Stakeholder Theory, Corporate Governance and Public Management: What can the History of State-Run Enterprises Teach us in the Post-Enron era?

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ABSTRACT. This paper raises a challenge for those who assume that corporate social responsibility and good corporate governance naturally go hand-in-hand. The recent spate of corporate scandals in the United States and elsewhere has dramatized, once again, the severity of the agency problems that may arise between managers and shareholders. These scandals remind us that even if we adopt an extremely narrow concept of managerial responsibility – such that we recognize no social responsibility beyond the obligation to maximize shareholder value – there may still be very serious difficulties associated with the effective institutionalization of this obligation. It also suggests that if we broaden managerial responsibility, in order to include extensive responsibilities to various other stakeholder groups, we may seriously exacerbate these agency problems, making it even more difficult to impose effective discipline upon managers. Hence, our central question: is a strong commitment to corporate social responsibility institutionally feasible? In searching for an answer, we revisit the history of public management, and in particular, the experience of social-democratic governments during the 1960s and 1970s, and their attempts to impose social responsibility upon the managers of nationalized industries. The results of this inquiry are less than encouraging for proponents of corporate social responsibility. In fact, the history of public-sector management presents a number of stark warnings, which we would do well to heed if we wish to reconcile robust social responsibility with effective corporate governance.

KEY WORDS: agency problems, corporate governance, corporate social responsibility, multitask agency problems, multiprincipal agency problems, public management, stakeholder theory

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Introduction

For supporters of the "stakeholder theory" (SHT) of the firm, shareholders are but one of a number of important stakeholder groups. Like customers, suppliers, employees, and local communities, shareholders have a stake in, and are affected by, the firm's success or failure. According to one typical formulation of the claim, "*In the same way* that a business owes special and particular duties to its investors ... it also has different duties to the various stakeholder groups."[1] The firm and its managers have special obligations to ensure that the shareholders receive a "fair" return on their investment; but the firm also has special obligations to other stakeholders, which go above and beyond those required by law. In cases where these interests conflict, the demands and interests of some stakeholders, including shareholders, must be moderated or sacrificed in order to fulfill basic obligations to other stakeholders.

Naturally, this idea of "shareholders as just another stakeholder group" is not one that underlies corporate law in most market economies. In corporate law, shareholders are given pre-eminent status as the owners of the firm. They are able to elect all or most of the members of Board of Directors,

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which in turn has the right to hire and fire senior executives and approve or reject important policies and strategies of the firm. In effect, the shareholders have the right to treat the firm as a vehicle to maximize the return on their investment. While the board is supposed to ensure that the firm respects its legal and contractual obligations to other stakeholder groups, it is also fully within its rights to instruct managers to consider the ultimate purpose of the firm to be the maximization of profits and shareholder value.[2]

Because of the extraordinary status and control that shareholders are given under corporate law, stakeholder theorists have tended to devote relatively little attention to defending shareholder rights. The assumption has been that shareholders already have the power to ensure that their interests are taken into account by the firm and its managers. Stakeholder theorists who have considered the basis for shareholders' rights have usually tried to demonstrate why these rights should be limited or circumscribed by the rights or interests of other stakeholder groups.

''Enron'' should make us reconsider this assumption. We use ''Enron'' here as a symbolic stand-in for the wave of corporate scandals that rocked American business between late 2001 and throughout 2002 (involving leading firms like Arthur Andersen, WorldCom, General Electric, Tyco, Qwest, Adelphia, Halliburton, Global Crossing, AOL Time-Warner, Merrill Lynch, Health South and, of course, Enron). As it turns out, shareholders in the Enron era did *not* have the power to assure that their interests were fully taken into account by senior management. While there is no common explanation of what went wrong in these companies, we can nevertheless trace the source of almost all of these scandals to a break-down of the governance relation between shareholders, the board, and the senior executives. There are obvious lessons here for those with a vested interest in the system of shareholder-focused capitalism – i.e. investors, brokerages, auditors, financial regulators, legislators, and so on – and their reaction has been swift. Authorities tried quickly to identify the flaws in the governance relation that had facilitated the most egregious malfeasance, and then proposed ''patches,'' often in the form of revised regulations or voluntary codes, to discourage or prevent similar scandals in the future.[3] The principal aim of virtually all of these post-Enron reforms has been to strengthen the accountability of corporate executives to their boards and their shareholders.

