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Globalization and the political role of the firm: Implications for corporate governance

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Globalization and the Political Role of the Firm: Implications for Corporate Governance

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IMPLICATIONS FOR CORPORATE GOVERNANCE**

ABSTRACT

Present-day discussion of corporate governance is mainly centered on finance-related issues and the relation of shareholders and management. However, this view neglects the fundamental changes of the operating conditions of business due to globalization and the weakening of regulatory frameworks, not only changing the role of business, rendering it a political actor in part. Furthermore, the very assumptions of dominant corporate governance theory are challenged. These developments can be regarded as a potential threat for organizational legitimacy. Whereas in the traditional view, corporate governance safeguarded organizational legitimacy by safeguarding organizational efficiency and thereby contributed to societal welfare and the legitimacy of the economic system as a whole, this congruence is not given in the situation of weak or even absent legal and regulatory frameworks. Drawing on suggestions to restore organizational legitimacy by means of discursive processes, I argue that corporate governance needs to become open to such processes to safeguard organizational legitimacy and therewith the legitimacy of the economic system in a globalized world. Based on these considerations, I will introduce basic requirements as well as limits for an according modification of current corporate governance practice.

GLOBALIZATION AND THE POLITICAL ROLE OF THE FIRM: IMPLICATIONS FOR CORPORATE GOVERNANCE

INTRODUCTION

Globalization fundamentally changes the operating conditions of firms in general and of multinational corporations in particular. Worldwide trade and foreign direct investment increase, the influence of transnational corporations is growing, the movement of capital is accelerating and financial markets are gaining momentum. As a result of these changes the capacity of national states to fulfil tasks that were ascribed to the state in the historical constellation of territorially constituted economies declined and still is declining. Despite the lingering formal monopoly of coercion, the effectiveness of national politics can be doubted in cases where problems transcend national borders and become global (Scherer and Palazzo, 2008).

With this decrease of national steering capacity, the freedom of action of multinational corporations expanded decisively. Due to the increasing importance and power of such enterprises on the one hand and the weakening of the power of states to provide legal security and guarantee enforcement of contracts on the other hand, the capacity of national states to control the actions of such enterprises is decreasing and regulation gaps occur (Giddens, 1991; Beck, 1997). In this “post-national constellation” political control is increasingly being replaced by economic steering mechanisms – money substitutes power (Habermas, 1998). Since the global economic system relies completely on the coordination capacity inherent to the price mechanism, the societal capacity of democratic self-control is diminishing.

In the course of these developments corporations increasingly engage in activities that were traditionally seen as the domain of national states (Hertz, 2001). Ranging from social activities (Teubner, 2000a), the provision of infrastructure and education, the administration

of civic rights (Matten and Crane, 2005a) to involvement in rulemaking on the global scale (Scherer et al., 2006), and to the generation of new law (Teubner, 2000b), corporations take on a political role besides their generic economic role. By doing so, corporations take part in the peaceful integration of society on the one hand. On the other hand, societal peace is threatened by these very actors. One example is the direct or indirect violation of human rights by multinational corporations (Kobrin, 2009), often directly flowing from the devotion to the objectives of growth and profit maximization (Kinley and Nolan, 2008).

These developments show that the division of labour between the economic and the political system developed over the last centuries gets increasingly challenged. And therewith, also the legitimacy of corporations gets questioned.

Corporate governance conceived of as a mechanism that guarantees the efficiency and thus the legitimacy of corporations is challenged by these developments in particular. Traditional corporate governance describes mechanisms designated to accommodate the specific role of shareholders bearing risk not completely covered by means of contracts. In turn, it is assumed that all other stakeholders are protected by enforceable contracts and thus protected by the law. The erosion of the traditional division of labour between private actors and the state has a twofold impact on corporate governance: Firstly, the assumptions of traditional corporate governance become increasingly challenged. Contracts are not enforceable in every case, externalities matter more in absence of state regulation and new responsibilities are being assigned to corporations in the global marketplace by an increasingly active civil society.

Secondly, corporate action reaches further and affects more diverse stakeholders than in the context of congruence between national state and economy. In addition, states' capacity to protect stakeholders affected by corporate action is limited in many cases. This potentially undermines corporate legitimacy and thus viability.

To analyze the implications of this new situation for corporate governance, following this introduction the traditional model of corporate governance will be described. In particular, its explicit as well as implicit assumptions will be delineated and their appropriateness to the contemporary shifting division of power between the economic and the political system will be explored. In the third section, I will conceptualize corporate governance from a functional perspective, describing the functions of corporate governance for the individual firm as well as for the economic system – granting efficiency and therewith legitimacy. Furthermore, I will emphasize the challenges resulting from the change of the economic and political environment of corporations.

Next, with the help of alternative approaches to corporate governance – team production theory, stewardship theory and stakeholder democracy –, I will detail shortcomings of traditional corporate governance in the light of the increased power and responsibilities of private business firms in a globalized world as well as requirements for improvements. In the fifth section, suggestions to transfer the approach of deliberative democracy to corporations (Palazzo and Scherer, 2006; Scherer and Palazzo, 2007) will be described. This approach is a possible conceptual foundation for rendering traditional corporate governance capable to constitute legitimacy for both corporations and the economic system as a whole under the new conditions of the post-national constellation. Opportunities and constraints will be presented, taking into account the trade-off between organizational efficiency and legitimacy.

Finally, following a short conclusion, I will discuss one barrier that is crucial for the effective promotion of legitimizing actions in economic organizations. Since systems level legitimacy can be described as a public good, problems of collective action might obviate its efficient provision.

WANING JUSTIFICATIONS AND RISING CHALLENGES

The Foundations of Current Corporate Governance Theory and Practice

Current corporate governance theory and practice is based on an entangled set of assumptions and arguments. In the following, the dominant strands of theory will be identified and examined in order to highlight the implications of the changing economic and political landscape for corporate governance.

