

R-13
•
2002

Tore Sandven

**Corporate Governance:
Theoretical Background and
Implications for the
Analysis of Corporate
Governance in Norway**

**Tore Sandven
STEP Group
Hammersborg torg 3
N-0179 Oslo, Norway**

Oslo, October 2002

STEP
group =

Studies in technology, innovation and economic policy
Studier i teknologi, innovasjon og økonomisk politikk

Hammersborg torg 3, 0179 Oslo, Norway

Telephone +47 2286 8010

Fax +47 2286 8049

<http://www.step.no/>



STEP publiserer to ulike serier av skrifter: Rapporter og Arbeidsnotater.

Publikasjonene i begge seriene kan lastes ned gratis fra våre nettsider.

STEP Rapportserien

I denne serien presenterer vi våre viktigste forskningsresultater. Vi offentliggjør her data og analyser som belyser viktige problemstillinger relatert til innovasjon, teknologisk, økonomisk og sosial utvikling, og offentlig politikk.

STEP maintains two diverse series of research publications: Reports and Working Papers.

Both reports and working papers can be downloaded at no cost from our internet web site.

The STEP Report Series

In this series we report our main research results. We here issue data and analyses that address research problems related to innovation, technological, economic and social development, and public policy.

Redaktører for seriene:

Editors for the series:

Finn Ørstavik (1998-2000)

Per M. Koch (2000)

© Stiftelsen STEP 2000

Henvendelser om tillatelse til oversettelse, kopiering eller annen mangfoldiggjøring av hele eller deler av denne publikasjonen skal rettes til:

Applications for permission to translate, copy or in other ways reproduce all or parts of this publication should be made to:

STEP, Hammersborg torg 3

0179 Oslo, Norway

CONTENTS

Introduction.....	1
Conceptions of corporate governance in different schools of thought.....	2
The mainstream approach	3
The Lazonick and O’Sullivan critique	7
The assumption of purely self-interested actors.....	7
Stiglitz and Simon: on the empirical basis for the axiom of pure self-interest	9
From imperfect information to...perfect contracts?.....	10
Oliver Hart on optimal principle-agent contracts.....	11
Critique of the concept of perfect information.....	12
A distorted conception of trust.....	12
Nelson and Winter and the implications of Knightian uncertainty	13
The dynamic aspects of markets and competition	15
The Austrian approach.....	16
Rejection of optimality claims and of the concept of perfect information.....	16
Different views of the firm: Ronald Dore’s classification	17
Governance, innovation and organisational intergration	19
Multiple identifications and loyalties.....	20
The firm in society	23
The historical background: the institutional arrangements underlying post-war growth.....	23
The neo-liberal reaction	24
Misunderstanding the foundations of a market economy: The critique of Tobin and Stiglitz	28
The assumption of rationality as narrowly instrumental	29
Investing for the future: Keynes on animal spirits	30
Lester Thurow on human beings as social builders	30
Understanding motivation: extrinsic and intrinsic motivation	31
Implications of the rejection of the neoclassical incentives paradigm	33
Outline of an alternative view – Lazonick and O’Sullivan	34
A comparative perspective.....	36
Implications for the analysis of Norwegian governance institutions	36
A research and policy agenda	39

Introduction

The term *corporate governance* relates to how corporations, firms, organizations etc. are owned, managed and controlled. This is an issue which has been the subject of much debate in recent years.¹ The general reason for this, of course, is that how firms are managed matters a good deal for their economic performance. However, to understand the reasons for the recent upsurge in the interest for these issues and the particular focus that the debates typically have had, one must look more closely at the particular background for these debates. In this paper we will try to give an overview of these background issues, trying to explain how different definitions of what corporate governance is about reflect different perspectives on how to understand economic activity and economic performance. A central aim of the paper is to give a theoretical background for empirically oriented research on corporate governance in Norway.² After having outlined the theoretical issues we thus conclude the paper by indicating some implications for empirical research.

The paper originated as a spin-off from the TSER-project 'Corporate Governance, Innovation, and Economic Performance in the EU.' The project was coordinated by William Lazonick and Mary O'Sullivan, who have written extensively on this subject. The present paper to a large extent builds on their contributions. An excellent summary of their work is found in their report *Perspectives on Corporate Governance, Innovation, and Economic Performance*,³ which is the main theoretical document from the TSER-project.

Lazonick and O'Sullivan's perspective on corporate governance has to a large extent been forged through a critique of the neoclassical economic thinking. To grasp their position it is thus important to understand the nature of this critique. For instance, one of their central concerns is to argue against the proposition that to 'maximize shareholder value' should be the dominant principle of corporate governance,⁴ a proposition which represents a relatively straightforward application of neoclassical economic thinking to the issue of corporate governance. The present paper shares this critical position towards the traditional neoclassical approach.

¹ See, for instance, David Greenaway, 'Policy Forum: Corporate Governance: Editorial Note,' *The Economic Journal*, Vol. 105, No. 430, May 1995, pp. 676-677; Mary O'Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany*, Oxford: Oxford University Press, 2000, p. 1.

² See the forthcoming papers by Anders Ekeland and Siri Aanstad, 'Corporate governance – a comment on recent Norwegian empirical research,' and 'State ownership in the Norwegian corporate governance debate.'

³ William Lazonick and Mary O'Sullivan, *Perspectives on Corporate Governance, Innovation, and Economic Performance*, report to 'Corporate Governance, Innovation, and Economic Performance in the EU,' a research project funded by the Targeted Socio-Economic Research (TSER) Programme of the European Commission (DGXII) under the Fourth Framework Programme, coordinated by William Lazonick and Mary O'Sullivan.

⁴ See, for instance, William Lazonick and Mary O'Sullivan, 'Maximizing shareholder value: a new ideology for corporate governance,' *Economy and Society*, Volume 29, Number 1, February 2000, pp. 13-35.

In addition to the work of Lazonick and O'Sullivan we will also give an overview of some other 'heterodox' contributions, i.e. contributions from outside of the mainstream of the economics tradition, belonging to the more loosely defined traditions of institutional and evolutionary economics, economic sociology, etc.

Conceptions of corporate governance in different schools of thought

The differences in theoretical perspective are reflected already in the definition of the subject area, in the delimitation of what the term corporate governance covers. Lazonick and O'Sullivan define corporate governance as the social process that shapes 'who makes investment decisions in corporations, what types of investments they make, and how returns from investments are distributed.'⁵ In their approach they explicitly focus on the implications that different corporate governance have for innovation and economic performance. Specifically, they claim that if a system of corporate governance is to support innovation, it must generate three conditions:

- Financial commitment
- Organizational integration
- Insider control.'⁶

In more detail, to be conducive to innovation a system of corporate governance must be constituted so as to 'provide the institutional support for:

- Commitment of resources to irreversible investments with uncertain returns
- Integration of human and physical resources into an organizational process to develop and utilize technology
- The vesting of strategic control within corporations in the hands of those who, as insiders, have the incentives and abilities to allocate resources to innovative investments.'⁷

If these conditions are not met, they claim, 'business enterprises cannot generate innovation through strategic investment in collective learning processes.'⁸ The emphasis here on the dependence of innovation on collective learning processes in its turn raises the question of what kind of collectivity is at issue here, who are insiders and who are outsiders to this collectivity, etc.⁹ Thus, in Lazonick and O'Sullivan's definition corporate governance covers a quite wide array of issues relating to how firms and corporations are managed and organized, and of organizational routines

⁵ Lazonick and O'Sullivan, *Perspectives on Corporate Governance, Innovation, and Economic Performance*, op.cit., p. 14.

⁶ O'Sullivan, *Contests for Corporate Control*, op.cit., p. 39.

⁷ *ibid.*

⁸ *ibid.*, p. 40.

⁹ See, for instance, William Lazonick, *Business Organization and the Myth of the Market Economy*, Cambridge: Cambridge University Press, 1991, especially pp. 23-58 (the chapter entitled 'Institutional foundations of industrial dominance and decline').

and practices more generally. In particular, they emphasize that a theory of corporate governance should integrate ‘an analysis of the economics of innovation.’¹⁰

The mainstream approach

In the mainstream or neoclassical approach the term corporate governance is typically defined more narrowly, as the processes of supervision and control ‘intended to ensure that the company’s management acts in accordance with the interests of the shareholders.’¹¹ This restriction of the class of phenomena to which the term refers can be seen to follow in a quite straightforward manner from the basic presuppositions of neoclassical economic theory. We will here not go into detailed discussion of whether adherence to this or that particular assumption is necessary for a contribution to be qualified as neoclassical. It should be quite uncontroversial, however, to say that the use of the idealised model of free competition as the reference model for understanding how an economy works is central to neoclassical economic thinking.¹² Mary O’Sullivan proposes a definition of neoclassical economics which well captures the essential points here. She uses the term ‘neoclassical theory’ to refer to ‘that body of economic thought that uses the theory of the perfect market economy, whether explicitly or implicitly, as the benchmark for economic efficiency.’¹³ Central to this model of the perfect market economy or perfect competition is the idea of a non-intentional coordination through the price mechanism of the plans of radically independent economic actors.¹⁴ These actors are portrayed as being concerned exclusively with maximally furthering their own private interests.

A normative theory of equilibrium – not of price adjustment and marked dynamics

In general, the economic actors are seen as utility maximization; in the case of firms, utility maximization takes the form of profit maximization. Given the ‘initial’ distribution of economic resources, the state of production technology, etc., the quantities of different goods which the economic actors will supply respectively demand in the market will depend on the prices of these goods. There is a very common misunderstanding of the general equilibrium models. People tend to think that in this model prices will then adjust so that total supply equals total demand, where nobody will have any incentive to alter the quantities they supply or demand and the system thus will be in equilibrium. *But this is not the case.*

The prices – like initial endowments and preferences are given, static, do not change. There is *only* adjustment of *quantum* of produced goods to prices which every

¹⁰ O’Sullivan, *Contests for Corporate Control*, op.cit., p. 42.

¹¹ See, for instance, J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, Oxford: Clarendon Press, 1993, p. 159; also Xavier Vives, ‘Corporate Governance: Does It Matter?’ in Xavier Vives (ed.), *Corporate Governance: Theoretical and Empirical Perspectives*, Cambridge: Cambridge University Press, 2000, pp. 1-21, especially p. 1.

¹² See, for instance, Bernard Guerrien, *L’économie néo-classique*, Paris: Éditions La Découverte, 1989, pp. 8-9.

¹³ O’Sullivan, *Contests for Corporate Control*, op.cit., p. 3.

¹⁴ See Guerrien, op.cit., p. 9.

producer takes as *given*¹⁵. There can in a general equilibrium model be *no* trading to prices that are not the equilibrium prices, that would change the initial endowments¹⁶ and the system would never reach equilibrium. One might then ask by what mechanism the equilibrium prices are found. Walras introduced the notion of ‘tantônement’, ‘groping’ - until the equilibrium prices were found. Others have proposed some type auctionarius, proposing prices until the consistent equilibrium set was found. How one shall explain the lack of such auctions in real life is beyond the scope of this paper¹⁷. The important thing here is not to confuse the *dynamic* economic thinking of Smith and Ricardo where actual prices by a dynamic process gravitate towards their prices of production¹⁸ with the pure adjustment of quanta to *given* prices. Contrary to very widespread views – general equilibrium theory is not a theory of markets, it is *not* a theory of competition, of markets but statement that given certain totally unrealistic restrictions on the utility and production functions a unique equilibrium can exist. But that is not a description of competition and markets, fundamentally *dynamic* phenomena.

That one can *compare* different equilibrium states has nothing to do with having a real theory of how one moves from one state to another. The mathematical apparatus for such a dynamic approach exists as differential/difference equation systems, but they do not *prove* that a perfect market economy is the most efficient system, that it is Pareto optimal at the same time etc. On the contrary, introducing dynamics makes the economic models just as ‘chaotic’ and unpredictable as the weather.¹⁹

Since the mechanism by which the equilibrium prices is not empirically founded the mainstream theory is extremely *normative*, much more so than most people tend to believe. They see it mostly as a very abstract representation of real life competition. But the normative aspects of mainstream GE (general equilibrium) theory are important. If the real economic system in question differs from that portrayed by the model of the perfect market, this reflects an imperfection in reality, a market imperfection. Something, for instance regulations, institutional practices, social norms, or the like, interferes with the workings of the market mechanism. If these interferences can be removed or suppressed so that the system can work more in accordance with the model of perfect competition, the result will be a more efficient allocation of economic resources.²⁰ As a guideline for policy this is very influential,

¹⁵ In the Norwegian tradition shaped by R. Frisch this is called ‘prisfast kvantumstilpassning’.

¹⁶ Endowments must be understood as amounts of exchangeable goods, there is no money in this model, it is a barter economy, where one unit good is chosen as the ‘numeraire’. But since money (numbers in a bank account) cannot have any utility in itself, the most plausible interpretation is that this is some real good. We shall not here go into the various ways one can reconcile this with the fundamental role that money plays in most economic systems.

¹⁷ See for example Rune Skarstein, *Sosialøkonomiens elendighet*, 1976 for a closer discussion of this in Norwegian. See also HAAVELMO, T. *Hva kan statiske likevektsmodeller fortelle oss? (What can Static Equilibrium Models tell us?)* In *Festskrift til Fredrik Zeuthen*. Copenhagen, 1958

¹⁸ Since there is continuous innovation (technical and organisational change) the system will never be in a static equilibrium – a notion foreign to Smith’s thinking.

¹⁹ An excellent overview is given in: *Chaos: Significance, Mechanism, and Economic Applications*, William J. Baumol, Jess Benhabib, *Journal of Economic Perspectives*, Vol. 3, No. 1, pp. 77-105

²⁰ *ibid.*, p. 11.

one extreme example being the case of Russia where the belief that if one just deregulated and privatized equilibrium would be reached, not understanding that general equilibrium theory is just what it says, an *equilibrium* theory that gives no theoretical insight into *dynamic* transformation process the most important of course being innovation and technical change²¹.