In this paper we argue that ''Enron'' offers even more important lessons for stakeholder theorists who oppose the dominant shareholder-focused conception of the firm. First, stakeholder theorists have underestimated the extent to which shareholder interests and shareholder control are crucial to furthering the interests of other stakeholders of the firm. Every one of the stakeholders of Enron was harmed when its senior managers conspired against the interests of the shareholders and when investors lost confidence in the company. And second, issues of governance and corporate law have received insufficient attention among advocates of a radical departure from the shareholder-focused conception of the firm. Although we will in several places highlight the reasons for believing there should be a strong convergence of the interests of shareholders and other stakeholders, our focus will be on the relevance of agency problems to governance in general, and to the governance of ''stakeholder-friendly'' firms in particular.

The breakdown of the governance relation in the scandals of the Enron era was at heart a failure of these firms and their shareholders to protect themselves against agency problems. By exploiting information asymmetries and conflicts of interests on the board, the agents (senior executives) were able to act against the interests of the principals (the shareholders), and to do so with a reasonable expectation of evading punishment. The central question posed in this paper will be whether governance relations in firms that assume primary obligations not just to shareholders but to other stakeholder groups as well can be safeguarded from comparable agency problems. This question will be approached from two angles: first, by looking at some abstract, structural features of agency problems that are likely to pose a challenge for what we might call a stakeholder theory of governance; and second, by proposing what we believe to be a fruitful area of empirical and scholarly research for those interested in the viable governance of stakeholder-friendly firms in the private sector, viz., the study of governance failures in *public sector* firms with multi-stakeholder, or ''social responsibility'' mandates.

The primary goal of this inquiry will be to make the case for bringing together two very extensive debates – within stakeholder theory, on the one hand, and within public management, on the other – that have hitherto been carried on in mutual isolation. The moral of this cautionary tale about agency theory and public management will be that any naïve restructuring of corporate law and corporate governance to encourage stakeholder management could result in firms that are prone to both the internal fraud of Enron and the colossal inefficiencies of, say, Ontario Hydro or British Steel.[4] Because of these potential problems, the basic normative intuitions behind stakeholder theory might best be met by strategies carried out within firms that retain a shareholder-focused governance structure.

Corporate social responsibility and stakeholder theory

It is important to begin by clarifying which aspects of ''stakeholder theory'' are most relevant to the analysis of corporate governance. It is not the purpose of this paper to provide an overview of the vast literature on corporate social responsibility (CSR), stakeholder theory (SHT) and the so-called Triple Bottom Line (3BL). What matters is simply the core conviction of those committed to such models: that corporations have more extensive duties to key stakeholder groups like employees, communities, customers, suppliers, and so on, than is strictly required by law. All of these theories stand in opposition to a supposedly more classical conception of managerial obligation where, to quote Milton Friedman, the only ''social responsibility of business is to maximize profits'' (Friedman, 1970), and where shareholders are the pre-eminent stakeholders. To get a clearer picture of both stakeholder theory and its classical alternatives it is worth distinguishing several very different, if sometimes interrelated, theories:[5]

1. *Ontological SHT.* A theory about the fundamental nature and purpose of the corporation. A firm is essentially an ''organizational entity through which many different individuals and groups attempt to achieve their ends''.[6] ''The very purpose of the firm…is to serve as a vehicle for coordinating stakeholder interests.''[7] This stands in contrast to the shareholder-centred view of the firm as an economic entity that marshals resources for the purpose of making a profit for its owners.
2. *Explanatory SHT.* A theory that purports to describe and explain how corporations and their managers actually behave. ''Managing stakeholder relations, rather than managing inputs and outputs, may provide a more adequate model for understanding what people in corporations actually do …''[8]
3. *Strategic SHT.* A theory about how devoting sufficient resources and managerial attention to stakeholder relations will tend to lead to positive (profitable) outcomes for the corporation.
4. *SHT of Branding and Corporate Culture.* A subset of strategic SHT, this is a theory about how a commitment to pay extraordinary attention to the interests of particular stakeholder groups (especially customers and/or employees, but also in some cases to ''communities'' concerned with the environment or with human rights) can be fundamental aspect of a firm's basic branding and corporate culture. ''Dolphin-friendly'' or ''The customer is king'' can be profitable strategies.
5. *Deontic SHT.* A theory that determines the legitimate interests and rights of various stakeholders (presumably going above and beyond their legal rights), and uses these as a way of determining corporate and managerial duties.
6. *Managerial SHT.* A catch-all theory of management (incorporating theories of organizational behavior, HRM, CRM, leadership, operations research, accounting, and so on) that helps leaders and managers to realize the strategic benefits and satisfy the deontic requirements of SHT. ''Stakeholder management requires, as its key attribute, simultaneous attention to the legitimate interests of all appropriate stakeholders, both in the establishment of organizational structures and general policies and in case-by-case decision making.''[9]