The concept of corporate governance in the form as it is prevalent nowadays can be traced back to a change of the relation between ownership and control of businesses, first described by Berle and Means (1968). By subdividing the concept of firm-ownership into several functions, Berle and Means highlighted problems arising from this changing relation. Their analysis was based on the observation of an increasing spread of shareholding. According to their study, an increase in the number of shareholders of corporations diminished the capacity of individual shareholders to participate in the steering of corporations. Professional managers gained influence and the owners lost the capacity to monitor the behaviour of the managers. Assuming utility-maximizing behaviour of the managers, shareowners ran the risk of managers shirking or utilizing the money supplied to the company to maximize their own utility instead of maximizing corporate value. This situation could eventually lead to under-supply of capital. Therefore a mechanism to preventing the managers from missing profits of the owners of capital by bad decisions or waste them became necessary to secure a constant supply of new capital (Shleifer and Vishny, 1997). Thus, from this perspective corporate governance can be described as a mechanism protecting the shareholders as owners of a firm. In the course of the development of the theory of the firm, the conception of corporations changed: initially seen as an entity, corporations were redefined as a nexus of contracts (Coase, 1937). Therewith the definition of shareholders as owners of a fraction of corporate assets was replaced by the definition of shareholders as having particular contractual claims

towards a corporation. This distinctiveness of shareholders is based on the fact that shareholders hold unspecified claims towards the management of a firm. While stakeholders of a corporation, such as employees, debtors, and suppliers have well defined claims towards a firm, the shareholders need to rely on the management to maximize their return by maximizing the firm value. This argument, describing shareowners as residual claimants is the basis for further justifications of corporate governance due to efficiency reasons. In contractarian logic, the maximization of these residual claims maximizes the overall productivity and value of the firm (Alchian and Demsetz, 1972). This in turn is seen as the optimal contribution to social welfare (Davis, 1973).

The relation of owners and managers in the constellation of publicly traded corporations was formalized by principle-agent theory (Jensen and Meckling, 1976), highlighting the situation of asymmetric information between shareowners (=principals) and managers (=agents) and determining the optimal relation of cost necessary to maximize firm value and simultaneously the value of shares. By means of this precise formulation, shareholder primacy got strengthened in a technical sense: since relations more complex than the dyadic shareholder-manager-relationship are not expressible and optimizable in a mathematically exact way, alternative constellations are getting out of the focus of corporate governance theorists. Closely interrelated with the efficiency allegedly resulting from the maximization of share value is a further argument pertaining to the management of corporations. Accordingly, corporate governance focussing on shareholder primacy is justified: To render a corporation manageable, it is necessary to reduce environmental complexity to a degree manageable within a single-valued objective function – shareholder value. Furthermore, thereby managerial performance can be assessed by shareholders and the market for securities by means of a single value (Jensen, 2002). The assumption central to all these justifications of corporate governance is the view that market-based allocation is most efficient in serving the

public good if extra-economic interferences are minimized (Hayek, 2001; Friedman, 1962; Sundaram and Inkpen 2004). Accordingly, the mechanism of corporate governance remedies these problems in the most efficient manner by means of market-logics. The market for securities assesses corporate performance by means of the share price. Since market-based allocation is seen as the most efficient way to coordinate the allocation of resources, any interference with this principle is a potential threat of efficiency and societal welfare.

Consequently, the supposed distinctiveness of shareholders in relation to a firm can be seen as deeply rooted in an interrelated complex of arguments. This complex is composed of the conception of shareholders as owners of a firm, the contractarian conception of the firm, which is the prevailing view today – not only in economics and management science, but also in law (Blair, 2005), the conception of shareholders as residual claimants, principal agent theory and the resulting considerations of efficiency both on corporate and on societal level. Being mutually enforcing in part, these assumptions and justifications are seldom doubted.

According to these theoretical considerations different mechanisms – such as various monitoring systems (Fama and Jensen, 1983), legal protection of shareowners, tight control by large investors or high powered incentive contracts for executive managers – are discussed (Shleifer and Vishny, 1997) to overcome the problem of asymmetric information. Despite the obvious failure of some of these arrangements in recent times and beginning refocusing of the debate on corporate governance on more long-term oriented mechanisms, the debate is still centred on the principal-agent problem discussed above.

Globalization and Corporate Governance

Globalization has changed the operating conditions of business in a significant way. These changes are partly reflected in the business literature. In particular, the different consequences for corporate governance are discussed: blurring organizational boundaries and increasing

importance of knowledge work (Blair, 1995; Bradley et al., 1999), gaining relevance of implicit contracts and the ongoing replacement of transactions by relations (Boatright, 2009). Common to these analyses is the purely economic perspective. However, as argued above, besides grave economic implications, globalization not only changes the operating conditions of corporations but also alters the role of the firm. Hence the analysis of the implications of the processes termed as globalization on business in general and on corporate governance in particular must not be confined on purely economic issues.

In the following, the implications of the rapid shift of the division of labour between the economic and the political system for corporate governance will be discussed in detail.

The question arising from the concentration of corporate governance on economic efficiency is whether the principal-agent constellation resulting from the divergence of firm-ownership and control is the only problem threatening the efficiency and thus also the legitimacy (the notion of legitimacy will be covered in detail below) of the economic system.

The debate about the purpose of corporations – generating value for shareowners or directly serving the public interest can be traced back to the second decade of the 20th century (Clark, 1916; for an overview see Lichner, 2009). Strongly tied to this topic is the debate about the function of corporate governance dating at least back to a debate between professors Berle and Dodd in the early 1930s (Weiner, 1964). Until today, this debate lives on in the conflicting views of shareholder primacy (Jensen, 2002; Sundaram and Inkpen, 2004) and the stakeholder view (Freeman, 1984) of the firm. Both these positions exist with different facets, stressing different aspects of the relations of corporations and their different stakeholders (including shareowners) and attaching different weight to the respective interests. However, common to the greatest part of these conceptions is the role ascribed to the nation-state: providing a proper regulatory framework.