Functionalism

The neoclassical model of the perfect market economy thus is an idea of an optimally functioning system, an economic system where resources are allocated optimally. This also would seem to imply an optimal functioning of each economic actor: no opportunities for gain will be left unexploited if actors are free to pursue their own interests. That economic practice in each firm actually will converge to best practice in the field is partly also explained by a functionalist argument: firms whose practice does not approach best practice in the field will not be able to survive in the competition. This conviction that in a perfect market economy economic resources will simply be utilized in an optimal way makes it understandable that the standard neoclassical theory has not been interested in what goes on inside firms or organizations.

Black box

As has often been said, the theory treats the firm as a ‘black box,’ operating instead with an idealized entity called the ‘representative firm.’ In the words of Joseph E. Stiglitz: ‘Many economists argued that there was no need to look carefully into the black box called the firm: firms maximized profits (stock market value); if managers didn’t, they would be replaced; and firms that didn’t maximize wouldn’t survive. Accordingly, what went on inside the black box was mere detail. The behavior of the firm could be described completely without knowledge of those details.’²² He adds that those who argued otherwise (here he mentions Berle and Means and March and Simon) ‘were given short shrift by the mainstream of the economics profession, as heretics who ill understood the basic tenets of the profession.’²³

Thus corporate governance, the governance of firms, how firms are managed and function, is for neoclassical economic theory a non-problem if the economic system in question is a perfect market economy, where all economic actors maximize their particular interests, and notably firms maximize profits. For corporate governance to be an issue, there thus has to come in element which in a significant way makes the system in question deviate from a perfect market economy, there has to be present an *anomaly* in relation to this ideal situation.

Corporate governance as an agency problem

This anomaly or disturbing element in relation to the ideal of the perfect market economy is what is termed *agency problems*. Thus, as Oliver Hart formulates it,

²¹ ‘False Expectations,’ in Lawrence R. Klein and Marshall Pomer (eds.), *The New Russia: Transition Gone Awry*, Stanford: Stanford University Press, 2001 with articles by Arrow, Stiglitz, Tobin and Klein among others.

²² Joseph E. Stiglitz, ‘Symposium on Organizations and Economics,’ *Journal of Economic Perspectives*, Volume 5, Number 2, Spring 1991, pp. 15-24. The quote is from p. 15.

²³ *ibid.*, p. 16.

‘corporate governance does not matter in the absence of agency problems.’²⁴ This is because ‘in the absence of agency problems, all individuals associated with an organisation can be instructed to maximise profit or net market value or to minimise costs.’²⁵

However, the problem here is precisely that one cannot simply take for granted that ‘all individuals associated with an organisation’ will in fact act as they are instructed to do, namely in accordance with the objective of maximizing the organization’s profits. Notably, if ‘an owner hires a manager to run his (or her) firm for him,’²⁶ the owner cannot take it for granted that the manager will act in the interest of the owner. An essential reason for this being so, is that ‘information is imperfect and costly.’²⁷ Whether a manager in fact acts in the interests of the owner or not will often not at all be immediately apparent. To find out about this, the owner would typically have to collect and process a lot of information, and this is costly. It follows that managers have ‘considerable discretion,’ notably ‘discretion to pursue their own interests,’²⁸ and there is no guarantee that the particular interests of managers will coincide with the owners’ interests in maximizing the profits of the firm. Thus, ‘the fundamental problem of owners of firms is how to motivate their managers to act in the interests of the owners.’²⁹ This gives rise to a system of efforts to control managers, through incentive schemes, monitoring, sanctions, etc., and it is this apparatus of supervision and control of managers which the term ‘corporate governance’ refers to in the neoclassical perspective.

The principle of maximizing shareholder value

We should note that this type of agency problem is in principle not restricted to the relationship between owners and managers. Also other categories of people associated with an organization, such as ordinary employees or workers, may have some discretion to pursue their own interests, which again may not coincide with the owners’ interests in maximizing the profits of the firm. Thus, within the overlapping traditions of neoclassical economics and rational choice theory there has developed a large literature on how to develop incentive systems so that employees will find it in their interests to act in the interests of the owners.³⁰

However, it seems that the term corporate governance largely has been reserved for agency problems in the relations between owners and managers. Especially, corporate governance is considered a significant issue in large, public companies, where share ownership is widely diffused over a large number of small owners. This creates particularly difficult problems from the point of view of controlling managers so that they act in the interests of the owners, because ‘the owners, that is, the

²⁴ Oliver Hart, ‘Corporate Governance: Some Theory and Implications,’ *The Economic Journal*, Vol. 105, No. 430, May 1995, pp. 678-689. The quote is from p. 678.

²⁵ *ibid.*

²⁶ *ibid.*

²⁷ Stiglitz, *op.cit.*, p. 16.

²⁸ *ibid.*

²⁹ *ibid.*

³⁰ See, for instance, Gary J. Miller, ‘Managerial Dilemmas: Political Leadership in Hierarchies,’ in Karen Schweers Cook and Margaret Levi (eds.), *The Limits of Rationality*, Chicago: The University of Chicago Press, 1990, pp. 324-348.

shareholders, even though they typically have (ultimate) residual control rights in the form of votes, are too small and numerous to exercise this control on a day-to-day basis.’³¹ Thus, the issue of corporate governance in particular arises in the context of ‘the separation of ownership and control,’ typical of the modern corporation.

Owners vs. other stakeholders

We can now see how the perspective that to ‘maximize shareholder value’ should be the dominant principle of corporate governance, represents a relatively straight-forward application of neoclassical economic thinking to the issue of corporate governance. An essential additional premise here is the view that shareholders are the *owners* of the corporation. The basic tenet of neoclassical theory that optimality requires that firms be run in accordance with the owners’ interest in maximizing profits then translates into the proposition that corporations be run so as to maximize shareholder value. Why are the shareholders considered to be the owners? From the perspective of neoclassical economic thinking, the essential point here is that they are ‘residual claimants.’ Whereas all other parties involved (managers, workers, suppliers, consultants, etc.) have their remuneration determined ‘on the basis of contracts that specify the relation between their contributions to the productive process and the returns they receive,’³² shareholders are the residual claimants whose remuneration is directly tied to the economic returns of the corporation.

The Lazonick and O’Sullivan critique

As Mary O’Sullivan characterizes this view: ‘As “residual claimants”, shareholders thus bear the risk of the corporation’s making a profit or loss and have an interest in allocating corporate resources to their “best alternative uses” to make the residual as large as possible.’³³ It follows that ‘the “maximization of shareholder value” will result in superior economic performance not only for the particular corporation but also for the economy as a whole.’³⁴ In other words, corporations should be run in the interests of the shareholders precisely because the shareholders are the ones who have a direct interest in the maximization of the corporation’s profits.

Had these shareholder interests been allowed to set themselves through unchallenged, this would have been in accordance with the presuppositions of the perfect market economy. However, the presence of an ‘agency problem, or conflict of interest,’ as Hart puts it,³⁵ distorts this picture, causing a deviation from optimality and thus making corporate governance an issue.

The assumption of purely self-interested actors

We should note how the nature of this conflict of interest is conceived. The interests in question are thought of as purely egoistic interests, the behaviour is purely self-interested. Individuals associated with an organization ‘do not care *per se* about the outcome of the organisation’s activities,’³⁶ but only with these outcomes in so far as

³¹ Hart, op.cit., pp. 680-681.

³² Lazonick and O’Sullivan, *Perspectives on Corporate Governance, Innovation, and Economic Performance*, op.cit., p. 24.

³³ O’Sullivan, *Contests for Corporate Control*, op.cit., p. 43.

³⁴ *ibid.*

³⁵ Hart, op.cit., p. 678.

³⁶ *ibid.*

they imply costs and benefits for themselves. The conflict of interest is thus constructed as a conflict between the purely private interests of the managers and the general interest of profit maximization. Managers are supposed to act against the interests of the organizations they are running whenever the private benefits to them of doing so exceeds the private costs for them, i.e. whenever they can benefit from this and get away with it. Likewise, employees will act against the interests of the organization whenever this is to their own personal advantage. Notably, employees are thought to have an interest in *shirking*: they will collect their wages and ‘work as little as they can get away with.’³⁷ Hence, the strong preoccupation in this theory with devising elaborate incentive schemes to align the private interests of managers and employees more closely with the goal of profit maximization.

That the economic actors in this conception are thought to be exclusively self-interested in their motivation for action also applies to the shareholders, but since their interests are in the maximization of the profits of the corporation, their particular personal interests happen to coincide with the general interest. Accordingly, in this way of thinking conflict within organizations is conceived exclusively as a conflict between actors who all try to further their own particular private interests, where, moreover, the interests of one category of actors happen to coincide with the general interest. The picture we thus get is one where the general interest in the optimal functioning of the economy in accordance with the model of the perfect market economy is obstructed by particular groups of actors like managers and employees furthering their own particular self-interest.

What is ruled out by assumption here is the possibility that some conflicts of interests in an organization might instead represent disagreement over, different perspectives on, what will further the common good of the organization. Different groups will have different experiences, will each have different notions of what are problems, what are strengths and weaknesses, of what is important and less important, etc. If these different perspectives of the general good are recognized as such, and not simply as expressions of particular egoistic interests, it might be sensible to view the organization’s objectives as emerging through some kind of process of reconciliation of different perspectives, like in the reciprocal critical examination of arguments in a discussion, where the dominant perspective is at least to some extent transformed through going into a dialogue with other perspectives, rather than seeing the organization’s objectives as something which is unambiguously given in advance.³⁸

³⁷ Miller, op.cit., p. 341. See also *ibid.*, pp. 327-328.

³⁸ For related ideas, cf. the treatment of organizational learning in Lazonick and O’Sullivan, *Perspectives on Corporate Governance, Innovation, and Economic Performance*, op.cit., pp. 73-79, where they discuss ideas of authors like Peter Senge on ‘shared vision,’ ‘co-creating’ and ‘generative learning.’ According to D. Flood, to whom Lazonick and O’Sullivan refer (op.cit., pp. 76-77), creating a ‘shared vision’ is ‘the antithesis of visioning exclusively from the top of a management hierarchy.’ The concern here is with ‘how to move visioning from the top of the management hierarchy to a widespread intensive dialogue – from “telling” to “co-creating.”’ By ‘co-creating’ is meant ‘a widespread and collaborative process where a shared vision is built in a mood of generative learning.’ The quotes here are from D. Flood, *Rethinking the Fifth Discipline: Learning Within the Unknowable*, Routledge, 1999, p. 24, which, in turn, discusses P. Senge, C. Roberts, R. Ross and B. Smith, *The Fifth Discipline Fieldbook*, 1994.

Stiglitz and Simon: on the empirical basis for the axiom of pure self-interest

Now, there seems to be little empirical evidence for the central premise of the neoclassical, agency problem conception of corporate governance, namely that individuals associated with an organization do not care *per se* about the outcome of the organization's activities and will only work for organizational goals to the extent that this contributes directly to their own economic self-interest. Discussing precisely this view that only economic incentives or rewards will make people work for organizational goals, Herbert Simon claims that 'organizations would be far less effective systems than they actually are if such rewards were the only means, or even the principal means, of motivation available. In fact, observation of behavior in organization reveals other powerful motivations that induce employees to accept organizational goals and authority as bases for their actions,'³⁹ the most important of these mechanisms being 'organizational identification.'⁴⁰

As Stiglitz approvingly summarizes Simon's point: 'Simon argues persuasively that in successful organizations, workers *identify* with the organization's objective; that they take on the organization's objective as their own.'⁴¹ What here is said about the motivation of employees or workers to act in accordance with organizational goals applies equally, or perhaps even more, to managers.⁴² Thus, in Stiglitz' view, 'the incentives paradigm can neither explain the structure of observed incentive schemes nor what it is that motivates managers and workers.' Consequently, 'if economists want to understand what makes managers work and what differentiates successful from unsuccessful organizations, we may need to look beyond the compensation schemes and the economists' standard incentives paradigm.'⁴³ Simon is even more explicit about the limitations of the neoclassical approach in this area: 'The attempts of the new institutional economics to explain organizational behavior solely in terms of agency, asymmetric information, transaction costs, opportunism, and other concepts drawn from neoclassical economics ignore key organizational mechanisms like authority, identification, and coordination, and hence are seriously incomplete.'⁴⁴ Clearly, to the extent that this is correct it indicates the need for a much broader approach to the issue of corporate governance than the agency problem approach of neoclassical tradition.

Clearly, then, there is reason to have serious doubts about the central premise of the agency problems approach to corporate governance, namely that managers and employees do not care *per se* about the performance of the organization but will only work for organizational goals to the extent that this contributes directly to their own economic self-interest. On the contrary, successful organizations are precisely characterized by managers and employees *identifying* with the goals of the organization, taking on these goals as their own.

³⁹ Herbert A. Simon, 'Organizations and Markets,' *Journal of Economic Perspectives*, Volume 5, Number 2, Spring 1991, pp. 25-44. The quote is from p. 34.

⁴⁰ *ibid.*

⁴¹ Stiglitz, *op.cit.*, p. 22. Italics in the original.

⁴² Cf. Simon, *op.cit.*, p. 30.

⁴³ Stiglitz, *op.cit.*, p. 22.

⁴⁴ Simon, *op.cit.*, p. 42.

A central question then becomes what are the conditions for this kind of identification to happen. An answer may run along the lines that this requires some measure of integration in some kind of collective or community: one participates in, contributes to, some kind of common project. For this participation, this membership, not simply to be a matter of rhetoric and manipulation, it must have some kind of real foundation, through some measure of commitment, some measure of communality of destiny, or the like. This is closely connected to the issue of *organizational integration*, central to the perspective of Lazonick and O'Sullivan,⁴⁵ where key questions are: How are different types of actors integrated into the organization? Who are integrated in the organization and who remain outsiders, treated as ordinary 'factors of production?' Under what conditions will different types of actors be integrated in the organization, in what ways, and what are the consequences for organizational learning, innovation and economic performance? We will come back to the issue of organizational integration further below.

From imperfect information to...perfect contracts?