7. *SHT of Governance.* A theory about how specific stakeholder groups should exercise oversight and control over management (e.g. which groups, in addition to shareholders, should be represented on the board, and how the board should function).
8. *Regulatory SHT.* The theory of which interests and rights of specific stakeholder groups ought to be protected by government regulation of business activities. In modern market societies, the dictate of "maximize profits while obeying the law" will necessarily involve fulfilling a vast body of obligations to suppliers, employees, customers, communities, and so on, since these obligations are legally binding.
9. *SHT of Corporate Law.* A theory about how traditional corporate law should be amended to reflect the principles and practices favoured by Ontological, Deontic and Governance approaches to SHT. Among other things, such an approach to corporate law would have to shield managers who favor non-profit-maximizing strategies of serving stakeholder interests from the wrath of shareholders and financial markets. Most importantly, it will have to give managers the ability to fend off hostile takeovers when other investors believe they could realize greater profits by changing managers and strategy.

There is a debate in the literature over whether it makes sense to talk about a unified stakeholder theory, or whether there are really many different kinds of theories that come into play. Without taking sides in this debate, one may conclude from the above list that thinking about the role of stakeholders in business involves a tremendous range of different theories, disciplines and methodologies – from economics, law, ethics, political philosophy, and all of the social sciences underlying the managerial sub-disciplines, not to mention metaphysics (for Ontological SHT). Even when discussing any particular category of so-called SHT, the use of the term "theory" is often very loose indeed. Thus we follow the authors of a recent survey article in taking "stakeholder theory" to denote not a theory *per se* but "the body of research which has emerged in the last 15 years by scholars in management, business and society, and business ethics, in which the idea of 'stakeholders' plays a crucial role" (Jones et al., 2002: 19).

The form of SHT that will serve as the focus for the discussion that follows is Deontic SHT. The goal is not to explore the foundations of the theory, which claims that firms have an ethical duty to stakeholders above and beyond what is required by law – and, in particular, ethical duties that require the firm to operate in ways that will foreseeably reduce long-term profits. For the sake of argument, *we will consider the case of a firm that has assumed extensive extra-legal, profit-diminishing obligations to some of its stakeholder groups* and will then inquire about the implications of such a decision for managerial and governance processes. We will refer to this as a "Deontic stakeholder program" or a "strong CSR program."

For this reason, not much will be said about the way government regulation supports and enforces stakeholder rights and obligations. It is nevertheless extremely important to see these state functions as setting the context for almost any practical discussion of SHT; and it is astounding how seldom this is discussed in the literature. After all, if there is a sound moral argument for the claim that a particular corporation ought to assume extensive obligations to particular stakeholder groups, then there is *prima facie* a strong argument for the claim that *all* firms in its industry ought to assume these obligations; and therefore a strong argument for the regulation of this industry to ensure that these obligations are met by all firms on a level playing-field. Contrariwise, if there is a good argument against the state imposing a particular regulation to protect a certain stakeholder group of some industry (because, say, the costs of such a regulation would outstrip the benefits), then there may be an argument for the claim that no particular firm within that industry has a strong moral obligation to act as if there were a regulation.[10] This is not to deny that there are often moral (and of course self-interested) reasons to do certain things, even though it would not make sense for the state to require them. But the case has to be made.

When CSR theorists and stakeholder theorists ignore the role of state regulation, they are omitting some context. But if they ignore the role of corporate law in laying out governance structures, fiduciary duties and stakeholder obligations, then their recommendations for socially responsible

management are both incomplete and, quite possibly, incoherent.[11] Corporate law varies significantly from one country to another (and from one state to another in the United States), and regulates, among other things, the rights of shareholders and other stakeholders to determine membership on the board as well as certain fundamental transactions (such as mergers and sell-offs). It also regulates the duties of boards and board members, and the duties that managers have to the board and the shareholders. In effect, corporate law is what defines the legal bounds of the governance relationships between owners (and sometimes other stakeholders), the board and managers. The most basic rights of shareholders that it regulates concern the information that the managers must disclose (about the financial health of the firm, but also potentially about its social and environmental record and policies), the rights to acquire and sell shares (including the tendering of offers to buy shares against the wishes of management), and about the voting rights of shareholders on board membership and basic corporate policies.