In the following, three major problems arising from the diminishing steering capacity of states and the changing division of labour between economic and political system will be described: the limited capacity of many states to enforce contracts and provide for a functioning regulatory framework in every instance; the increasing relevance of negative externalities resulting from the weakening of states; the legitimacy problems arising from the provision of public goods by corporations. Subsequently the core common to these problems will be formulated in terms of a changing allocation of risk.

Enforcement of contracts

One of the basic assumptions of the contractarian view of the firm in general and of the theory of corporate governance in particular is the enforceability of contracts. As described above, shareholder primacy implied by the contractarian conception of the firm is justified by the protection of a firms stakeholders (except shareowners) through contracts and the legal system (Bradley et al., 1999; Sundaram and Inkpen, 2004), emphasizing the important role the “...legal system and the law play in social organizations, especially, the organization of economic activity....” and the availability of “... police powers of the state ... used to enforce performance of contracts or to enforce the collection of damages for non-performance” (Jensen and Meckling, 1976).

With states becoming weaker and corporations operating out of the reach of legal enforcement mechanisms, be it in weak states or in undemocratic ones, the option of the legal enforceability of contracts becomes curtailed. Scarcely realizing this fundamental shift, suggestions to respond to this threat to the contractarian view still operate in a pre-globalization logic, postulating some ‘worldwide contracting infrastructure’ on the one hand and suggesting enforcement of contracts by firms themselves on the other hand (Bradley et al., 1999), disregarding potential corporate wrongdoing.

Externalities

A further aspect of the increasingly limited capacity of states to enforce laws relates to externalities. While in the constellation of national economies negative externalities could be limited by laws, this option becomes increasingly unviable.

Admitting that the maximization of shareholder value does not maximize social welfare when externalities exist, Jensen (2002) implicitly relies on the regulatory framework to create the conditions necessary to avoid externalities. However, such solutions proposing the internalization of externalities by the allocation of property rights (classical: Coase, 1960; Williamson, 1984) are only viable to a limited degree, since relations between stakeholders and firms can not be formalized by contracts where no enforcing mechanisms exist (see above).

Besides the problem of externalities in general, the problem of externalities originating from the properties of corporate governance, i.e. the concentration on shareholder value and its ‘distasteful implications’ (Tirole, 2002), is in particular becoming increasingly urgent in the light of the decreasing steering capacity of states.

Public Goods

Strongly interrelated with these developments is the increasing power of business in general and of multinational enterprises in particular. In opposition to the widespread fear that the power of the state might become too strong and thus hamper the efficiency of markets (Hayek, 2001), nowadays a multitude of tasks assigned to the state in liberal models is fulfilled by business. Corporations engage in the provision of public goods, reaching from schooling and infrastructure and to the administration of rights (Matten and Crane, 2005a) to engagement in the formulation of international standards (Scherer et al., 2006). This indicates

that corporations exert significant power (Coglianese, 2007) without being legitimized and accountable in a democratic manner.

The Privatization of Risk

The special role of shareowners is justified by the risk they bear through investing in corporations (Jensen and Meckling, 1976; Fama and Jensen, 1983). While all stakeholders of a firm are involved in contracts with this firm, only the residual claims of shareowners can not be sufficiently protected by means of contracts. According to this view an agency problem occurs, rendering the shareowners the principals vulnerable to the moral hazard of the managers acting as the agents of the shareowners. Therefore additional mechanisms, e.g. corporate governance, are necessary to protect these claims. Insofar, corporate governance can be described as a mechanism to protect shareholders from risks, which can not be made subject to contracts. However, in the light of the shrinking power of states shareholders is not the only group being exposed to risk.

As described above, firstly the enforceability of contracts is not given any more. Therefore the existence of claims vis-à-vis a corporation resulting from any kind of contract must not be seen as a guarantee for the fulfilment of these claims. In this rising disequilibrium of power, claimants often are exposed to the goodwill of corporate actors.

Secondly, different groups of stakeholders are increasingly exposed to risks resulting from externalities generated by corporations, bare of any legal protection.

Thirdly, corporations increasingly engage in the provision of public goods and thereby assume a state-like role. According to Crane and Matten (2008), in some cases corporations should be treated more like states than like private actors. In this situation of democratic deficit individuals thus become exposed to corporate power and need to rely on corporate benevolence.

Summing up, these developments can be interpreted as evidence for a shifting distribution of risk. In a regulatory vacuum, many risks that were traditionally attended to by the regulatory framework and therefore mitigated are becoming virulent for the individuals. In other words: the risk gets privatized (Beck, 1986). With an increasingly unbuffered impact of corporate action and rising attention of the public sphere for such actions, an issue formerly taken for granted is slipping into the center of corporate concern: legitimacy. Traditionally, states were seen as responsible for enforcement of legal claims towards corporations, for arbitration in conflicts between citizens and corporations and for the provision of public goods; in the absence of state regulation responsibility is increasingly directly ascribed to corporations. In cases of perceived injustice and harm resulting from corporate action, corporations are nowadays addressed directly by affected groups or activists (Spar and La Mure, 2003; Zadek, 2004).

In the following, the role of corporate governance for constituting legitimacy and its centrality for organizational survival will be described and legitimacy problems resulting from the change of the economic/political constellation will be analyzed.