We should here comment upon a central element in the agency problem perspective of corporate governance, namely that what course of action will maximize a firm's profits is in principle something which is given in advance. This is closely connected to the assumption of perfect information on the part of economic actors in the model of the perfect market economy. When this model is applied as a measuring rod for judging actual economic systems, it may then be recognized that the assumption of perfect information is not a reasonable assumption under the given circumstances. Thus, it may be acknowledged that information is imperfect, but this assumption of imperfect information is precisely then conceptualized as a deviation from an ideal of perfect information, as a secondary complication introduced into the picture, making adaptations deviate from the ideal situation of the perfect market economy. Notably, the relaxation of the assumption of perfect information and the consequent introduction of imperfect information is made through introducing information costs, the costs of gathering and processing information, as a new production cost. In the words of Israel M. Kirzner, 'for the mainstream, imperfect information is primarily a circumstance constraining the pattern of attained equilibrium.'⁴⁶

Thus, for the mainstream (neoclassical) tradition it appears as a problem that managers may have considerable *discretion*. Discretion is here exclusively thought of as a discretion to pursue own interests, as opposed to the interests of owners in maximizing the profit of the organization, a discretion they have owing to the fact that owners (shareholders) have imperfect information concerning the managers' actions.⁴⁷ The managers have discretion to choose whether to maximize own interests or owners' interests, but what courses of action each of these objectives imply is not thematized as an issue. Discretion is here *not* conceptualized as a basic trait of actors who act creatively in a largely open situation. As Richard Nelson claims, in neoclassical theories of the firm 'the "economic problem" is basically about getting private incentives right, not about identifying the best thing to do,

⁴⁵ See, for instance, O'Sullivan, *Contests for Corporate Control*, op.cit., p. 39, Lazonick, *Business Organization and the Myth of the Market Economy*, op.cit., pp. 23-58.

⁴⁶ Israel M. Kirzner, 'Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach,' *Journal of Economic Literature*, Volume XXXV, March 1997, pp. 60-85. The quote is from p. 62.

⁴⁷ Cf. Stiglitz, op.cit., p. 16; Hart, op.cit., pp. 678-679.

which is assumed to be no problem.⁴⁸ In other words, the theory takes ‘a firm’s choice sets as obvious to it and the best choice similarly clear and obvious.’⁴⁹ Thus, a frequently raised objection against the neoclassical approach is that ‘neoclassical theory has portrayed the individual decision as a mechanical exercise in constrained maximization,’ a portrayal which ‘robs human choice of its essentially open-ended character, in which imagination and boldness must inevitably play central roles.’⁵⁰

Oliver Hart on optimal principle-agent contracts

Let us illustrate these points further by commenting on Oliver Hart’s discussion of ‘optimal principal–agent contracts.’⁵¹ (The principal hires an agent to perform some task for him or her, for instance run a firm. In this case, the owner is the principal, the manager is the agent.) Optimal principal–agent contracts are contracts which ‘are “comprehensive” in the sense that a contract specifies all parties’ obligations in all future states of the world, to the fullest extent possible (i.e. to the extent that these obligations are observable and verifiable).’⁵² The notion of optimal principal–agent contracts is for Hart central to an understanding of corporate governance because if contracts are comprehensive, governance structure will not matter: ‘in a comprehensive contracting world, everything has been specified in advance, i.e. there are no “residual” decisions.’⁵³ Thus, a second necessary condition for corporate governance to matter, in addition to the presence of agency problems, is that contracts be incomplete: ‘governance structure matters when some actions have to be decided in the future that have not been specified in an initial contracts.’⁵⁴

Now, to explain that there are incomplete contracts Hart invokes the *costs* of writing comprehensive contracts. He refers to the transaction cost literature, which he claims has identified three costs that are particularly important: ‘First there is the cost of thinking about all the different eventualities that can occur during the course of the contractual relationship, and planning how to deal with them. Second, there is the cost of negotiating with others about these plans. Third, there is the cost of writing down the plans in such a way that they can be enforced by a third party – such as a judge – in the event of a dispute.’⁵⁵ It is because of these costs that ‘the parties will not write a comprehensive contract,’ but instead ‘write a contract that is incomplete.’⁵⁶

⁴⁸ Richard R. Nelson, ‘Why Do Firms Differ, and How Does It Matter?’ in Richard R. Nelson: *The Sources of Economic Growth*, Cambridge, Massachusetts: Harvard University Press, 1996, pp. 100-119, quoted from p. 105. The article was originally published in *Strategic Management Journal*, Winter 1991, pp. 61-74.

⁴⁹ *ibid.*, p. 107.

⁵⁰ Kirzner, *op.cit.*, p. 64.

⁵¹ Hart, *op.cit.*, pp. 679-680.

⁵² *ibid.*, p. 679.

⁵³ *ibid.*

⁵⁴ *ibid.*

⁵⁵ *ibid.*, p. 680.

⁵⁶ *ibid.*

Critique of the concept of perfect information

However, there is reason to have serious doubt about this whole notion that it is in principle possible to specify all eventualities in advance, but that the costs of doing this would be so high that maximization dictates that one only incurs some of these costs, settling for a level of comprehensiveness of the contract which is some way from the ideal state where everything is specified in advance. One may instead claim that this is intrinsically impossible that this could be known in advance, that the whole idea is incompatible with basic traits of human action, such as its largely open-ended character, creativity, initiative. Even for simple, standardized work operations the idea of specifying everything in advance is problematic.⁵⁷ More generally, instructions are generally not given as detailed commands to do specific actions, but, for instance, as more general instructions concerning the result to be produced.⁵⁸ As Herbert Simon reminds us, 'obeying operating rules literally is a favorite method of work slowdown during labor-management disputes.' Instead, 'what is required is that employees take initiative and apply all their skill and knowledge to advance the achievement of the organization's objectives.'⁵⁹

The idea that a comprehensive contract where everything has been specified in advance constitutes the ideal, but where consideration of the costs of establishing such a contract necessitates a deviation from this ideal, is also highly problematic as a practical understanding, i.e. to the extent that the actors themselves have this understanding and are guided by this understanding in their actions. Commenting on these issues in the case of cooperation between separate business units, Stewart Macaulay observes that 'carefully planned arrangements may create undesirable exchange relationships between business units. Some businessmen object that in such a carefully worked out relationship one gets performance only to the letter of the contract. Such planning indicates a lack of trust and blunts the demands of friendship, turning a cooperative venture into an antagonistic horse trade.'⁶⁰ If one really has the setting up of comprehensive contracts where all possible eventualities have been specified in advance as an ideal, this looks more like an obsession with control than a rational way of collaborating to get things done. This applies whether we are dealing with relationships between separate business units, between managers and workers, or between owners and managers.

A distorted conception of trust

More generally, accounting for trust is a fundamental problem for theories which conceive human actors as exclusively opportunistic and self-interested. If actors are exclusively interested in costs and benefits to themselves, they will break their commitments whenever they find that this is to their advantage. Charles F. Sabel

⁵⁷ Cf., for instance, Alain Lipietz, *Towards a New Economic Order: Postfordism, Ecology and Democracy*, Cambridge: Polity Press, 1992, p. 4 (originally published in French in 1989), on the separation of conception and execution of work operations in 'Taylorism.'

⁵⁸ Cf. Simon, op.cit., p. 31.

⁵⁹ *ibid.*, p. 32.

⁶⁰ Stewart Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study,' *American Sociological Review*, Volume 28, Number 1, 1963, pp. 55-67. The quote is from p. 64. This passage is quoted and discussed in Mark Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness,' *American Journal of Sociology*, Volume 91, Number 3, November 1985, pp. 481-510. Here the quote is on p. 496.

aply characterizes this perspective on human action as ‘a science of suspicion.’⁶¹ As he observes, the corollary to the exclusive concern with own interests is a fear of being deceived: ‘it makes the pursuit of self-interest and the fear of deception (because the others are pursuing their own interests, too) the spring of individual action and the guiding motive of institutional construction.’⁶² As Mark Granovetter observes, in this perspective, the way to hinder people from cheating and breaking commitments is to set up clever institutional arrangements which make these practices too costly to engage in. But as Granovetter emphasizes, these arrangements ‘do not produce trust but instead are a functional substitute for it.’⁶³ Hence the distorted view of trust typically found in rational choice theory and related approaches: whether one trusts another person or not becomes exclusively a question of one’s assessment of what the other person sees as being to his advantage.⁶⁴

Again we may inquire into the practical implications of having this understanding as a practical understanding guiding one’s own actions. Would not having this kind of understanding as a practical understanding imply that one does not trust the other person but expects him to cheat and break commitments whenever he finds this to his advantage? And does one not also at the same time admit that one is not to be trusted oneself but will likewise always be ready to cheat the other if one finds that one can profit from it? But of course it would not be smart to say this openly, so instead one pretends that one is not exclusively self-interested and pretends that one does not believe the other to be exclusively self-interested, while at the same time expecting the other to put up the same pretence. To the extent that the actors themselves have this understanding this would precisely seem to imply a social world dominated by suspicion and deceit, as Sabel indicates.⁶⁵ It is doubtful whether this kind of social world will function very well. We will come back to the issue of trust further below.

Nelson and Winter and the implications of Knightian uncertainty

To recapitulate, we have seen that in the neoclassical, agency problems approach to corporate governance, the fact that managers (or, for that matter, other actors involved in the organization) may have considerable discretion appears as a problem. This is so because in this conception discretion is exclusively thought of as a discretion to pursue own interests, in contradistinction to the interests of owners in maximizing the profit of the organization. Behind this way of posing the issues lies the fact that neoclassical theory treats ‘a firm’s choice sets as obvious to it and the best choice similarly clear and obvious.’⁶⁶ Thus, the theory portrays profit

⁶¹ Charles F. Sabel, ‘Constitutional Ordering in Historical Context,’ in Fritz W. Scharpf (ed.), *Games in Hierarchies and Networks: Analytical and Empirical Approaches to the Study of Governance Institutions*, Frankfurt am Main: Campus Verlag, 1993, pp. 65-123. The quote is from p. 65.

⁶² *ibid.*

⁶³ Granovetter, *op.cit.*, p. 489.

⁶⁴ This view is very explicit in one of the most authoritative statements of rational choice theory, James S. Coleman’s *Foundations of Social Theory*, Cambridge, Massachusetts: The Belknap Press of Harvard University Press, 1990. See especially the chapter entitled ‘Relations of Trust,’ pp. 91-116.

⁶⁵ Sabel, *op.cit.*, p. 65.

⁶⁶ Nelson, *op.cit.*, p. 107.

maximization as something which has a precise, unique solution.⁶⁷ This may perhaps seem reasonable for very short term, localized problems where the conditions affecting the outcome of the action may be considered more or less given and known. However, isolating the short term from the longer term is in any case an arbitrary operation and when actions are taken in a longer term perspective the conditions affecting the outcome of the actions are much more uncertain. The situation is in large part open and successful action will to a large extent depend on creativity, initiative, etc. Neoclassical theory here tries to preserve the picture of the maximizing problem as something which has a precise, unique solution by essentially transforming the central terms of the maximization problem, preferences and the conditions of the choice situation, from given, observable magnitudes to increasingly hypothetical, inner, mental states of the actors: from given, observable prices of different observable goods and factors of production, to hypothesis of the actors' beliefs about future states of the world, of the actors' time discounting of preferences, their degree of risk aversion, etc.

As Richard Nelson and Sidney Winter claim in their critique of 'orthodox' (i.e. mainstream, neoclassical) economic theory, when 'faced with the facts of uncertainty and change, it attributes great explanatory force to elaborate hypothetical structures of preference and subjective probability. In gross disregard of Occam's Razor, it multiplies these entities far beyond the empirical necessities imposed by any reasonable prospect of endowing them with operational content.'⁶⁸ Thus, Nelson and Winter reject the notion of profit maximization in the neoclassical sense. They agree that the striving for profit is an important objective for business firms, but they disagree that this is fruitfully dealt with through the neoclassical approach. Accordingly, they endorse an assumption of 'profit seeking' or 'profit-motivated striving,' but not an assumption of profit maximization.⁶⁹ This distinction is especially important in the context of *change*: 'In a sufficiently calm and repetitive decision context, the distinction between striving for profit and profit maximization may be of little moment, but in a context of substantial change it matters a great deal. Strict adherence to optimization notions either requires or strongly encourages the disregard of essential features of change – the prevalence of Knightian uncertainty,

⁶⁷ On the importance attached to unique predictions both in neoclassical economics and in rational choice theory more generally, see, for instance, Jon Elster, 'When Rationality Fails,' in Cook and Levi (eds.), *op.cit.*, pp. 19-51, especially pp. 24-25; or Jon Elster, *Nuts and Bolts for the Social Sciences*, Cambridge: Cambridge University Press, 1989, especially pp. 30-32. According to Elster, the theory gives unique predictions in standard cases. Elster then discusses some special, non standard cases where the theory does not give unique predictions, where thus 'rationality fails.' The claim that the theory in standard cases predicts one unique course of action as the one which maximizes utility, and which thus in this perspective is the one which rationality dictates, presupposes, of course, that the preferences and the beliefs (concerning the alternatives available) of the actor be known in advance. One might claim that this in many cases is not a very fruitful assumption, perhaps not even very meaningful. At a more fundamental level one may question whether the description of human action as following from decisions where actors compare alternatives and the pick out the best of them (cf., for instance, Jon Elster, *Making Sense of Marx*, Cambridge: Cambridge University Press, 1985, p. 13) is very fruitful as a general description of the structure of human action. We will briefly touch on these questions further below.

⁶⁸ Richard R. Nelson and Sidney G. Winter, *An Evolutionary Theory of Economic Change*, Cambridge, Massachusetts: The Belknap Press of Harvard University Press, 1982, p. 33.