Why should the reform of corporate law matter to stakeholder theorists? There are at least two general reasons. The first is related to the argument for the *prima facie* preference for rules that are binding on all firms in a sector rather than self-imposed (and thus possibly disadvantageous) for one firm. If one is really committed to Ontological SHT – the idea that the firm exists essentially to serve the interests of all stakeholders – then why not build that into the governance structures by enabling certain stakeholders a fundamental role in governance, for example, by having representatives of these groups on the board (such as unions enjoy in certain European states)? The implications of such a reformed governance structures will be discussed more extensively below, in the context of "multiprincipal agency problems."

Perhaps more urgently, CSR and stakeholder theorists must be concerned about the justification and reform of corporate law, since many of the proposals they might recommend for socially responsible managers would be self-defeating under the current legal regime. Consider one simple illustration. In most market societies (Germany and Japan are exceptions), shareholders are given the exclusive right to elect the board, and the board is supposed to ensure that managers act in the shareholders' interests. Managers who forsake shareholders' interests may be fired by the board, and in some cases even sued by shareholders. Now one of the ways in which managers can fail to act in shareholders' interests is by following a strong CSR program, sacrificing a certain amount of profit to advance other stakeholder interests. (Other ways include, of course, lining their own pockets, or simply making bad decisions and managing ineffectively.) In such a case, under the governance structures laid out in corporate law in many countries, CSR managers could be fired. But even if managers are not fired by the current shareholders, they could very well be dismissed by future "corporate raiders." Corporate law governs the tendering of offers and the ways in which managers are able to resist hostile takeovers. One ever-present danger for a management team committed to a strong CSR program – and this holds even if they can convince the board to sanction such a program – is that CSR and stakeholder-friendly policies might fail to maximize profits and would, therefore, depress share prices. Investors who think that they could make more money with the resources of the firm under new management will then have an incentive to take the firm over and rid it of its CSR management team. In most market societies, such a takeover would be likely to succeed, because managers have limited freedom to create "poison pills" or "shark repellent," to make such acquisitions unpalatable for the raider. It would seem to follow that supporters of strong CSR and Deontic SHT must necessarily be in favor of reforming corporate law in ways that prevent the market from, in effect, swallowing up any stakeholder-friendly firm that failed to maximize profits.

This sort of situation illustrates a dilemma for stakeholder theorists that will be explored in the following two sections. On the one hand, if shareholder-centred corporate law is not reformed, then any CSR strategy that is not simultaneously profit-maximizing is likely to be snuffed out by free exchanges within financial markets. On the other hand, if corporate law is reformed to give managers the right to protect themselves and their CSR strategies from hostile takeovers, serious agency problems are likely to arise. Managers could use these protections simply to shield themselves from the market consequences of ineffective or even downright corrupt practices. Just as a feasible polit-

ical theory cannot assume that leaders within the proposed system of government will be altruistic and public-spirited, a feasible theory of stakeholder management cannot assume that the managers will always have the stakeholders', rather than their own, interests at heart. It is possible that stakeholder management will give us both the worst of public management and the worst of Enron. The mere fact that Deontic SHT is a normative theory does not give us license to ignore this concern.

Governance and principal–agent theory

Governance questions, along with questions about the nature and justification of the corporate law that sustains governance, are indispensable to any coherent theory of CSR. Questions of corporate governance, however, only become interesting when one refrains from thinking of firms as unified entities that make decisions and carry them out like individual agents. Notwithstanding its status as an artificial person under some articles of commercial law, the modern corporation is generally owned by thousands or millions of actual persons, directed by a dozen or so who are supposedly acting on the owners' behalf, and run by a deep hierarchy of managers – many of whom are also part-owners. Whatever obligations the corporation may have to outsiders can only be understood in the context of the vast and complex network of obligations between these owners, directors, managers and employees who think on behalf of the organization, but also on behalf of themselves. Principal–agent theory is one powerful tool for making sense of these obligations.

