivations and methods of research makes such a task not only humanly impossible to carry out, but also intellectually flawed. More modestly, we would like to take up the challenge posed by the giant puzzle of ideas that today constitute corporate governance and offer a meta-analysis that shows how research on the performance, the evolution, and the legitimacy of different forms of corporate governance can be rendered coherent. In other words, we would like to propose a framework for interpretation that allows economists, historians, and political philosophers to *talk to each other*.

In order to establish such a dialogue, we propose to work with the liberal political model as a basis. We do not pretend to judge the validity of this model, but simply take it as the ideological and political context in which the corporation is situated and to which questions of corporate governance necessarily refer. This remark is important, for we will not cover alternative forms of governance such as cooperatives or mutuals in this book; nor will we provide any detailed discussion of political alternatives such as those Marxism has long argued for. We focus on understanding corporate governance within the liberal context, and our interpretation is based on an assessment of the historical evidence. Since the origins of modern liberal society, two forces have opposed each other in corporate governance: on the one hand, the *entrepreneurial force*, whose role it is to *provide direction to collective activity*. Like any force, the entrepreneurial force is balanced by a *counterweight* that limits its scope and defines its content. The entrepreneurial force is *legitimate*, if it leads to *performance*. However, in providing direction to collective activity, the entrepreneurial force invariably impinges upon the autonomy of the individual, either inside the corporation or through the actions of the corporation. In effect, the existence of an entrepreneurial force contradicts the principle of individual freedom, the principle upon which modern liberal society has been built. This is why the liberal political project gave birth to a second constitutive force of governance: *social fragmentation*. The institutions, the rules, and the practices of governance that are considered legitimate in modern society are those that prevent power from being concentrated, because the concentration of power bears the seeds of oppression for all. The power to govern therefore has to be fragmented to ensure the freedom of the individual. While the entrepreneurial power tends to prevent the dispersion of energies, social fragmentation tends to prevent their concentration. Too much entrepreneurial force can be highly performing, but also oppressive; too much fragmentation ensures individual freedom, but also reduces efficiency. From the unstable equilibrium between entrepreneurial force and social fragmentation emerges corporate governance that is both legitimate and performing.

In the first part of this book, we show that the opposition between the entrepreneurial force of direction and social fragmentation is a central concern in *liberal political philosophy*. In working with the principal philosophical texts, we demonstrate that, ever since liberalism's foundational debate between Hobbes and Locke, this dialectical opposition of forces forms the basis of all models of legitimate governance in modern society. A fortiori, it also constitutes the basis of legitimate corporate governance. Two of the defining characteristics of capitalism – the function of the entrepreneur and the system of corporate governance – are thus shown to be linked by the same question: how to direct the productive action of people who want to stay autonomous and free.

In the second, historical part of the book, we review the three principal models that ensure such an equilibrium of forces: the familial model, the managerial model, and the public model of corporate governance. The entrepreneurial force of direction and the social fragmentation of this force oppose each other, but they also complement each other, and their interactions give rise to the institutions and the rules that ensure an equilibrium between them. This is why there exist not just one possible model of governance, but as many models as there are equilibria between the *performance* demanded by the entrepreneurial force and the *legitimacy* assured by social fragmentation. Historical observation reveals that the large corporations that dominate their markets have moved, over time, from the familial model, to the managerial model, and on to the public model. We describe the characteristics of each model, defining who holds the entrepreneurial force (successively, over time: the single entrepreneur, the managerial technocracy, and shareholders) and what counterweight limits this force (successively, over time: the family, the trade union, and public opinion). We will show how, at each stage in history, the entrepreneurial force is confronted by social fragmentation, a confrontation that results in corporate governance institutions that are specific to each model and era. One can discern a process of transformation in corporate governance that accompanies economic development over time. We show that this process can be understood as the *democratization* of corporate governance. Our reflection is based upon the observation that, in modern liberal society, the governance of human beings tends, over time, to democratize: the more the entrepreneurial force becomes concentrated in ever larger corporations, the greater the need for social fragmentation to maintain the legitimacy of governance – so as to ensure that corporations are governed according to the liberal spirit. This tendency is of general import, but becomes especially clear when one takes a long-term, historical view.

We do not wish to make an evaluative judgement of this evolution. In our reading, democracy is a technique of government *à la* Foucault that, by means of its institutions and procedures (which we will rigorously define), provides an effective means of orienting collective activity as the fragmentation of interests becomes more and more pronounced. In much the same way as we do not consider liberalism in terms of its virtues and ideals but recognize it as the ideological system that has imposed itself upon our societies over the last two centuries, we do not pronounce judgement on democracy, but note that it is the technique of government that is best suited to liberalism. In the heritage of Tocqueville and Schumpeter, we argue that democracy, as a technique, has the tendency to extend its reach in line with the extension of modern liberal society. Democracy has spread from the political sphere, to the civic and economic spheres: the history of corporate governance does not escape this movement.

The observed tendency of corporate governance to democratize over time begs the question of economic efficiency. Can one explain the continuing evolution of corporate governance models in terms of improvements in performance? Conversely, if different models of governance co-exist during the same period of time, are they equally performing? Even more generally, the democratization observed over the long term – does it serve economic performance or is it imposed by political attitudes against the economic interests of society? In order to answer these questions, in the third part of the book we subject our framework to a confrontation with economic analysis and an explicit consideration of *performance*. We show that, following the pioneering study of Berle and Means,[7] corporate governance was stated as an

[7] A. Berle and G. Means, *The Modern Corporation and Private Property*, New York: Macmillan, 1932.

economic question, a new way of addressing the fundamental problem of liberal society, namely the problem of balancing the entrepreneurial force of direction and social fragmentation so as to ensure corporate governance that is both legitimate and performing. Agency theory represents a relatively recent, but brilliantly succinct economic reformulation of this problem in the spirit of liberal political philosophy. If we reflect upon agency theory from this point of view, its analytic strengths, but also its limitations manifest themselves very clearly. Paradoxically, we find that agency theory is not liberal enough, because it underestimates the degree to which interests are fragmented today. Division occurs not only between shareholders and management, but also, in increasing measure, among shareholders who differ in terms of their size, motivation, time horizon, and willingness to exert influence and within management itself, according to hierarchical position. The current state of affairs leads to agency problems that are so general as to appear insoluble. To counter this generalized agency problem, we show how the economic theory of the *guarantee* can be invoked to overcome these difficulties and form a new basis for analysing the relationship between corporate governance and economic performance in the liberal context. Consequently, we are able to conclude that the democratization of corporate governance does not represent a political evolution that is unrelated to economic performance, but, on the contrary, that there are good economic reasons to think that the democratization of corporate governance and the growth of economic performance go hand in hand.

Our work might appear overambitious, if it were not for the fact that, as we have already pointed out, our intent is not to do the work of philosophers, historians, and economists, but rather to propose a common ground for dialogue between these disciplines on the subject of corporate governance. We wish to acknowledge explicitly the debt we owe to past research in these fields. By offering a meta-analysis that makes the links between the political *legitimacy* of power in the corporation, the historical *evolution* of corporate governance forms, and economic *performance*, our framework for analysis attempts to provide a bridge between the different approaches. We believe that the dialectic opposition between the entrepreneurial force of direction and social fragmentation provides the principle upon which such a bridge can be built: it stands as the basis of modern political philosophy, develops over time in the history of the institutions of governance, and plays a determining role in the economic performance of the corporation.