⁶⁹ *ibid.*, pp. 30-31.

the diversities of viewpoint, the difficulties of the decision process itself, the importance of highly sequential “groping” and of diffuse alertness for acquiring relevant information, the value of problem-solving heuristics, the likely scale and scope of actions recognized *ex post* as mistaken, and so forth.⁷⁰

Thus, Nelson and Winter contend that profit-motivated striving is central to the understanding of firm behaviour, but claim that the interpretation which orthodox economic theory gives of this is static and distorted, depicting the economic actors as ‘automaton maximizers’ merely picking the best alternative from a given choice set, a given set of alternatives.⁷¹ One consequence of this is that the theory is ill-equipped to analyse entrepreneurship. This, in its turn, is closely connected to the almost exclusive concern with equilibrium as opposed to disequilibrium. Consequently, while competition is a central term in orthodox theory, it is ill-equipped to analyse competitive processes. In effect, orthodoxy does not give an account of the competitive processes at all, but only of hypothetical results of such processes, without being able to show that these will actually come about as results. It has no adequate concepts for behaviour out of equilibrium: ‘there is no well-defined dynamic process of which the “equilibrium” is a stationary point: consistency relations, and not zero rates of change, define equilibrium.’⁷²

In other words, although neoclassical economic thought reserves an absolutely central place for competition, one may raise serious doubts as to whether its theoretical constructions adequately grasps this phenomenon. For instance, the Austrian tradition in modern economics, with its emphasis on the entrepreneurial dimension, is characterized by its sharp opposition to neoclassical theory in this regard. Summing up the Austrian position, Kirzner states that ‘the essence of competition is precisely that dynamic rivalry which the neoclassical equilibrium notion of competition is at great pains to exclude.’⁷³ According to Kirzner, for the modern Austrian approach, the ‘perception of competition as the dynamic, driving force for discovery in the market process has become central.’⁷⁴

The dynamic aspects of markets and competition

This points to a perspective on competition and the market which is quite different from the neoclassical one. As Edward S. Nell claims, ‘the function of the market is to generate competitive pressures to innovate and to assemble the financial resources to invest in innovations. Allocation of existing resources is of secondary importance; moreover, in practice, competition often generates waste, offsetting allocative efficiency.’⁷⁵ Also Nelson and Winter focus on the dynamic properties of competition, on innovation and change. Commenting on economic models that have tried to graft ‘variables relating to technical advance onto orthodox theory in ways

⁷⁰ *ibid.*, p. 31.

⁷¹ *ibid.*, p. 32. The term ‘automaton maximizers’ they take from W.J. Baumol, ‘Entrepreneurship in economic theory,’ *American Economic Review*, Volume 58, 1968, pp. 64-71.

⁷² Nelson and Winter, *op.cit.*, p. 32.

⁷³ Kirzner, *op.cit.*, p. 68.

⁷⁴ *ibid.*, p. 69.

⁷⁵ Edward S. Nell, *Making Sense of a Changing Economy: Technology, Markets and Morals*, London: Routledge, 1996, p. 57.

that aim to preserve as much as possible of the standard theoretical structure,⁷⁶ in particular retaining ‘the basic assumptions that the firms in the economy maximize profit faultlessly and that the system as a whole is in (moving) equilibrium,’⁷⁷ they state that in the Western market economies ‘much technical advance results from profit-oriented investment on the part of business firms. The profit from successful innovation are *disequilibrium* phenomena, at least by the standard of equilibrium proposed in the models in question. They stem largely from the lead over competitors that innovation affords.’⁷⁸

The Austrian approach

Also for the Austrian approach the focus is on the dynamic aspects of competition. According to Kirzner, ‘for the Austrian approach competition is socially beneficial primarily in a dynamic sense.’⁷⁹ To get a grasp on this, the neoclassical notion of perfect competition or the perfect market economy is an irrelevant, indeed misleading, theoretical construction: ‘whatever social efficiency may be achieved in the market economy is not achieved at all by its participants behaving as if they were agents in a perfectly competitive equilibrium state – but precisely by their behaving entrepreneurially and (dynamically) competitively, under conditions of disequilibrium.’⁸⁰ Kirzner here explicitly rejects the neoclassical claims of *optimality* for the market system or the perfect market economy: ‘Austrian economics makes *no* claim that the market outcomes at any given date are efficient and socially optimal (in any sense in which traditional neoclassical welfare theory would use these terms).’⁸¹ This entails rejection of the very notion of an ideal state where ‘the configuration of production and consumption decisions currently made is one which could, in the light of the relevant costs, not possibly have been improved upon.’⁸²

The Austrian position is of special interest here because it clearly shows that one may be a strong supporter of the market system while at the same time wholly reject any claims for optimality of this system, any claims that it produces outcomes which are optimal in the neoclassical sense. The issue here is clearly not one of merits or demerits of the market, but of what the market and competition is all about.

Rejection of optimality claims and of the concept of perfect information

We should also note that Kirzner’s rejection of any optimality claims for the market system also entails rejection of any claim for ‘informational efficiency for the price system’ or ‘informational efficiency for market outcomes.’⁸³ This suggests that

⁷⁶ Nelson and Winter, *op.cit.*, p. 27.

⁷⁷ *ibid.*, p. 28.

⁷⁸ *ibid.* Italics in the original. This, of course, is also Marx’ point about the ‘civilizing role of capital.’ The competitive process forces upon each capitalist a constant quest for temporary super profits through the production of relative surplus value, i.e. through constant innovation and technical advance. Capitalism thus becomes a tremendous engine for the development of the forces of production.

⁷⁹ Kirzner, *op.cit.*, p. 74.

⁸⁰ *ibid.*, p. 78.

⁸¹ *ibid.*, p. 81. Italics in the original.

⁸² *ibid.*, p. 65.

⁸³ *ibid.*

strongly implicated in the neoclassical notion of profit maximization as a type of problem which has a precise, unique solution, is the neoclassical view of knowledge as ideally perfect information. In reality, no actor has perfect information, but this presence of 'imperfect information' is then precisely conceptualized as a deviation from the ideal state of perfect information, as a secondary complication introduced into the picture, represented through the introduction of a specific type of costs, information costs: the ideal of perfect information is in principle attainable, but this is costly. In Kirzner's words, the neoclassical notion of imperfect information 'refers to known-to-be-available information which it is costly to produce,' while the Austrian focus is on something quite different, namely on what has been termed 'previously unthought-of knowledge.'⁸⁴ Richard Nelson illustrates these points well, asking 'Does the assumption that "actors maximize" help one to analyze situations where some actors are not even aware of a possibility being considered by others?'⁸⁵

At a more fundamental level, we may raise doubts as to whether the structure of human action is well captured by portraying action as the simple carrying out of a decision. Taking up this issue would involve discussing questions of a more epistemological character, concerning the relationship between theoretical (descriptive) and practical knowledge, the nature of competence and learning, the issue of the distinction between tacit and codified knowledge, and so on. We will not go further into these questions here.

Different views of the firm: Ronald Dore's classification

Having discussed some of the presuppositions for the mainstream or neoclassical approach to corporate governance, where corporate governance is restricted to the issue of how to ensure that managers follow the interests of the shareholders, let us now widen the perspective by looking at different view of the business firm in capitalist societies, to see which of these are compatible with the mainstream approach to corporate governance and which are not. In an article on what distinguishes Japan from other highly developed capitalist economies, Ronald Dore proposes a classification of such views, distinguishing four major positions on what a firm is.⁸⁶ These are, first (1) the property view; then there are two sub-versions of the entity / community view, namely (2) the managerial community view and (3) the employee community view; lastly there is (4) the arena view.⁸⁷

The property view

The 'key assumption' of the property view, according to Dore, is that 'the legal situation ... represents social reality.' Thus, 'a company is an entity set up by its capital-providing members to further their own material interests,' and 'the managers are their agents with a duty to give priority to that shareholder interest.' Notably, for the managers it applies that 'the careful buying of the best labour as cheaply as they can is as much part of their duty as getting the best bargain out of their suppliers of

⁸⁴ *ibid.*

⁸⁵ Nelson, 'Why Do Firms Differ, and How Does It Matter,' *op.cit.*, p. 108.

⁸⁶ Ronald Dore, 'The Distinctiveness of Japan,' in Colin Crouch and Wolfgang Streeck (eds.), *Political Economy of Modern Capitalism: Mapping Convergence and Diversity*, London: Sage Publications, 1997, pp. 19-32, especially pp. 19-20

⁸⁷ *ibid.*, pp. 19-20.

raw materials.’ The treatment of employees is purely instrumental in relation to the goal of furthering shareholder interests. Hence, ‘policies of “worker involvement”, paternalistic welfare policies and premium wages above market “going rates” may all be permissible tactics, provided that they are “manipulations” designed to yield better value for money in the purchase of labour.’⁸⁸

The entity/ community view

By contrast, the entity / community view sees the firm not merely as a set of instrumental arrangements, but more as a social entity analogous to a nation. This involves, on the one hand, that the firm is seen as an entity which transcends the group of individuals involved in it at any one time. The individuals involved may come and go, but the firm subsists. On the other hand, the group of people who at any one time embody the firm ‘constitute a community, tied together by bonds of interest in the community’s fate, obligations of cooperation and trust, the sharing of similar risks.’⁸⁹ What motivates the distinction between two sub-versions of this view is the fact that there is variation concerning the definition of the boundaries of this community. The community may ‘be limited to the group of senior managers, or senior and middle managers, or it may be extended to the whole body of people who work in the firm, blue collar and white collar,’ although in the latter case usually only ‘core’ workers are included, i.e. not part-time or temporary workers.⁹⁰ To the extent that the community is limited to managers, whether only senior or also including middle managers, we are concerned with the managerial community view, to the extent that all people working in the firm are included, we have the employee community view.

The arena view

Lastly, in the arena view the firm is seen as an arena where different kinds of actors (such as managers, skilled workers, suppliers, etc.), ‘motivated exclusively by self-interest,’ make contracts and bargains of various kinds. Productive activities are seen as the fulfilment of such contracts. Thus, ‘the organization of a firm can be “dissolved” into a network of contracts’ between exclusively self-interested actors.⁹¹

According to Dore, in the USA and UK the property view of the firm dominates, ‘with some deviation towards the Managerial Community View.’ By contrast, ‘the dominant concept in Japan corresponds to the Employee Community View.’ The

⁸⁸ *ibid.*, p. 19.

⁸⁹ *ibid.*

⁹⁰ *ibid.*, p. 20. For William Lazonick where exactly the boundaries of this community lie constitutes precisely one of the basic characteristics distinguishing British, American and Japanese capitalism, where in British capitalism the community is typically limited to senior managers, in American capitalism it is extended to include also middle managers, and in Japanese capitalism includes all the people who work in the firm, again apart from ‘peripheral’, i.e. part-time or temporary, workers. See Lazonick, *Business Organization and the Myth of the Market Economy*, *op.cit.*, especially pp. 23-58 (the chapter entitled ‘Institutional foundations of industrial dominance and decline’).

⁹¹ Dore, *op.cit.*, p. 20.

arena view he sees first and foremost as ‘one favoured by academic analysts – professional economists, business school teachers, etc.’⁹²

Dore also comments that ‘principal-agent theory’ is compatible with both the property view and the arena view, and sometimes it may be ‘not incompatible with’ the managerial community view. However, it is never compatible with the employee community view.⁹³

Correspondingly, the maximising shareholder value perspective on corporate governance, conceiving corporate governance as an agency problem where shareholders, i.e. owners, are principals and managers are agents, fits into both the property view and the arena view. The actors involved in the firm are indeed seen as exclusively self-interested, concerned exclusively with furthering their own interests. At the same time, this is explicitly seen from the point of view of how to further the interests of one particular group of actors, namely owners or shareholders. Partly this position rests on an assumption that the legal situation with regard to ownership adequately represents social reality, as Dore observes. But perhaps more importantly, as we have seen this position has a very explicit theoretical justification connected to the alleged the optimality properties of the perfect market economy: shareholders are seen as ‘residual claimants,’ consequently maximizing the profit of the firm implies maximizing shareholder value, and an optimal allocation of economic resources presupposes that firms are profit maximizers.

However, as we have also seen, there serious doubts concerning the relevance of the model of the perfect market economy as a measuring rod for real economic processes. Thus, to the extent that one has such doubts, the question of the economic function of shareholders and the importance to attach to shareholder interests becomes an open one. For instance, from the perspective of the enterprise community view of the firm, the interests of shareholders are not a central concern. On the contrary, according to Dore, in this view ‘the shareholders are just one of the groups of outsiders who have to be taken into account for the community to survive and prosper.’⁹⁴

Governance, innovation and organisational intergration

From a perspective explicitly concerned with dynamics and production, and not primarily with equilibrium and exchange, it becomes an important question what kinds of views of the firm are fruitful for understanding *innovative* firms. This requires getting a grasp of the basic characteristics of innovation processes. On the background of the literature on the economics of innovation, Mary O’Sullivan proposes a stylized characterization of innovation as a process that is, in addition to cumulative and uncertain, also collective.⁹⁵ Thus the importance Lazonick and O’Sullivan attach to *organizational integration*,⁹⁶ the integration of different kinds of employees in the organization. This is connected to Simon’s point that in a

⁹² *ibid.*

⁹³ *ibid.*

⁹⁴ *ibid.*

⁹⁵ O’Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany*, op.cit., p. 12, and furthermore pp. 12-19.

⁹⁶ Lazonick, op.cit., pp. 23-58, O’Sullivan, op.cit., p. 39.

successful organization, employees identify with the organization: they internalize the organization's goals, make them their own.⁹⁷ These arguments suggest that some version of the entity / community view of the firm may be the most fruitful for grasping the nature of innovative firms.

Multiple identifications and loyalties

However, we should also take into account that there is not only here a question of the degree and manner of integration of different groups of actors in the firm in question. People working for a given firm will also be more or less integrated in other kinds of collective entities, internalizing in various manner and degree the perspectives and orientations and objectives of these other entities. These different orientations will partly reinforce one another, partly be in conflict, etc. People's identity, loyalties and commitments only partly refer to the firm they are working for. To a large extent, and in varying degrees, people have their identities defined also elsewhere. The Japanese case is perhaps extreme in that employees' identities and whole lives are in a very high degree tied to the company they work for. Discussing so-called *lean production* in Japanese firms, Wolfgang Streeck claims that 'it depends on workers making themselves freely available to the organization in a way that cannot be expected in a pluralist social structure.'⁹⁸ By contrast, 'in a society such as Germany, where workers do not primarily identify with their place of employment, involvement of individuals in secondary organizations of work must be *negotiated*, protecting workers' "privacy" from being consumed by requirements of organizational efficiency. Reliable and enforceable demarcations of rights and responsibilities, in particular of managerial power, is felt to be indispensable as a brake on what in a pluralist environment is perceived as a totalitarian tendency of organizations under competitive pressures to absorb their members.'⁹⁹

Thus, there is nothing absolute about the boundaries delimiting a firm or an organization. People working in an organization will not only be more or less integrated in the organization in question, but in different ways and degrees in other kinds of social entities, carrying with them commitments to and orientations of these other types of entities into the organization. This will influence how they interpret the goals of the organization, how they see their own role, how they see conflicts of interests, etc.