LOSING HOLD: CORPORATE GOVERNANCE AND LEGITIMACY

Corporate Governance from a Functional Perspective

Functional explanations of social phenomena explain the reproduction of a specific arrangement or institution in terms of the consequences it has for the social system it is embedded in (Merton, 1951; Stinchcombe, 1968; Mahoney, 2000). Accordingly, corporate governance can be analyzed in respect of the function it fulfils within a corporation. Typically, this function is seen in the protection of shareholders (Shleifer and Vishny, 1997) and the resulting improvement of corporate performance (Filatotchev, 2008).

Distinct from this efficiency-centered function of corporate governance explained above – but strongly correlated with it – a further function of corporate governance can be seen in its function to generate legitimacy. Legitimacy, as defined by Suchman (1995), “is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definition”.

Following the concept of legitimacy proposed by Suchman, legitimacy can be regarded as socially constructed. In the process of social construction (Berger and Luckmann, 1967) legitimacy is ascribed to an entity due to the congruence between the behaviors of this entity and the beliefs of the social group granting legitimacy. As described above, the erosion of national steering capacity and the accompanying increase of corporate power result in the problems of lacking enforceability of contracts, externalities, public goods. Being involved in these problems and often regarded as their causes, corporations lose the capacity to gain legitimacy in the mode viable in the pre-globalization era is diminishing (Palazzo and Scherer, 2006). While under conditions of intact regulatory frameworks and in relatively homogenous environments legitimacy resulted from the economic value generated by corporations (i.e. pragmatic legitimacy) and the taken-for-grantedness of corporations (cognitive legitimacy), these sources of legitimacy are becoming less reliable. Therefore the legitimacy of corporations as organizations and as representatives of the predominant economic order – market economy – is increasingly challenged in several respects and a third type of legitimacy (moral legitimacy) is becoming increasingly relevant.

Based on the assumption of economic theory that the market is legitimized by its capacity to maximize societal welfare by providing the optimal supply of goods and services to the all actors participating in the economy, corporate governance can be conceptualized in terms of legitimacy. Legitimacy can be regarded as a consequence of productivity, competitiveness and viability (Monks and Minow, 1995), which are the concern of the interplay of

shareholders, managers and directors in traditional corporate governance. Following the assumption that corporate governance secures market efficiency and therefore maximizes social wealth (O'Sullivan, 2000), it can be described as a mechanism securing the legitimacy of the single firm as well as the legitimacy of the economic system by improving the efficiency both on company and market level. Insofar, besides the function to guarantee sufficient supply of money for a corporation on the micro-level, corporate governance has the function to guarantee the efficiency of the market economy and therefore its legitimacy on the systems-level.

Legitimacy on the Firm Level

Seen from an institutionalist perspective, legitimacy can be regarded as necessary for organizational survival (Meyer and Rowan, 1977; DiMaggio and Powell, 1983), positively affecting the availability of resources necessary for organizational survival (Pfeffer and Salancik, 1978; Deephouse and Suchman, 2008). In a narrow view, corporate governance can be regarded as one mechanism legitimizing a corporation through the appointment of a corporate board (Hillman and Dalziel, 2003).

In a broader view, the function of corporate governance can be described as the function of risk-reduction or as a function of guarantee, as described by Gomez and Korine (2008). By means of proper corporate governance, a corporation signals sound risk-control towards potential shareholders, thus enhancing their trust in the corporation and minimizing their transaction costs resulting from the collection of information about eventual risks.

In the light of the rising complexity of organizational environments due to processes of globalization, the management of legitimacy is becoming more and more difficult. Firstly, corporations are often confronted with allegations concerning violations of human rights and labor standards, pollution and other problematic issues (Palazzo and Scherer, 2006) raised by

an increasingly sensitized civil society (Doh and Teegen, 2001). Secondly, global activity in heterogeneous environments still advances the problem of corporate legitimacy since corporations on the one hand have to adapt to local conditions (Kostova and Zaheer, 1999) and on the other hand need to keep their identity as an organization. Therefore traditional corporate governance, being adapted to the conditions of the pre-globalization era, is becoming less effective in securing organizational legitimacy.

Legitimacy on the Systems Level

Besides the necessity of organizational legitimacy for the survival of an individual firm, legitimacy can be defined as a necessary condition for the sustained stability of the economic system as a whole.

Assuming that the system of market economy derives its legitimacy from its efficiency in resource allocation (Steinmann and Löhr, 1993), inefficiency on the firm level indirectly threatens the legitimacy of the economic system as a whole. Corporate governance as a mechanism to secure firm-level efficiency thus indirectly safeguards the legitimacy of the economic system. This is in line with shareholder primacy view and a contractarian conception of corporate governance emphasizing the special need for protection of shareholders and at the same time the thorough protection of all other stakeholders by enforceable contracts and state regulation (Sundaram and Inkpen, 2004).

Conceding the maximization of share value being not equivalent to maximizing the total social value created by a firm (Blair, 2003), the justification of the privileged relation of shareholders and corporations (e.g. Sundaram and Inkpen, 2004) becomes questionable.

As emphasized by the notion of the market as a fragile system, the societal function of the market – contribution to the public good – can be destroyed by the actions of its actors

(Dubbink, 2004). Furthermore, it can be argued, that sustained dysfunctions of the market mechanism undermine the conditions for its very existence.

Since the assumptions underlying traditional corporate governance are not valid any more in every case, as shown above, the capacity of corporate governance to fulfil its function of securing legitimacy both on firm and on systems level gets increasingly impaired. Corporate legitimacy can be regarded as constituted – firstly in part by means of corporate governance and secondly by corporate regulation enforced within a regulatory framework. While the former type of legitimacy can be described as procedural, the latter can be described as substantive (Coglianese, 2007). Given the fact that states are decreasingly capable of providing a reliable regulatory framework, procedural legitimacy is becoming crucial.