In short, people associated with an organization will have loyalties to the wider society which the organization is a part of, along several important dimensions, for instance according to social class, profession, or local community.

Owners, managers – an elite

Owners and managers, especially large owners and managers of large firms, will tend to be members of the same broad social class, the capitalist class or the propertied class. They will tend to be socialized into the same kind of social values

⁹⁷ Simon, op.cit., pp. 34-38.

⁹⁸ Wolfgang Streeck, 'Lean Production in the German Automobile Industry: A Test for Convergence Theory,' in Suzanne Berger and Ronald Dore (eds.), *National Diversity and Global Capitalism*, Ithaca: Cornell University Press, 1996, pp. 138-170, quoted from p. 153.

⁹⁹ *ibid.*, p. 152. Italics in the original.

and have the same kind of outlook, an important component of which is to see their own positions as leaders in society as natural. The unity of class is not based solely on similar social position and socialization to similar social values. In general, as Mark Granovetter argues, to a large extent ‘business relations are mixed up with social ones.’¹⁰⁰ Trade associations are of great importance. Furthermore, ‘that business relations spill over into sociability and vice versa, especially among business elites, is one of the best-documented facts in the sociological study of business.’¹⁰¹ Another important phenomenon is the fact that many firms ‘are linked by interlocking directorates so that relationships among directors of firms are many and densely knit.’¹⁰² C. Wright Mills, in his classic study of ‘the power elite’ in American society, argued that the ‘growth and interconnections of the corporations’ had resulted in ‘the rise of a more sophisticated executive elite which now possesses a certain autonomy from any specific property interest. Its power is the power of property, but that property is not always or even usually of one coherent and narrow type. It is, in operating fact, class-wide property.’¹⁰³ Mills saw the phenomenon of ‘interlocking directorships’ as a central part of this picture: “Interlocking Directorate” is no mere phrase: it points to a solid feature of the facts of business life, and to a sociological anchor of the community of interest, the unification of outlook and policy, that prevails among the propertied class.’¹⁰⁴ What these relationships between different sections of the capitalist class look like will have consequences for how unitary or fragmented the class will be, which fractions of the class will be dominating, etc. These relationships will vary with time and place, for instance among countries.¹⁰⁵

Employee organisations

On the labour side the conditions of organizational integration will depend, among other things, on the character of labour unions, which in its turn will reflect wider social relations. Let us again refer to Wolfgang Streeck’s discussion of contrasts between Germany and Japan. In Japan, labour unions are ‘company unions that represent workers tied to their employer in a company “community of fate”.’¹⁰⁶ Thus, ‘Japanese unions are part of a unitary, *monistic* company structure designed to support the shared interests of management and of a “committed,” “dedicated” work

¹⁰⁰ Granovetter, ‘Economic Action and Social Structure: The Problem of Embeddedness,’ op.cit., p. 495.

¹⁰¹ *ibid.*, pp. 495-496.

¹⁰² *ibid.*, p. 495.

¹⁰³ C. Wright Mills, *The Power Elite*, New York: Oxford University Press, 1956, p. 122.

¹⁰⁴ *ibid.*, p. 123. See also Michael Soref and Maurice Zeitlin, ‘Finance capital and the internal structure of the capitalist class in the United States,’ in Mark S. Mizruchi and Michael Schwartz (eds.), *Intercorporate Relations: The Structural Analysis of Business*, Cambridge: Cambridge University Press, 1987, pp. 56-84, who refer to the work of Mills (see especially p. 66).

¹⁰⁵ See, for instance, several of the contributions to Mizruchi and Schwartz (eds.), *Intercorporate Relations: The Structural Analysis of Business*, op.cit., in particular James Bearden and Beth Mintz, ‘The structure of class cohesion: the corporate network and its dual,’ pp. 187-207; John Scott, ‘Intercorporate structures in Western Europe: a comparative historical analysis; and the already cited article by Soref and Zeitlin, ‘Finance capital and the internal structure of the capitalist class in the United States,’ pp. 56-84.

¹⁰⁶ Streeck, ‘Lean Production in the German Automobile Industry: A Test for Convergence Theory,’ op.cit., p. 151.

force in the firm's economic success.'¹⁰⁷ In Germany, by contrast, social identities and identifications are to a much lesser extent than in Japan linked to a particular firm. According to Streeck, 'the collective interests attached to such identities require representation by unions organized outside and above individual companies, at the level of industries or the country as a whole. While these could be craft unions, it so happens that in the German case they are political-industrial unions each of which organizes and represents not just one occupation but a large number of them.'¹⁰⁸ Accordingly, 'political-industrial unions of the German kind exercise influence on firms by bringing to bear on them power mobilized in the public sphere, outside the private sphere of the firm.'¹⁰⁹ In Japan, on the other hand, the firm is not to the same degree confronted by an independent public sphere. On the contrary, in the Japanese case one finds 'an astounding capacity of firms to enlist the support of informal structures and community values for organizational control.'¹¹⁰

Professional loyalties

People working in a firm may also to an important extent have their identities linked to a specific profession. The standards they acknowledge in their work may largely be professional, reinforced through interaction with other members of their own profession, in networks which largely cut across the boundaries of firms. The professional networks will also be important as sources of information, as fora for discussion of policy, etc. What kinds of professions dominate in different parts of the economy may be an important characteristic distinguishing different economies. Among the factors influencing this will be the characteristics of the educational systems in different countries.¹¹¹

The local community

Also people's integration in and loyalties to a local community may in important ways condition the way they are integrated into specific firms. As Charles F. Sabel claims in a discussion of the 'new industrial districts' (for instance, in Emilia-Romagna, Veneto, Baden-Württemberg, etc.), 'markets in the new industrial districts are "socially constructed" in that they form "productive communities" which limit competition to encourage innovation by means of "social pacts".'¹¹² He also speaks of a tendency to the 'reconsolidation of the region as an integrated unit of production' from the 1970's and onwards.¹¹³ There then comes the question of how to understand these regional economies, as 'a negotiated alliance of fundamentally

¹⁰⁷ *ibid.*

¹⁰⁸ *ibid.*

¹⁰⁹ *ibid.*

¹¹⁰ *ibid.*, p. 153.

¹¹¹ For a discussion of the role of the engineering profession in Norwegian industry, see Tor Halvorsen, Olav Korsnes and Rune Sakslind: 'The Norwegian disconnection: Professional unity and industrial division,' in Richard Whitley and Peer Hull Kristensen (eds.), *The Changing European Firm: Limits to Convergence*, London: Routledge, 1996, pp. 305-328.

¹¹² Charles F. Sabel, 'Flexible Specialisation and the Re-emergence of Regional Economies,' in Paul Hirst and Jonathan Zeitlin (eds.), *Reversing Industrial Decline? Industrial Structure and Policy in Britain and Her Competitors*, Oxford: Berg, 1989, pp. 17-70, quoted from p. 29.

¹¹³ *ibid.*, p. 18.

distinct groups, or as integral communities with a fluid but discernable division of labour?’¹¹⁴

The firm in society

In general, then, different interests and perspectives from the wider society will be present also inside the individual firms, making the organizational integration into the firm not simply a question of integrating individuals qua individuals, but of integrating individuals qua members of different classes, professions, subcultures, etc., thus also of reconciling or at least neutralizing conflicting interests and perspectives of different social groups. This is perhaps especially evident in Germany, where the internal life of business firms is explicitly treated as a matter of public concern. In the words of Wolfgang Streeck, ‘German society treats the internal life of an enterprise as a matter of public interest and subjects it to public intervention and regulation. Firms in Germany are in this way part of a politically constructed and legitimized public order consisting of a wide array of formally institutionalized and accountable mechanisms of governance, foremost among them an “enabling” democratic state, centralized industrial unions and employers associations, chambers of industry with obligatory membership for firms, and works councils.’¹¹⁵ However, even where the internal life of the enterprise is not explicitly an object of public intervention and regulation as in Germany, i.e. even when the public interest in the internal life of the enterprise is not sanctioned by the state, it seems evident that the balance of forces within the enterprise, and thereby the actual functioning of the enterprises, through the compromises made, their materialization in institutional arrangements and practices, etc., will be affected by the balance of forces in society at large. Among other things, the nature and strength of labour unions will be of importance here. In this connection it will also matter whether there is a climate of cooperation between social classes, where one has some kind of shared vision of contributing towards a common social good, or whether the relationship between the classes is more dominated by antagonism and distrust. This will partly be a question of whether any social class or class fraction or coalition of forces is able to assume leadership and formulate a vision of the good life or of social progress which large sections of society are willing to support. This, in turn, will be related to the levels of inequality in society, etc. Concerning the German case, it might be said that the very fact of having the internal life of enterprises recognized as a matter of public interest already says something about the balance of power in society.

The historical background: the institutional arrangements underlying post-war growth

The reference here to the balance of power between social classes and groups, and social institutions in which compromises between these forces are materialized, points to an important background for the recent concern with maximizing shareholder value as the prime objective of corporate governance. This concern is very much part of the neo-liberal reaction against the elaborate institutional

¹¹⁴ *ibid.*, p. 29.

¹¹⁵ Streeck, ‘Lean Production in the German Automobile Industry: A Test for Convergence Theory,’ *op.cit.*, p. 154.

structures built up in the advanced capitalist economies in the course of the post-World War II period. Post-war economic growth, stability and prosperity rested on these elaborate institutional arrangements, regulating and giving direction to market processes.¹¹⁶ Price competition was limited. Both final and intermediate product markets were organized according to oligopolistic competition, where 'price wars were replaced by gentlemen's agreements between large firms which adopted mark-up price formation and cosmetic product differentiation.'¹¹⁷ Money and credit were thoroughly regulated: 'The Keynesian revolution taught that a stable monetary regime was a public good to be provided by a central bank along with complex regulations imposed on commercial banks and financial institutions.'¹¹⁸ Also wage formation was to a large extent mediated through complex institutional arrangements (collective agreements, long-term contracting, etc.). Central to the post war order was a compromise between capital and labour, where wage-earners received a proportion of productivity growth through in the form of rising real wages, through 'indexation of nominal wages with respect to consumer prices along with productivity sharing schemes,' in exchange for not interfering with managers' rights to organize production and labour processes.'¹¹⁹ Important was also the extension of the welfare state, which meant that also people temporarily or permanently unable to earn a living remained consumers.¹²⁰

The neo-liberal reaction

This whole set of institutional arrangements has come under attack since the beginning of the 1970s. During the 1970s growth became slower and more unstable, and a number of structural problems of the developed economies received widespread attention, with a consequent widely perceived need for structural change. For a number of writers within the neoclassical tradition of economic theory, the fundamental reason for these structural problems were seen to be a number of 'rigidities' which distort the workings of the market economy.¹²¹ The basis for this view is the fundamental assumption of neoclassical theory that in a perfectly functioning free market, flexibility is assured through the price mechanism, the outcome ideally being an 'optimal' allocation of resources at every point in time. Among the phenomena held responsible for creating 'rigidities' which distort the workings of the market are notably state intervention, the welfare state, the power of labour unions and of the labour movement more generally. Not only do these 'disturbing' forces make the price signals deviate more and more from those that a 'perfect' market would produce, they also contribute to making the various economic

¹¹⁶ For the following, see, for instance, Robert Boyer, 'State and market: A new engagement for the twenty-first century?' in Robert Boyer and Daniel Drache (eds.), *States Against Markets: The Limits of Globalization*, London: Routledge, 1996, pp. 84-114, especially pp. 87-95, and Alain Lipietz, *Towards a New Economic Order: Postfordism, Ecology and Democracy*, op.cit, especially pp. 1-13.

¹¹⁷ Boyer, op.cit., p. 87.

¹¹⁸ *ibid.*

¹¹⁹ *ibid.* See also Lipietz, op.cit. pp. 4-7 and p. 11.

¹²⁰ Lipietz, op.cit., p. 7.

¹²¹ See for instance Tibor Scitovsky, 'Can Capitalism Survive? - An Old Question in a New Setting', *American Economic Review*, 70, 1980; Assar Lindbeck, *Work Disincentives in the Welfare State*, Stockholm: Institute for International Economic Studies, 1980.

actors less responsive to such signals.¹²² Thus, for many a top priority became to promote structural change through deregulation, the fight against 'rigidities' and instead increased reliance on 'the market'. Significantly, this also to a large extent became an essential element of governmental policy in different countries in the 1980s.¹²³ For many the 'rigidities' in the *labour market* have come to be perceived as the principal cause of structural problems and stagnation.¹²⁴ These 'rigidities' have typically been understood in terms of the collective conventions and legal regulations governing the wage contracts, in particular arrangements interfering with the rights of employers to dismiss their employees.¹²⁵ According to this view, top priority should be given to increasing 'labour flexibility' by attacking these legal regulations and the bargaining power of labour, thus weakening the contractual and legal attachments of the employees to their particular firms and enterprises.

Thus, the dominant concern of neo-liberal reaction against the elaborate institutional arrangements built up since the second world war is with establishing or restoring the discipline of the market, with making economic actors maximally responsive to market signals. We have seen that this is precisely the point of the concern with maximizing shareholder value as the major principle of corporate governance: to get profit-maximizing firms requires making managers act in accordance with the interests of shareholders or owners, i.e. the 'residual claimants.' Given the central premise of this tradition of economic thought that economic actors are motivated solely by the prospect of personal economic gain, this means aligning the private interests of managers with the interests of shareholders through stock-options to managers, etc.

From 'mixed economy' to 'profit maximization'

Thus, even in the so-called Anglo-Saxon economies of the USA and Britain, where the ideology of maximizing shareholder value has been strongest, 'the exclusive focus of corporations on shareholder value is a relatively recent phenomenon.'¹²⁶ According to Lazonick and O'Sullivan, this focus rose 'to prominence in the 1980s as part and parcel of the Reaganite and Thatcherite revolutions.'¹²⁷ Correspondingly, in the words of Ronald Dore, 'Anglo-Saxon capitalism has not always assumed its thorough-going, neo-liberal form.'¹²⁸ Dore claims that 25 years ago, most people in Britain accepted the term 'mixed economy' as an accurate characterization of the

¹²² Cf. Rune Åberg, 'Market-Independent Income Distribution: Efficiency and Legitimacy', in John H. Goldthorpe (ed.), *Order and Conflict in Contemporary Capitalism*, Oxford: Clarendon Press, 1984, pp. 209-230.

¹²³ Cf. Robert Boyer, 'Rapport salarial, croissance et crise: une dialectique cachée', in Robert Boyer (ed.), *La flexibilité du travail en Europe*, Paris: Éditions La Découverte, 1986, pp. 11-34, especially p. 11.

¹²⁴ Cf. *ibid.*, pp. 11-12; also Åberg, 'Market-Independent Income Distribution: Efficiency and Legitimacy', *op.cit.*, pp. 209-210.

¹²⁵ Cf. Robert Boyer, 'Segmentations ou solidarité, déclin ou redressement: quel modèle pour l'Europe?', in Boyer (ed.), *La flexibilité du travail en Europe*, *op.cit.*, pp. 201-304, especially pp. 236-240.

¹²⁶ Lazonick and O'Sullivan, 'Maximizing shareholder value: a new ideology for corporate governance,' *op.cit.*, p. 14.

¹²⁷ *ibid.*

¹²⁸ Ronald Dore, 'Will Global Capitalism Be Anglo-Saxon Capitalism?', *New Left Review* 6, November December 2000, pp. 101-119, quoted from p. 101.

world they lived in. The term ‘mixed economy’ not only referred to the economy at large as a mixture of different institutional arrangements, combining markets and non-market arrangements, but also implied an acknowledgement ‘that people worked for a mixture of motives, some more for personal profit, some more for public service.’¹²⁹ This extended to a recognition that ‘those who managed corporations should also have mixed motives, mixed objectives, not just that of profit maximization. They should acknowledge that they had obligations not only to shareholders, but also to those who would later become known as stakeholders,’¹³⁰ i.e. all involved in the running of the firm and being affected by its dispositions and actions, ultimately the local community and society at large.

Similarly, Mary O’Sullivan discusses the justification for managerial rule in the context of the US economy especially after the second world war.¹³¹ She notes that the ideology that corporations were run in the interests of the shareholders was strong, and that it lived on after the war. However, ‘the separation of ownership and control in many of the nation’s leading corporations made it increasingly clear that managers’ characterization of themselves as shareholder-designates was unrealistic as well as coy.’¹³² Instead, with the growing importance of big corporations, a view of corporate managers as ‘trustees for society as a whole’ gained ground, and after the war ‘corporate managers increasingly represented themselves as “socially responsible”.’¹³³ O’Sullivan emphasizes that the view of corporate managers as trustees for society was not simply a view which managers had of themselves, but was broadly accepted, subscribed to also by ‘journalists, writers, and scholars of the corporation in the post-war period.’¹³⁴ She notes, however, that this widely accepted view of the social responsibilities of managers was not reflected in corporate law.¹³⁵

Connected to the changing view of managers and their responsibilities there also seems to have been a change in the view of the enterprise as an institution. In an article from 1986 on the US economy, Michel Aglietta claims that the enterprise as an institution has a very high prestige and legitimacy in the USA.¹³⁶ This is so because large parts of the population in the enterprise see a ‘reconciliation between individual initiative and cooperation, between the chances of social promotion and membership in a group,’¹³⁷ which Aglietta claims are basic values in American culture. Thus, ‘in American culture, the enterprise is more than an economic organization. It is a place of social integration,’ and well suited as an institutional

¹²⁹ *ibid.*

¹³⁰ *ibid.* pp. 101-102.

¹³¹ O’Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany*, op.cit., pp. 100-104 (the section entitled ‘Defending Corporate Managers’ “Right” to Manage’).

¹³² *ibid.*, p. 101.

¹³³ *ibid.*

¹³⁴ *ibid.*, p. 102.

¹³⁵ *ibid.*

¹³⁶ Michel Aglietta, ‘États-Unis: persévérance dans l’être ou renouveau de la croissance?’ in Robert Boyer (ed.), *Capitalismes fin de siècle*, Paris: Presses Universitaires de France, 1986, pp. 33-66, especially pp. 35-36.

¹³⁷ *ibid.*, p. 35 (our translation).

background for the pursuit of ‘individual accomplishment in accordance with the rules of competition for monetary gain.’¹³⁸

A change in ideological climate

Thus, it is primarily in the course of the last 25 years that the view that maximizing shareholder value should be the dominant principle of corporate governance, and with it the underlying assumption that economic actor are in effect motivated only by the prospect of personal economic gain (and the fear of personal economic loss),¹³⁹ has risen to prominence. This has first and foremost been the case in the USA and Britain, but in the last few years these ideas have gained influence also in continental European countries, and even in Japan. Lazonick and O’Sullivan are highly critical of these developments and of the theoretical ideas justifying them. They challenge the claim that maximizing shareholder value will result in the highest common good, and instead claim that the rise of shareholder value as a principle of corporate governance in the USA has been closely tied to a ‘transformation of US corporate strategy from an orientation towards retention of corporate earnings and reinvestment in corporate growth through the 1970s to one of downsizing of corporate labour forces and distribution of corporate earnings to shareholders over the last two decades.’¹⁴⁰

The causal relationships involved here are many and complex. These are matters which have been extensively discussed in books and articles by Lazonick and O’Sullivan. We cannot go into this in any detail here, and will only try to sum up some of the main points of their story. During the hegemony of the strategy of retain and reinvest, up through the 1970s, ‘managers tended to be integrated with the business organizations that employed them and governed the corporate enterprises that they controlled accordingly.’¹⁴¹ Their salaried compensation was ‘largely determined by pay structures within the managereial organization.’¹⁴² However, forces were at work which ‘increasingly segmented top managers of US corporations from the rest of the managerial organization.’¹⁴³ Stock options for top managers became more common, while at the same time the pay of top managers started to grow more rapidly ‘than the pay of everyone else in the corporation. During the 1980s and 1990s the explosion in top management pay has continued unabated, with stock-based rewards playing an ever more important role.’¹⁴⁴ Thus, top managers more and more came to ‘align their own interests with external financial interests rather than with the interests of the productive organizations over which they exercised control.’¹⁴⁵ Managers thus ‘developed an ever-growing personal interest in boosting the market value of their companies’ stock.’¹⁴⁶ In general, ‘the demands of financial interests to reap high returns’ gaine in importance relative to ‘the needs of

¹³⁸ *ibid.*, p. 36 (our translation).

¹³⁹ See Dore, ‘Will Global Capitalism Be Anglo-Saxon Capitalism?’, *op.cit.*, pp. 102-103.

¹⁴⁰ Lazonick and O’Sullivan, ‘Maximizing shareholder value: a new ideology for corporate governance,’ *op.cit.*, p. 13.

¹⁴¹ *ibid.*, p. 24.

¹⁴² *ibid.*

¹⁴³ *ibid.*

¹⁴⁴ *ibid.*, p. 25.

¹⁴⁵ *ibid.*, p. 27.

¹⁴⁶ *ibid.*, p. 25.

companies to improve their productive capabilities.¹⁴⁷ Behind these developments were such phenomena as the rise of powerful institutional investors, the rise of a market for corporate control, etc. The growing importance of financial interests to reap high returns also means a growing pressure for financial liquidity, at the expense of financial commitment. This is unfavourable to innovation, since financial commitment is a precondition for the development and utilization of productive resources on the basis of organizational learning which is central to innovation.¹⁴⁸ This is some of the background for the ‘new regime’ where ‘top managers downsize the corporations they control, with a particular emphasis on cutting the size of the labour forces they employ, in an attempt to increase the return on equity.’¹⁴⁹

Thus, according to O’Sullivan, with the growing importance of financial interests to reap high returns, and the institutional changes accompanying these developments, there came to be set in motion ‘a dynamic that was, in its origins and its momentum, distinct from the real economy.’¹⁵⁰ This in particular was evident during the 1980s, which O’Sullivan refers to as ‘the Deal Decade’, where ‘the challenge of developing and utilizing productive resources paled into insignificance beside the hubris of making deals.’¹⁵¹ The rise to prominence of the principle of maximizing shareholder value thus did not have the benign effects that its proponents claimed. According to O’Sullivan, the real import of these developments lay elsewhere, at a more ideological level, affecting the norms and standards guiding people’s actions. Her conclusion is that the ‘true significance’ of the ‘Deal Decade’ was that ‘it transformed the notion of what was legitimate for one person or a small group of people to extract from US corporate enterprises.’¹⁵² Formerly, even though corporate executives had earned incomes which were several times higher than the people they managed, ‘they had nevertheless been structured by the logic of building and sustaining an organization. During the 1980s, however, corporate executives began to realize that they could break free of the long-term logic of the organizations which they controlled to the extent that they were willing to exploit, as individuals, the positions which they had won through their success within the organization.’¹⁵³

Misunderstanding the foundations of a market economy: The critique of Tobin and Stiglitz

These developments point to basic shortcomings in the mainstream, neoclassical understanding of the functioning of markets and economic systems. As James Tobin warns in a critical discussion of Western economic advisers recipes for the transition to a market economy in Russia, ‘there are perils to counting too heavily on the

¹⁴⁷ O’Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany*, op.cit., p. 175.

¹⁴⁸ See, for instance, *ibid.*, p. 154.

¹⁴⁹ Lazonick and O’Sullivan, ‘Maximizing shareholder value: a new ideology for corporate governance,’ op.cit., p. 18.

¹⁵⁰ O’Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany*, op.cit., p. 175.

¹⁵¹ *ibid.*

¹⁵² *ibid.*

¹⁵³ *ibid.*

beneficent results of unmitigated self-interest.’¹⁵⁴ Understanding the institutional context is essential here: ‘The market system works within social institutions that channel and guide self-interested energies into constructive activities.’¹⁵⁵ As Marshall Pomer emphasizes, trust and cooperation are central ingredients of well-functioning economic arrangements: ‘The neoclassical paradigm, extolling the benefits of unbridled self-interest, bolsters an individualistic ethic that can impede the functioning of the market. Without a culture that fosters trust and cooperation, potential market transactions, including long-term contractual arrangements, are stifled.’¹⁵⁶ He adds that ‘an individual who, in accordance with the neoclassical paradigm, is concerned exclusively with his or her own self-interest is not trustworthy.’¹⁵⁷ Also Tobin makes it clear that the question of social institutions cannot be reduced to a question of designing clever incentive schemes which make compliance with social norms and values a matter of self-interest, claiming that ‘a civilized society cannot survive if obedience to laws and other social norms becomes solely a matter of self-interest. It cannot survive, for example, if people pay taxes only if hedonistic calculus reveals that the probability-discounted penalty of being caught exceeds the probability-discounted gain from the violation.’¹⁵⁸ Tobin also reminds us that perspectives on human action are not simply descriptions which may be more or less accurate or correct as such. To the extent that they are accepted as reasonable accounts of human action by the actors themselves, they are themselves part of the institutional context, giving standards and guidance for action. Thus, ‘the glorification of self-interested behavior and the denigration of government in recent years bear some responsibility for recent trends.’¹⁵⁹ As a summary of the above arguments we may quote Joseph Stiglitz, who claims that ‘the success of a market economy cannot be understood in terms of narrow economic incentives: norms, social institutions, social capital, and trust play critical roles.’¹⁶⁰ Failure to grasp these points he characterizes as ‘misunderstanding of the very foundations of a market economy.’¹⁶¹

The assumption of rationality as narrowly instrumental

We should also point out that in the neoclassical perspective the economic actor is not only depicted as motivated exclusively by self-interest. Closely related to this is the assumption is that human action is instrumental in a narrow sense, that we will only perform an action, engage in a project, if the expected benefits resulting from our activity exceed the costs represented by the efforts of engaging in the activity.

¹⁵⁴ James Tobin, ‘False Expectations,’ in Lawrence R. Klein and Marshall Pomer (eds.), *The New Russia: Transition Gone Awry*, Stanford: Stanford University Press, 2001, pp. 65-72, quoted from p. 66.

¹⁵⁵ *ibid.*

¹⁵⁶ Marshall Pomer, ‘Transition and Government,’ in Klein and Pomer (eds.), *op.cit.*, pp. 21-52, quoted from p. 31.

¹⁵⁷ *ibid.*, p. 44 (note 13).

¹⁵⁸ Tobin, *op.cit.*, p. 66.

¹⁵⁹ *ibid.*

¹⁶⁰ Joseph E. Stiglitz, ‘Preface,’ in Klein and Pomer (eds.), *op.cit.*, pp. xvii-xxiii, quoted from p. xxi.

¹⁶¹ *ibid.*, p. xx.

Investing for the future: Keynes on animal spirits

It is far from obvious that this is a reasonable assumption. Keynes was convinced that human activity, especially activity consisting of investment for the future, whose consequences will only materialize some time in the future, was inexplicable if understood as purely instrumental, as simply a cost which will be incurred only if exceeded by the benefits resulting from the action. To account adequately for human action we must thus not see it as motivated only by expected consequences, but also as supported by a primary urge to activity in human beings, by what Keynes called 'animal spirits': 'Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.'¹⁶² Keynes claims that mathematical expectation simply does not have a solid enough foundation here: 'human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist;' consequently, 'it is our innate urge to activity which makes the wheels go round.'¹⁶³ This suggests that it is important build and sustain an institutional environment which allows animal spirits to thrive: 'Thus if animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die.'¹⁶⁴

Lester Thurow on human beings as social builders

A similar argument is made by Lester Thurow. He claims that 'human beings are social builders who can get direct benefits – utility – from building,'¹⁶⁵ a view which is 'completely left out of standard economic theory.'¹⁶⁶ Building, he contends, 'is a process of creation, and humans are by nature creative.'¹⁶⁷ However, how individuals will in actual fact value building 'depends upon their social conditioning.'¹⁶⁸ The dominant ideology in America today, he claims, is not favourable to building. On the contrary, 'all our social conditioning is now leading not just toward toward the primacy of individual consumption but toward the view that nothing else matters at all.'¹⁶⁹ This comes on top of what he claims is a built-in tendency of capitalism 'to save and invest too little.'¹⁷⁰ Thurow thus claims that 'building must be seen not just as an investment made to increase future consumption but as an end in and of itself.'¹⁷¹ This requires that an ideology extolling investment be invented and

¹⁶² John Maynard Keynes, *The General Theory of Employment, Interest and Money*, Volume VII of The Collected Writings of John Maynard Keynes, London: Macmillan, 1973, p. 161. Originally published in 1936.