Therefore, to remedy the dysfunctions of corporate governance, namely the inability to secure legitimacy and the threat of organizational and systems-level legitimacy, a procedural approach is needed in absence of means to secure legitimacy in a substantial way. In absence of substantial legitimacy provided by a state maintaining the legitimacy of individual firms and of the economic system under conditions of fading substantive legitimacy, requirements for procedural legitimacy and thus for corporate governance are rising considerably.

While this separation of firm-level and systems-level function of corporate governance is possible in theory, in practice these two functions are tightly intertwined.

Seen from a historical perspective, in the pre-globalization era of efficient national steering mechanisms, legitimacy was no direct problem for business. Firstly, legitimacy of the economic system was provided by regulatory agencies, generating a link to governmental legitimacy by protecting shareholders and consumers (Hillman et al., 2000) as well as other stakeholders. Secondly, the invisible hand – postulated in classical economics – has worked sufficiently and thus economic efficiency and legitimacy converged. By safeguarding efficiency (inter alia by means of corporate governance) legitimacy got safeguarded as well.

Nowadays, one necessary condition for this convergence – a functioning regulatory framework – is not satisfied in many cases any more. Safeguarding efficiency does not assure legitimacy in every case and regulatory agencies increasingly fail to protect stakeholders that are negatively affected by corporate action, furthering the legitimacy deficit. With weakening law and order, the legitimacy of corporate governance is in decline (Judge et al., 2008). This can be interpreted as a lack of adaptation of corporate governance to the changed conditions described above.

Defining corporate governance as a multifunctional structure constituting economic efficiency and thereby legitimacy of single firms and of the economic system as a whole allows the framing of this problem in a workable way: while economic efficiency is still safeguarded, the attainment of societal welfare does not follow from this any more and thus legitimacy is threatened. In other words: with changing conditions, this structure is becoming dysfunctional in part. The challenge therefore lies in modifying corporate governance according to these changing conditions.

Basically, this means that the advantages of traditional corporate governance must not be sacrificed while its dysfunctions need to be repaired. The question is how to direct economic efficiency and societal welfare back to convergence?

IN SEARCH OF NEW PRINCIPLES

Contesting conceptions of the purposes and objectives of a corporation and therefore of the adequate focus of corporate accountability and governance are discussed at least since the second decade of the last century (see above). Moral arguments (Freeman et al., 2004) as well as the reconsideration of theoretical foundations of traditional corporate governance (Blair and Stout, 1999) triggered the development of alternative approaches to corporate governance. In the following, the most important of these approaches will be analyzed in

respect of their potential to address the problems resulting from rising corporate power and weakening governmental regulation.

Team Production Theory

One attempt to modify corporate governance is team production theory (Blair, 1995; Blair and Stout, 1999). As described above, traditional corporate governance is conceptualized as a tool for overcoming the principal-agent problem which essentially threatens the efficiency of a corporation defined as a nexus of contracts. In team production theory, corporations are defined as teams. In these teams, various stakeholders make enterprise-specific investments to jointly generate surplus. Since some of these investments are irrevocable, decision-making procedures are necessary to guarantee the fairness in disputes about the utilization of the investments. In this view, the boards task is not the protection of a single principal (the shareholder), but rather the mediation of ‘...disputes among team members about the allocation of duties and rewards’ (Blair and Stout, 1999). The core argument of this critique is based on the increasing importance of implicit contracts and the resulting shift of risk towards stakeholders, particularly the employees. These become risk-bearers by investing firm-specific skills in a team production effort – the firm – and thus contributing to value creation. While the risk of shareholders is limited by the amount of money invested, in case of layoff employees can ‘reinvest’ their skills elsewhere only to limited extent due to firm-specificity. The credit of this approach to corporate governance lies in taking into account the changing risk-constellation in corporations, dethroning the shareholder as the residual risk-taker and the sole party in need of protection. Nevertheless, the focus of team production theory still is a purely economic one. Team members join a team and invest in a project voluntarily, expecting some kind of reward for their investment. From this follows necessarily, that individuals and groups affected by a corporation without making some kind of investment and

thereby voluntarily joining a bilateral relation can not be regarded as team members. According to team production theory, risk imposed on them by a corporation thus can not be considered within corporate governance.

Stewardship Theory

In line with the theory of team production, stewardship theory represents a theoretical critique of the principal-agent theory described above. Whereas team production theory is based mainly on a critique of the dysfunctionalities of shareholder primacy (Blair, 2003), stewardship theory is based on a critique of the assumptions constitutive for shareholder primacy. The behavioural premise of agency theory is the *homo oeconomicus* depicting humans as rational utility maximizers. Based on psychological and sociological considerations, this view is shown to disregard the complexities of organizational life. Instead, humans and therewith managers are considered intrinsically motivated, responsible and seen as ‘...collective self-actualizers who achieve utility through organizational achievement’ (Davis et al., 1997). If managers are seen as potentially detrimental for a firms goals and not as stewards of a firms interest – and hence as stewards of holders of a firms shares – organizational arrangements to overcome the lacking trustworthiness of the managers always impede corporate performance. If instead both managers and principles (shareowners) behave in a steward-like way, the potential performance of a firm is maximized.

Following from these alternative behavioural assumptions, practical implications of principal agent theory for corporate governance are challenged and alternative ways of steering corporations are made. Accordingly, division of the roles of board members and CEO – the essence of agency-theory oriented traditional corporate governance and seen therein as the mechanism to prevent managerial shirking – does inhibit the effective management of a

corporation. Instead, identity of these roles is seen to '...provide benefits of unity of direction and of strong command and control...' to an organization (Donaldson and Davis, 1991).

One credit of stewardship-theory lies in the emphasis on integrity of decision-making. Especially in ethical dilemma-situations, flexibility of decision-making has major advantages in comparison to compliance-based action (Paine, 1994). Governance structures aiming at preventing managerial misconduct resulting from an inadequate model of man therefore run the risk of working like a self-fulfilling prophecy, creating the evil they are destined to prevent.

The concentration on individual integrity implicitly postulated by steward theory harbours the danger of illegitimacy. From the perspective of motivation and efficiency, assuming the integrity of managers seems to be a more prolific approach than expecting misconduct. However, a fortiori under conditions of expanding corporate and therefore managerial power not only in economic but also in political respect, potential restrictions of managerial misconduct need to be in place to render corporate action legitimate.

Stakeholder Democracy

The contested and value-laden notion of stakeholder democracy (Matten and Crane, 2005b) constitutes a more heterogeneous approach than the ones described before. It basically emphasizes the importance of democratic participation in corporate decision-making for two reasons. One strand of argumentation favours democratic involvement in the steering of corporations for reasons of organizational efficiency. This efficiency-centered line of argument has several distinct facets. From a motivational point of view, participation of stakeholders in organizational decision-making is a means to avoid a 'hold-up' problem concerning competitive disadvantages arising from the exclusion of groups crucial for value

creation from organizational gains. Active participation is seen to enhance the motivation of employees and thus corporate performance (Driver and Thompson, 2002).

From an informational point of view, involvement of stakeholders is seen as a means to enhance the capacity of a firm for decision-making adequate to the requirements of complex organizational environments. According to Gomez and Korine (2005; 2008), corporate governance developed as a mechanism to secure the consent of the individuals governed by corporate actions. Facing increasing complexity in the organizational environment, the integration of various stakeholders into corporate governance in a democratic way is seen as a way to increase the internal organizational complexity and thus rendering a corporation capable of surviving in this environment. This is in line with cybernetics-oriented considerations. According to Turnbull, open-endedness of hierarchies is flawed due to conflicts of interest resulting from a concentration of power, distortion of communication and a lack of mechanisms for self-control and self-correction (Turnbull, 1994). Furthermore, Gomez and Korine (2008) argue, that corporate governance capable of processing information about a complex environment in a superior way in turn works as a guarantee towards potential suppliers of capital.

A second line of argument demands the inclusion of stakeholders for moral reasons. Based on the debate about the proper corporate objective (see above) and the work of Freeman (1984), besides the shareholders stakeholders can be seen as legitimate beneficiaries of corporations due to their intrinsic value (Donaldson and Preston, 1995).

Consequences for Corporate Governance

Summing up, each of the described alternatives highlights important shortcomings of conventional corporate governance theory and can be seen as an adaptation to the changing operational and environmental conditions of business firms. Common to the team production

theory of the firm and stewardship theory is the neglect of the fundamental changes of the role of business resulting from the post-national constellation.

Despite enriching the debate of corporate governance with important aspects, the described alternatives, except for suggestions concerning stakeholder democracy, still rely – explicitly or implicitly – on the steering power of national states and the resulting enforceability of contracts. However, instead of being only quantitative, these changes are qualitative and do not only necessitate the consideration of additional groups of stakeholders in organizational decision-making or the modification of the assumptions about the behaviour of managers.

The argument that shareholders have contractual ties with a firm – even if imperfect ones – is often used to qualify this particular group of stakeholders in contrast to other stakeholders for special protection. This understanding of contractual relations is centred exclusively on explicit contracts and potential limitations of such contracts under specific circumstances. However, this view ignores another type of contract. Implicit contracts are not formalized but nevertheless vital elements of economic transactions. Taking into account this type of contract besides explicit contracts facilitates the formulation of the relation between firms and different stakeholders in a systematic way. Risk not accounted for in explicit contracts thus becomes conspicuous (Boatright, 2009). Accordingly, the exclusive concentration of corporate accountability on shareholders seemingly disregards numerous equally legitimate claims, already under pre-globalization conditions. Taking into account the diminishing steering power of states, the often insufficient enforceability of contracts and the coincidentally rising economic and political power of corporations, the question of corporate accountability becomes even more urgent. Furthermore, the question is becoming more and more political in addition to its economic relevance. Nevertheless, despite its potential to address numerous legitimate claims towards a corporation, the contractarian view has its limits where relations between a corporation and its stakeholders are unidirectional, i.e. where

no exchange relationship of any nature whatsoever exists. Redefining corporate responsibility by extending the notion of property rights to ‘both the legal aspect of property rights and the social conventions that govern (business) behaviors’ (Asher et al., 2005) seems to be a promising way to recognize the importance of a firms stakeholders (Blair, 2005). However, the possibility to define all stakeholder relations in terms of contracts and property rights, especially under conditions of cultural heterogeneity and complex global interdependencies seems to be limited.

Globalization and Accountability Gaps

Parallels to the problem of accountability gaps undermining organizational and systems level legitimacy discussed above can be found in political science. In the light of the increasingly political role of corporations, these can be regarded as similar to states in some respect (Crane and Matten, 2008). Therefore the application of theories rooted in political science seems appropriate.

According to Keohane (2003), there are three normative criteria justifying and necessitating the accountability of an actor towards specific groups: authorization, support, and impact.

Especially the third criterion is becoming increasingly relevant in the light of the increasing economic and political power of corporations, often exercised unidirectionally. As argued by Held (2002), actors who become ‘choice-determining’ for others and thus restricting the autonomy of these actors need to be held accountable. Since corporations determine choices of many people, this claim also applies to corporations. Accordingly, the accountability of corporations needs to be redesigned to ensure that the rights of individuals affected by corporate action are protected sufficiently (Matten and Crane, 2005a). Consequently, the suggestion to enhance the notion of responsibility from being past-oriented towards a forward-looking concept (Young, 2004) could be the basis to formulate the specifications of

an extended concept of corporate accountability and of corporate governance transcending mere compliance with external regulation.