¹⁶³ *ibid.*, pp. 162-163.

¹⁶⁴ *ibid.*, p. 162.

¹⁶⁵ Lester C. Thurow, *Creating Wealth: The New Rules for Individuals, Companies, and Countries in a Knowledge-Based Economy*, London: Nicholas Brealey Publishing, 1999, p. 159.

¹⁶⁶ *ibid.*

¹⁶⁷ *ibid.*, pp. 159-160,

¹⁶⁸ *ibid.*, p. 159.

¹⁶⁹ *ibid.*, p. 160.

¹⁷⁰ *ibid.*, p. 159.

¹⁷¹ *ibid.*

sustained: ‘Urges to build have to be supported so that they are at least coequal with urges to consume.’¹⁷²

Understanding motivation: extrinsic and intrinsic motivation

This is closely related to the question of the motivation of employees and of economic actors more generally, which we discussed above in relation to the perspectives of, especially, Herbert Simon. In an article summing up research on the question of variable pay for performance, Margit Osterloh and Bruno S. Frey point to the central distinction between *extrinsic* and *intrinsic* motivation.¹⁷³ *Extrinsic motivation* obtains when an activity is performed in order to get something else, i.e. some external reward, in practice money. This is, in effect, the only type of motivation acknowledged in mainstream economic thought, and is the view of motivation which justifies the view that employees’ pay be linked to performance.¹⁷⁴ *Intrinsic motivation* means that the activity is undertaken for its own sake or because one believes that the result of the activity is important. This may relate to a ‘self-defined goal, such as, for example, climbing a mountain, or to the obligations of personal and social identities.’¹⁷⁵ One may be concerned about the contribution one’s activity makes to community, and one may also simply find the task one is set to perform challenging and interesting, become absorbed in the problems needing to be solved in order to accomplish the task, etc. Intrinsic motivation is, of course, the type of motivation involved when Herbert Simon emphasizes the identification of employees with the goals of the firm, pride in one’s work among employees, etc., without which it becomes inexplicable why ‘many workers, perhaps most, exert more than minimally enforceable effort.’¹⁷⁶

The conclusions which Osterloh and Frey refer may be summed up as follows. Extrinsic motivation is sufficient for some work. More specifically, extrinsic motivation, and thus variable pay for performance, is ‘adequate only for simple jobs,’ ‘when the work is routinized and the performance is easy to measure.’¹⁷⁷ By contrast, for complex and novel tasks, of the kind which are ‘a typical feature of knowledge-intensive companies which today comprise the most rapidly growing segment of the economy,’ requiring involvement and creativity, intrinsic motivation is crucial.¹⁷⁸ However, the conclusion here is not simply that extrinsic motivation is *insufficient* in the latter cases, thus in need of being supplemented by intrinsic motivation. The conclusion is much stronger than this. The relationship between extrinsic and intrinsic motivation is not additive. ‘Rather, there is a systematic dynamic relationship between the two,’ referred to as ‘crowding effects.’¹⁷⁹ Particularly, ‘monetary compensation can crowd out intrinsic motivation’¹⁸⁰ and thus ‘undermine

¹⁷² *ibid.*, p. 160.

¹⁷³ Margit Osterloh and Bruno S. Frey, ‘Does pay for performance really motivate employees?’ in Andy Neely (ed.), *Business Performance Measurement: Theory and Practice*, Cambridge: Cambridge University Press, 2002, pp. 107-122.

¹⁷⁴ *ibid.*, pp. 108-109.

¹⁷⁵ *ibid.*, p. 109.

¹⁷⁶ Simon, *op.cit.*, p. 34.

¹⁷⁷ Osterloh and Frey, *op.cit.*, p. 108, p. 116.

¹⁷⁸ *ibid.*, pp. 107-108.

¹⁷⁹ *ibid.*, p. 108.

¹⁸⁰ *ibid.*

employees efforts.’ Reward systems such as variable pay for performance and bonuses thus ‘usually, but not always, make employees lose interest in the immediate goal’ and accordingly ‘lower their performance.’¹⁸¹ Furthermore, ‘monetary incentives in complex and novel tasks tend to produce stereotyped repetition.’¹⁸²

These conclusions are backed by a large number of empirical studies, both experimental and field studies.¹⁸³ Thus, the crowding-out effect ‘provides a possible explanation for the overwhelming empirical evidence that there is no significant connection between pay and performance, except for simple jobs’ – and even in the latter case the literature is full of counter examples.’¹⁸⁴ Furthermore, these insights have strong support from theoretical arguments. For instance, ‘according to *cognitive evaluation theory* intrinsic motivation is substituted by an external intervention which is perceived as a restriction to act autonomously. The locus of control shifts from inside to outside the person. The person in question no longer feels responsible but rather attributes responsibility to the person undertaking the outside intervention.’¹⁸⁵ These arguments are quite compatible with the arguments concerning *trust* which we have discussed earlier in this paper.

To these problems are added the well known distortions introduced by measurement problems. Actors focus on the indicators used to measure the results, which may more or less accurately reflect what one is really after, and they focus on rewarded aspects of the job, neglecting the unrewarded ones.¹⁸⁶ Not least there is the problem of identifying individual contributions in cases where products largely are the results of collective efforts and processes.

To sum up these arguments, ‘intrinsic motivation is needed for tasks that require creativity; in contrast, extrinsically motivated persons tend to produce stereotyped repetition of what already works.’¹⁸⁷ In addition, intrinsic motivation is crucial, and extrinsic motivation dysfunctional, in relation to learning and the transfer of tacit knowledge.¹⁸⁸

The above arguments seem quite devastating for the view that incentive schemes to control managers and assure that they act in the interests of shareholders are a requisite for a sound system of corporate governance – unless, that is, one should consider what managers do as ‘simple jobs.’ (Which, incidentally, is precisely what Kirzner, among others, claims that neoclassical theory in effect assumes, as we saw above.)

Thus, instead of presupposing what Stiglitz calls ‘the economists’ standard incentives paradigm,’¹⁸⁹ thus severely restricting the range of questions which it becomes

¹⁸¹ *ibid.*, p. 110, p. 107.

¹⁸² *ibid.*, p. 107.

¹⁸³ *ibid.*, pp. 112-114.

¹⁸⁴ *ibid.*, p. 114.

¹⁸⁵ *ibid.*, p. 111. Italics in the original.

¹⁸⁶ *ibid.*, p. 107, p. 114.

¹⁸⁷ *ibid.*, p. 114.

¹⁸⁸ *ibid.*, pp. 114-115.

¹⁸⁹ Stiglitz, ‘Symposium on Organizations and Economics,’ *op.cit.*, p. 22.

possible to ask by in effect simply assuming that motivation is extrinsic, Osterloh and Frey claim that an important task becomes to understand the conditions for producing ‘the right balance between intrinsic and extrinsic motivation.’¹⁹⁰ This also implies coming to grips with intrinsic motivation, what conditions favour it, how it can be supported. This has much to do with communication and dialogue, with organizational learning, with cooperation, participation and co-determination, with self-determination and responsibility.¹⁹¹ In general, the question of intrinsic motivation in a particularly clear way points to the need to see firms and other organizations as collective entities, where the people involved are seen as members of these collective entities – although, as pointed out above, also at the same time members of other social entities, with complex relationships among these different social entities.¹⁹² This raises a number of important questions, for instance concerning conditions for membership, the importance of fairness and justice,¹⁹³ the nature of authority and leadership, the central question of legitimacy, etc.

Implications of the rejection of the neoclassical incentives paradigm

In this paper we have discussed the recent concern with the issue of corporate governance. We have seen that this concern has been driven and dominated by a view that the principle of corporate governance should be to maximize shareholder value. The issue of corporate governance has thus been restricted to the relationship between shareholders and managers, where the dominating problem is seen to be how to make managers act in the interests of the shareholders.

We have also seen that this conception of what corporate governance is all about rests on quite specific assumptions, namely neoclassical ideas about the optimality characteristics of the perfect market economy, with the underlying assumptions that economic actors are exclusively self-interested and thus motivated only by the prospect of personal economic gain. We have discussed these assumptions quite extensively, and argued that there is ample reason to have serious reservations against them.

Once one has major reservations against these assumptions and thus rejects the idea of using ‘the theory of the perfect market economy ... as the benchmark for economic efficiency,’¹⁹⁴ there is no longer any basis for restricting corporate governance to a relationship between owners (shareholders) and managers, or more generally between ‘principals’ represented by owners (shareholders) and ‘agents’ represented in principle not only by managers but by everyone which the nominal owner is seen to employ to perform the tasks necessary to run the enterprise.

¹⁹⁰ Osterloh and Frey, op.cit., p. 107.

¹⁹¹ *ibid.*, pp. 116-117.

¹⁹² For an interesting theoretical contribution in this regard, conceptualizing society in terms of multiple overlapping networks of interaction, power and organization, see Michael Mann, *The Sources of Social Power. Volume I: A History of Power from the Beginning to A.D. 1760*, Cambridge: Cambridge University Press, 1986, especially pp. 1-32.

¹⁹³ Osterloh and Frey, op.cit., p. 112, pp. 117-118.

¹⁹⁴ O’Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany*, op.cit., p. 3.

With this restriction of the field of enquiry rejected, there then opens up a large array of questions and problems potentially relevant for the issue of corporate governance. If this issue is not simply to cover a multitude of questions which are vaguely relevant to how business firms are governed and function, one needs an organizing theoretical perspective which guides research and points out why and in which ways different questions are important and relevant and thus worth investigating more closely

Outline of an alternative view – Lazonick and O’Sullivan

In the literature explicitly addressing the issue of corporate governance there has, according to Mary O’Sullivan, in effect only been one contender to the maximizing shareholder value perspective, namely what has been known as the ‘stakeholder’ perspective.¹⁹⁵ Stakeholders are everyone with a stake in the enterprise, i.e., in addition to shareholders and managers, also employees, consumers, suppliers, the local community, etc. The stakeholder perspective is also concerned with the allocation of resources, but argues that the interests of other stakeholders besides shareholders should also be taken into account. The stakeholder perspective is, according to O’Sullivan, much less theoretically grounded than the shareholder perspective, indeed, it is ‘more often expounded as a political position than as an economic theory of governance.’¹⁹⁶ This perspective thus risks simply becoming ‘a de facto theory of corporate welfare,’ easily encouraging ‘the entrenchment of the claims of economic actors who have participated in and benefitted from wealth creation in the past, even when the integration of their skills is no longer a viable basis on which the economy can generate the returns to meet these claims.’¹⁹⁷ O’Sullivan mentions the work of Margaret Blair as one of the few within this perspective (she calls it an ‘exception’) which bases its reasoning on explicit economic analysis. Blair’s work, however, also uses neoclassical ideas of residual risk and residual claimants: employees invest their ‘human capital’ in firm-specific skills, and are thus also in effect ‘residual claimants.’¹⁹⁸ This perspective also, like the neoclassical perspective, considers resource allocation only as rewards to individuals, which ‘precludes an understanding of the economic foundations of strategic control by one group of people over the learning opportunities of others.’¹⁹⁹

Focus on innovation

Lazonick and O’Sullivan instead propose what they call an organizational control theory of corporate governance. The theoretical perspective is here oriented towards coming to grips with the *innovative* firm; it thus has to be based on a theoretical understanding of innovation processes. Instead of a theory of corporate governance based on the idea that the essence of economic success consists in constrained

¹⁹⁵ See *ibid.*, pp. 52-58.

¹⁹⁶ *ibid.*, p. 52.

¹⁹⁷ *ibid.*, p. 56.

¹⁹⁸ *ibid.*, pp. 53-57. O’Sullivan refers to Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*, Washington, DC: Brookings Institution, 1995.

¹⁹⁹ O’Sullivan, *op.cit.*, p. 58.

maximization, where firms take products and their prices as given data, Lazonick and O’Sullivan claim that to grasp capitalist development we need a theory of the innovative enterprise, constantly aiming at supplying ‘higher-quality products at lower unit costs.’²⁰⁰ They thus propose an organizational control perspective on corporate governance. Developing innovations necessitates a sustained commitment of resources over a considerable period of time, and the outcome of the effort is uncertain. They claim that a system of corporate governance which is to support innovation must generate three conditions: ‘financial commitment, organizational integration, and insider control.’ These are needed for, respectively, ‘1) the commitment of resources to irreversible investments with uncertain returns; 2) the integration of human and physical resources into an organizational process to develop and utilize technology; and 3) the vesting of strategic control within corporations in the hands of those with the incentives and abilities to allocate resources to innovative investments.’ These conditions ‘support *organizational control* in contrast to *market control* over the critical inputs to the innovation process: knowledge and money.’²⁰¹

The role of commitment of resources

The importance here attached to *commitment* (financial commitment, commitment of resources) contrasts sharply with the orthodox ideas of market coordination as the superior form of economic coordination. The orthodox theory assumes *opportunistic* actors, constantly on the search for the highest possible returns from their investments. Commitment, on the other hand, fundamentally implies some form of curtailment or suspension or limitation of opportunism. This, however, to the orthodox perspective appears as *irrationality*, something which hinders the smooth and efficient working of the market mechanism. From the perspective of Lazonick and O’Sullivan, on the other hand, this confirms the orthodox theory’s almost exclusive preoccupation with how resources and returns are allocated at a point in time, and the consequent failure to focus on the question of how resources are developed and utilized over time.²⁰² Thus, as O’Sullivan comments, ‘from the perspective of innovation, the most critical “market imperfections” that conventional economists cite – imperfection in financial markets, labour markets, and product markets – may not be imperfections at all but rather improvements in social organization that foster technological innovation and economic development.’²⁰³

Lazonick and O’Sullivan thus claim that from the perspective of the development of resources over time organizational allocation of resources tends to be superior to market allocation of resources. This is furthermore closely connected to Lazonick’s critique of the neoclassical characterization of modern capitalist economies as ‘market economies.’ Although ‘market exchange remains a distinctive feature of advanced capitalist economies,’ Lazonick claims, ‘the historical experience of capitalist development demonstrates the growing importance of *organizational coordination* relative to *market coordination* in the value-creation process.’²⁰⁴ This,

²⁰⁰ Lazonick, *Business Organization and the Myth of the Market Economy*, op.cit., p. 92.