This becomes even more important taking into account that corporations resemble states in several respects without being legitimized for that in any manner. Considering the legitimacy-securing function of corporate governance described above as well as the centrality of corporate governance for questions regarding the responsibilities of corporations, it becomes clear that corporate governance has to adapt to the changed economic and political conditions. In the context of the discussion about the nature and limits of the corporate responsibility for stakeholders Goodpaster argues that extending the fiduciary relationship between shareholders and management to an inclusion of stakeholders would represent the transformation of the modern private corporation into a public institution that “probably calls for a corresponding restructuring of corporate governance” (Goodpaster, 1991, p. 66). Firstly, the severity of such a transformation, blurring the traditional corporate goals, prompts him to deny the existence of fiduciary obligations of managers vis-à-vis stakeholders other than shareowners. Secondly, the adverse implications for the efficiency of organizational decision-making – a push “towards paralysis” – are seen as a reason for this denial.

However, in the light of the increasingly political nature of corporate action described above (Matten and Crane 2005a; Palazzo and Scherer 2006; Scherer et al. 2006), the first concern loses some of its relevance. In the reverse conclusion, it rather implies that the governance of corporations increasingly acting beyond national regulatory frameworks and involved in political action requires a revision.

Thus the second concern – considerations of efficiency within extended governance relations – alone can not be seen as a decisive obstacle for the modification of corporate governance. In contrast, it can be understood as a guideline for the modification of traditional corporate governance.

In summary, it becomes evident that traditional corporate governance as well as alternative conceptions in many instances fall short of taking into account the fundamental changes in the economic as well as in the political sphere. By either concentrating on the performance of corporations (stewardship theory) or limiting the participation in decision-making to a clearly defined target group (team production theory), the contingent legitimate claims vis-à-vis a corporation can not be addressed in a comprehensive way. Confrontation with this problem can be described as an enormous increase in complexity of decision for corporations. In times of sufficient state regulation economic rationality was the only focus necessary for corporate decision-making. Social rationality was achieved firstly by economic decision-making (via the invisible hand) and secondly by the regulatory framework, setting the side-conditions for the economic calculus. In the light of insufficient regulatory frameworks, corporations increasingly need to consider problems of social rationality and thus of legitimacy.

Apparently only democratic approaches are appropriate to suffice the requirements of a broad participation-oriented approach towards corporate legitimacy. For directing such efforts, boundary conditions need to be formulated. In the following, a general suggestion for maintaining organizational legitimacy in a communicative way will be applied to the field of corporate governance, accentuating requirements and limits of such a fundamental shift.

CONSTITUTING LEGITIMACY BY DELIBERATION: THE ROLE FOR CORPORATE GOVERNANCE

One way to manage legitimacy of organizations in a procedural communication-based way is proposed by Palazzo and Scherer (2006). Based on the threefold concept of legitimacy by Suchman (1995) described above – pragmatic, cognitive and moral legitimacy – it is argued that under the conditions of globalization and the post-national constellation the capability of business to constitute pragmatic or cognitive legitimacy is decreasing. Transferring the

concept of deliberative democracy (Habermas, 1996; Dryzek, 1999) from political science to the context of organizations (Palazzo and Scherer, 2006; Scherer and Palazzo, 2007), deliberation is regarded as a means for corporations to compensate for the loss of pragmatic and cognitive legitimacy by switching to the constitution of moral legitimacy by means of discursive processes when necessary and appropriate. Thereby an active justification vis-à-vis society replaces the mere response to societal demands or the strategic manipulation of the perceptions of stakeholders (Palazzo and Scherer, 2006).

Gomez and Korine (2008), implicitly referring to the ‘Law of Requisite Variety’ by W. Ross Ashby (1971), suggest the increase of the complexity of corporate governance by democratization as a suitable means to tackle the rising complexity of organizational environments and to control major risks in an efficient and credible way. Therewith, the central role of corporate governance for managing environmental complexity and simultaneously signalling the capacity to do so is emphasized.

A similarly important role is attributed to environmental complexity in approaches in strategic management theory based on systems-theory, which highlight the relevance of complexity for strategic decision-making (Schreyögg and Steinmann, 1987). Therein the replacement of strategic planning oriented to a Taylorist monological rationality by a process-oriented dialogical type of rationality (Steinmann and Kustermann, 1998) is advocated. This is regarded as a means to tackle the complexity of organizational environments in a superior way and thus contribute to the survival of an organization. The former type of monological rationality shows parallels to the theoretical foundations of traditional corporate governance. Conceptions of corporate governance postulating the necessity of shareholder-value and the resulting single-valued objective function as a condition necessary for the manageability of corporations refer to exactly the mentioned type of monological rationality. A deliberation-based conception of corporate governance by contrast can be regarded as analogous to the

latter type of dialogical rationality. Accordingly, the requirements for rendering corporate governance qualified to contribute to the constitution of dialogical rationality can be oriented to remarks concerning strategic management in complex environments from a systems-theory perspective.

Following that suggestion, it becomes necessary to find a mode of information collection and processing respecting the requisites of a deliberative concept of legitimacy which is efficient and at the same time takes into account the trade-off between organizational efficiency and legitimacy. At the one extreme, broad deliberation will ensure a maximum of legitimacy but simultaneously harbours the danger of a deadlock inhibiting organizational survival in complex environments. At the other extreme, organizational efficiency can be maximized by avoiding any kind of coordination with stakeholders at the cost of organizational legitimacy. With legitimacy as well as efficiency being vital for organisational survival, some compromise between efficiency and legitimacy needs to be found.