²⁰¹ Lazonick and O’Sullivan, *Perspectives on Corporate Governance, Innovation, and Economic Performance*, op.cit., p. 70.

²⁰² *ibid*, p. 46.

²⁰³ O’Sullivan, op.cit., p. 31.

²⁰⁴ Lazonick, *Business Organization and the Myth of the Market Economy*, op.cit., p. 59.

in essence, is also a point made Herbert Simon. He questions why we should call our economies ‘market economies’ at all, and suggests that ‘organizational economy’ would be a better term, ‘with market relations among organizations.’²⁰⁵

Again we should remember that this issue is not only one of the respective importance of markets in relation to other types of institutions and arrangements, but also of the very conception of what markets themselves are all about and how they function.

A comparative perspective

In general, as Richard Nelson emphasizes, ‘once the optimality argument falls away, there would seem to be no way to avoid comparing how market organization performs against alternative structures.’²⁰⁶ However, ‘modern market capitalism (or any plausible alternative system) is very complex and variegated,’²⁰⁷ and market organization thus comes in many different forms. So rather, once arguments based on the optimality of the model of the perfect market economy are rejected as invalid or irrelevant, there is no way to avoid comparative empirical investigation of different institutional arrangements, implying comparing different forms of market organizations, different ways markets are embedded in wider social structures, different norms and standards guiding the orientation of market participants, etc. Modern capitalist economies are highly complex institutional structures, and these institutional structures also vary considerably *across* economies.²⁰⁸ Different institutional arrangements will have different strengths and weaknesses, for instance in different regards, in different kinds of situations, in different kinds of production, different ways of organizing economic activity may be more or less suited to different kinds of cultures,²⁰⁹ etc.

Implications for the analysis of Norwegian governance institutions

The above discussion provides a background for the analysis of Norwegian corporate governance institutional arrangements. Rejecting the neoclassical optimality argument and the corresponding reduction of corporate governance to an agency problem, we are left with a perspective emphasizing a much more empirically grounded analysis of different institutional arrangements. This perspective must in essence be comparative. The description of analysis of institutional arrangements must be done with a view to compare the performance of different kinds of institutional arrangements under different circumstances. The theoretical background will be the kinds of critical contributions referred to in support of our argumentation

²⁰⁵ Simon, ‘Organizations and Markets,’ op.cit., p. 28-29.

²⁰⁶ Richard R. Nelson, ‘The problem of market bias in modern capitalist economies,’ *Industrial and Corporate Change*, Volume 11, Number 2, 2002, pp. 207-244, quoted from p. 221.

²⁰⁷ *ibid.*, 222.

²⁰⁸ See, for instance, Colin Crouch and Wolfgang Streeck, ‘Introduction: The Future of Capitalist Diversity,’ in Crouch and Streeck (eds.), *Political Economy of Modern Capitalism: Mapping Convergence and Diversity*, op.cit., pp. 1-18, and, more generally, all the contributions to this volume.

²⁰⁹ Cf. Wolfgang Streeck’s discussion of the question of introducing Japanese types of ‘lean production’ in the German cultural and institutional setting, in Streeck, ‘Lean Production in the German Automobile Industry: A Test for Convergence Theory,’ op.cit.

above. The contributions of Lazonick and O’Sullivan will be central here, but also many other contributions will be highly relevant. For even if, as O’Sullivan claims, in the literature explicitly addressing the issue of corporate governance there is not much to build on if one is critical of the shareholder value perspective dominating this literature, there are many highly relevant contributions outside of the literature explicitly addressing the issue of corporate governance. These range from studies of organizations to studies addressing economic governance issues more generally.

Of special interest are theoretical traditions stressing the embeddedness of economic mechanisms in broader institutional arrangements and the diversity of institutional arrangements across countries and regions and their variation across time, such as the contributions by, for instance, Ronald Dore and Wolfgang Streeck referred to above.²¹⁰ One tradition we can mention here is the French regulation school, connected to names like Michel Aglietta, Robert Boyer and Alain Lipietz.²¹¹ Another, related, tradition, connected to names like J. Rogers Hollingsworth, Wolfgang Streeck and John L. Campbell also explicitly addresses the issue of the governance of capitalist economies from the perspective of the embeddedness of economic mechanisms in broader social institutions.²¹² The term *governance* here has more or less the same meaning as the term *regulation* as used within the regulation school. The same kind of concern with institutional arrangements is found in the writing on regional economies by authors like Charles F. Sabel and Jonathan Zeitlin.²¹³ A related, and highly relevant perspective is represented by the work on the comparative analysis of business systems by Richard Whitley and associates.²¹⁴ Of very high relevance is of course also more micro level studies of firms and of organizations more generally, as for instance the work of Herbert Simon. We can here also mention the evolutionary perspective on the firm, as developed by authors like Nelson and Winter, where firms and organizations are viewed in terms of ‘packages of routinized competence’ and ‘repositories of productive knowledge and arrangements for advancing such knowledge.’²¹⁵ These are only some of the

²¹⁰ A classical contribution here is Granovetter, ‘Economic Action and Social Structure: The Problem of Embeddedness,’ op.cit. For other interesting contributions, see J. Rogers Hollingsworth and Robert Boyer (eds.), *Contemporary Capitalism: The Embeddedness of Institutions*, Cambridge: Cambridge University Press, 1997, and Crouch and Streeck (eds.), *Political Economy of Modern Capitalism: Mapping Convergence and Diversity*, op.cit.

²¹¹ See, for instance, the references to these authors earlier in this paper.

²¹² See J. Rogers Hollingsworth, Philippe C. Schmitter and Wolfgang Streeck (eds.), *Governing Capitalist Economies: Performance and Control of Economic Sectors*, New York: Oxford University Press, 1994, and John L. Campbell, J. Rogers Hollingsworth and Leon N. Lindberg (eds.), *Governance of the American Economy*, Cambridge: Cambridge University Press, 1991.

²¹³ See, for instance, the previously mentioned article by Sabel, ‘Flexible Specialisation and the Re-emergence of Regional Economies,’ op.cit.

²¹⁴ See Richard Whitley (ed.), *European Business Systems: Firms and Markets in their National Contexts*, London: Sage Publications, 1992, and Richard Whitley and Peer Hull Kristensen (eds.), *The Changing European Firm: Limits to Convergence*, London: Routledge, 1996.

²¹⁵ See, for instance, Sidney G. Winter, ‘Survival, Selection, and Inheritance in Evolutionary Theories of Organization,’ in Jitendra V. Singh (ed.), *Organizational Evolution: New Directions*, Newbury Park: Sage Publications, 1990, pp. 269-297. The quotes are from p. 280 of this article.

contributions in the social science literature relevant for the issue of corporate governance more broadly conceived.

These and other theoretical perspectives can help us construct dimensions along which issues and problems may be identified.

One important dimension here relates to the question of organizational integration, central to Lazonick and O’Sullivan’s perspective. To what extent does the economy invest in narrow or broad skill bases, to what extent is the economy elitist or democratic in this regard? In Dore’s terminology, to what extent do firms conform to the managerial community view and to what extent to the employee community view? How large part of the work force is reduced to doing simple, repetitive jobs, for which extrinsic motivation and extrinsic incentives are adequate, labour thus having the character of an ordinary ‘factor of production’? How large is the segment of the working population who work on complex tasks where intrinsic motivation is crucial, thus in effect requiring integration in the organization for which they work? Here the USA typically lies towards the elitist pole, Germany and Japan towards the democratic. What are the strengths and weaknesses of each of these contrasts? This will, among other things, depend on the kind of technology prevailing and on the tendencies of technological development, which, again, will vary across industries. More generally, the elitist type will allow more short term flexibility, thus being better at the destruction part of the process of creative destruction which capitalist development implies.²¹⁶ It may thus be especially well suited to turbulent periods with large changes in industrial structures, etc. The more democratic type, will have other strengths, perhaps allowing for more cumulativeness and social cohesion, etc. We cannot go further into these questions here, but they are important for questions of the relationship between corporate governance and economic performance.

Another important dimension relates to what Lazonick and O’Sullivan calls ‘financial commitment,’ concerning how investments are financed. What is the role of the banking system, retained earnings, the stock market, etc. in this regard? Of high relevance here will be the balance of power between financial and industrial interests in society, etc.

A third dimension relates to the structure of ownership and control. What is the relationship between formal ownership and effective control? What does the distribution of shares look like, what are the conditions for groups of share owners to effectively control companies, etc.? Under this dimension we also get the question of to what extent there is what Lazonick and O’Sullivan term ‘insider control,’ i.e., strategic control ‘in the hands of those who, as insiders, have the incentives and abilities to allocate resources to innovative investments.’²¹⁷

Here we also get the question of whether and to what extent the concrete identity of owners matters. In a Norwegian context this is especially relevant both in relation to public ownership and to foreign ownership. Do public owners tend to be more socially responsible, more oriented to longer term development? Are foreign owner less committed to the particular society where the firm in question is located, and

²¹⁶ Cf. Thurow, *Creating Wealth: The New Rules for Individuals, Companies, and Countries in a Knowledge-Based Economy*, op.cit., pp. 82-98.

²¹⁷ O’Sullivan, *Contests for Corporate Control*, op.cit., p. 39.

thus more likely to shut down or reduce activity when profit opportunities appear to be larger elsewhere?

The issue of the real control of firms also brings in the question of the relationships among firms. Firms may in varying degrees be involved in networks of cooperation with other firms. As Mark Granovetter argues, they may in varying degrees be integrated or bound together, ranging from ‘completely’ to ‘barely at all,’ from ‘legally consolidated into a single entity’ to ‘bound merely by short-term strategic alliances,’ the most interesting cases perhaps being firms bound together at ‘an “intermediate” level of binding,’ in which case we have what Granovetter refers to as ‘business groups.’²¹⁸ The binding may be more or less formalized, for instance according to the degree it involves firms owning shares in other firms. Relationships among firms may also in varying degrees be formalized through membership in associations. Another important characteristic concerns the equality or inequality of the relationships. Are the relationships in question relationships between relatively equal partners, or are they relationships based on the dominance of some partners over others? And to the extent that the relationships are based on dominance of some firms over others, does this domination tend to have a repressive, exploitative quality, based primarily on force, or does it rather have the character of hegemonic leadership of a more benign, cooperative kind.

An important issue here is to what extent public institutions are involved in these kinds of relationships among firms, and, furthermore, to what extent they are involved as public authorities. Also cultural conditions, for instance regarding attitudes towards entrepreneurship, towards cooperation and authority, etc., will in important ways influence what corporate governance institutions will look like. More generally, the shaping of corporate governance institutions will crucially depend on ideological and political conditions.

A research and policy agenda

As argued at length above; as soon as one widens the view from the narrow, equilibrium agency-problems there opens up quite another research and policy agenda. The overall aim is of course to maximise social welfare through producing goods and services in the most efficient and sustainable way. Doing so one would in a way reformulate, give quite new meaning to many of the core concepts of neo-classical economics. A bit paradoxical one could argue that ‘perfect information’ on firm level is reached when all the information of all the employees are utilised to the maximum through transparent, interactive, inclusive information systems in each firm. That ‘perfect information’ on a societal basis is reached by various mechanism of knowledge diffusion taking its starting point:

- The ‘common good’ character of information and knowledge,
- The importance of trust,
- Of professional networks.
- Of information sharing and power structures enhancing the innovative capabilities of firms, clusters and society as a whole

²¹⁸ Mark Granovetter, ‘Coase Revisited: Business Groups in the Modern Economy,’ *Industrial and Corporate Change*, Volume 4, Number 1, 1995, pp. 93-130, quoted from p. 95 and pp. 96-97.

- The importance of entrepreneurial culture, of both competition and cooperation
- the attitude of owners and managers to the lower level employees

STEP RAPPORTER / REPORTS

ISSN 0804-8185

STEP ARBEIDSNOTATER / WORKING PAPERS

ISSN 1501-0066

All reports and working papers are available for free download in full text from

<http://www.step.no/>

Hammersborg torg 3, N-0179 Oslo, Norway
Telephone +47 2286 8010
Fax: +47 2286 8049
Web: <http://www.step.no/>



STEP-gruppen ble etablert i 1991 for å forsyne beslutningstakere med forskning knyttet til alle sider ved innovasjon og teknologisk endring, med særlig vekt på forholdet mellom innovasjon, økonomisk vekst og de samfunnsmessige omgivelser. Basis for gruppens arbeid er erkjennelsen av at utviklingen innen vitenskap og teknologi er fundamental for økonomisk vekst. Det gjenstår likevel mange uløste problemer omkring hvordan prosessen med vitenskapelig og teknologisk endring forløper, og hvordan denne prosessen får samfunnsmessige og økonomiske konsekvenser. Forståelse av denne prosessen er av stor betydning for utformingen og iverksettelsen av forsknings-, teknologi- og innovasjonspolitikken. Forskningen i STEP-gruppen er derfor sentrert omkring historiske, økonomiske, sosiologiske og organisatoriske spørsmål som er relevante for de brede feltene innovasjonspolitik og økonomisk vekst.

The STEP-group was established in 1991 to support policy-makers with research on all aspects of innovation and technological change, with particular emphasis on the relationships between innovation, economic growth and the social context. The basis of the group's work is the recognition that science, technology and innovation are fundamental to economic growth; yet there remain many unresolved problems about how the processes of scientific and technological change actually occur, and about how they have social and economic impacts. Resolving such problems is central to the formation and implementation of science, technology and innovation policy. The research of the STEP group centres on historical, economic, social and organisational issues relevant for broad fields of innovation policy and economic growth.