Geared to the observation of corporate governance adapting increasingly to the characteristics of democratic governments (Coglianese, 2007; Gomez and Korine, 2005; Gomez and Korine, 2008) and to the suggestion to transfer of the principle of subsidiarity to organizations (Melé, 2004) I therefore propose to harness the political concept of subsidiarity for the constitution of legitimacy of the governance of corporations. Accordingly, within an organization, the constitution of legitimacy has to take place at the lowest level possible.

The processes aiming at opening a corporation for deliberation need to take place on the operational level of a firm. Firstly, this is due to reasons of the efficacy of these deliberative processes themselves. Drawing on the parallels between the problems of managing legitimacy in complex environments and the systems-theory oriented approaches in strategic management described above, the necessity of organization-wide sensitivity for issues relevant for organizational legitimacy becomes clear. That is to say, on every hierarchical

level members of the organization need to be able to identify potential threats for organizational legitimacy. Furthermore, they need to be authorized and able to make decision based on dialogue with persons or groups affected by corporate actions in a flexible way. And secondly, the necessity for such decentrality follows from the potential threat to organizational efficiency resulting from diverging interests on the top decision level.

However, such decentral mechanisms alone do not guarantee for a corporation to constitute and maintain legitimacy in a deliberative way. Responsibility cannot easily be localized and identified by shareholders as well as by the general public. The function of signalling trustworthiness can not be fulfilled. Therefore, an identifiable mechanism is necessary to establish trust in the governance of corporations, thereby securing organizational legitimacy. Firstly, this is due to the fact that the upper echelons in corporations wield the most power – in economic and increasingly also in political respect. On top management level it is decided whether or not data are signalling strategic threats and fundamental directions in the course of strategic decision making are selected (Schreyögg and Steinmann, 1987). Secondly, there is a possibility of failure deliberative processes on lower level. Distortions in moral deliberation resulting from the hierarchical structure of firms and causing a diffusion of personal responsibility (Rhee, 2008) cannot be ruled out. Therefore some kind of guarantee equivalent to a court of last resort is necessary to provide the possibility of changing the direction of corporate activity. This seems to be the potential role for corporate governance in a framework aiming at a corporation capable of constituting dialogical rationality and therewith legitimacy.

However, to counter negative consequences for organizational efficiency, processes of decision-making concerning the core activities and processes of deliberation constituting organizational legitimacy have to be decoupled to some extent (Scherer et al., 2008).

One practical suggestion pointing in this direction and concerning corporate justice plans and possibilities for stakeholders to contest corporate decisions is mentioned by Parker (2002). However, this solution stipulates access to justice as an ultimate option and is therefore only of limited use under conditions of a weak or absent regulatory framework. A further reaching suggestion concerning the modification of corporate governance structures towards a four-tier system, involving all legitimate stakeholders in processes of organizational decision-making (Driver and Thompson, 2002), might lead in the direction of full corporate accountability beyond the boundaries of law. Despite being far apart from realization, seemingly there are no less fundamental ways to restore the capacity of corporations in general and of corporate governance in particular to maintain the legitimacy of corporations in a way appropriate to the conditions of heterogeneous complex environments and the increasingly politicized role of business.

CONCLUSION

In the face of fundamental changes in their economic environment and a shift in the division of labour between the private and the political sphere, corporations are increasingly confronted with the problem of diminishing legitimacy. In the pre-globalization era intact regulatory frameworks guaranteed the congruence of profit-making and the social welfare. Contracts were reliable, negative externalities were limited by law and the provision of public goods was a public task fulfilled by public authorities. With the diminishing of public steering power and the widening of regulation gaps, these assumptions are becoming increasingly unfounded. In many cases, the enforceability of contracts can be doubted. The limitation of negative externalities by state authorities is becoming increasingly difficult due to the global reach of corporate power, the range of many negative externalities transcending national borders and the weakening of national regulatory frameworks. The distinction between the

private and the public sphere is blurring because of the fact that corporations often participate or independently engage in the provision of public goods. Summing up, these developments constitute an increase in corporate power and thus a higher risk for those affected by this power. This *inter alia* results in immensely increased requirements for corporate governance conceived of as a mechanism designated at securing organizational legitimacy and thereby also the legitimacy of the economic system as a whole, particularly in the light of the strengthening of global civil society. Whereas traditional corporate governance was able to achieve organizational and systems-level legitimacy by protecting the shareholders in a monological way, this does not apply to the current situation of increased economic and political power of corporations in a post-national world. To restore and maintain organizational and systems-level legitimacy, corporate governance needs to open up for contingent legitimate claims towards a corporation. The transfer of the concept of deliberative democracy to the corporate level in general and to corporate governance in particular is a promising way to re-establish legitimacy in a dialogical way.

However, the way towards the democratically accountable corporation is still long. On organizational level, ways need to be found to process and balance legitimate claims towards an organization and organizational efficiency.

On the systems-level another problem might impede the enhancement of corporate accountability: systems-level legitimacy is not completely established by the mere generation of firm-specific legitimacy. The debate about the sphere of influence of business (Human Rights Council, 2008) is exemplary for this incongruence. Even if a firm behaves correctly within a sphere where illegitimate behaviour could be attributed to the firm and therefore damage its legitimacy, the firm still might cause illegitimate behaviour beyond this sphere, e.g. in complex supply chains without venturing legitimacy. Each individual firm could take an advantage from opting out of contributing to the legitimacy of the economic system.

Therefore systems-level legitimacy can be regarded as a public good a problem of collective action occurs. Approaches towards resolving this problem could lie in the establishment of schemes of effective self-regulation. Initiatives like the United-Nations Global Compact and the Global Reporting Initiative as well as sector-specific initiatives like the Equator Principles for responsible project financing point in this direction. Nonetheless, as such initiatives are still far from being widespread and binding, the legitimacy of the economic system is in decline as rising dissatisfaction with capitalism (Globescan, 2009) shows.

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