Principal–agent theory deals with situations in which one person, *the principal*, wants to induce another, *the agent*, to perform some task that it is in the principal's interest, but not necessarily the agent's. The principal can achieve this effect either through moral suasion (in effect, changing the agent's intentional states in order to make him more disposed towards performance of the task), or through the provision of incentives. Although the economics literature has tended to focus upon the latter mechanism, this is not an intrinsic feature of the model (Buchanan, 1996; Campbell, 1995). Almost any real-world principal-agent relationship will involve some combination of internal and external control. For an employee working under a piece-rate compensation scheme, the external incentives are largely sufficient to guarantee compliance with the principal's aims. In fiduciary relations, on the other hand, external incentives tend to be extremely weak, and so principals depend very heavily upon moral constraint on the part of the agent to secure compliance.[12]

In general, the employees, managers and shareholders of a firm all have a common interest in ensuring the success of the enterprise. However, this common interest does not necessarily generate a natural harmony of individual interests. Individuals can often derive personal advantage from actions that are contrary to the common interest; in other words, they can "free ride." The most familiar example of such a strategy is *shirking* – investing less work effort in a task than possible (or than is expected), while enjoying the benefits of the higher effort levels of others. In effect, a productive, successful firm is a "public good" for its members (i.e. they all derive a benefit from it, but individually self-interested action will fail to secure it). In order to produce this good, it is necessary to overcome a complex set of collective action problems. These collective action problems arise not only among co-workers, or between supervisors and employees. The separation of ownership and control in the modern corporation also generates the potential for significant free-rider problems between managers and shareholders. This potential divergence of interests is what makes it fruitful to conceive of the relationship between managers and shareholders as a principal–agent relationship.

The primary function of corporate governance structures is to mitigate or resolve these collective action problems. Of course, when actions are fully observable, and all other information is common knowledge, then the construction of such incentive systems is trivial. The principal–agent framework becomes interesting only when there is some information asymmetry between the principal and the agent. This is certainly the case between senior managers and shareholders or board members. Such asymmetries give rise to the potential for opportunistic behavior: managers can use their more intimate knowledge of what is going on within the firm to enrich themselves at shareholders' expense. Two

situations have been the focus of particular interest in the literature:

- *Moral hazard* arises when the agent's action, or the outcome of that action, is only imperfectly observable to the principal. A manager, for example, may exercise a low level of effort, waste corporate resources, or take inappropriate risks.
- *Adverse selection* can arise when the agent has some private information, prior to entering into relations with the principal. Individuals with poor skills or aptitude will present themselves as having superior ones, people with low motivation will apply for the positions that involve the least supervision, and so forth.[13]

It has long been understood that extremely severe moral hazard problems may arise between senior management and shareholders. Experience has shown that managers may misappropriate or destroy not millions, but *billions* of dollars worth of corporate assets, when given the opportunity to do so. For example, the profligacy and waste that occurred at RJR Nabisco during the 1980s were due to a generalized failure to impose effective discipline upon management (Burrough and Heylar, 1992). At one point, senior managers had a fleet of 10 private jets and 36 pilots at their disposal, along with a private hangar at the Atlanta airport to service the fleet, complemented by a separate three-story facility to serve as a waiting lounge. The latter was built and appointed under explicit instructions from the CEO that the budget was "unlimited" (Burrough and Heylar, 1992, p. 93). In the Enron era, of course, the issue was not so much waste as it was the direct transfer of wealth from the corporation and its shareholders into the bank accounts and stock portfolios of senior executives. The root cause, however – an underlying moral hazard problem – was the same.

Thus despite the standard assumption in the business-ethics literature that management serves (at very least) the shareholders of the firm, in reality the alignment of incentives needed to obtain this result can be difficult to achieve. The exploitation of shareholders by management remains extremely common. Apart from the power to hire and fire managers, there are only two important levers that shareholders control and that serve as a check on management. The first is compensation. Firms often experiment with different compensation schemes, including performance pay, bonuses, stock ownership and stock options, in order to give managers a personal interest in maximizing shareholder value. Managers can be given a bonus, for example, that is equivalent to some fraction of the output that can be achieved when they exercise high effort (an incentive structure similar to a sales commission). The second major control mechanism, as mentioned earlier, is the discipline imposed by the stock market through the threat of hostile takeover. Managerial waste and inefficiency tend to depress stock value, which makes the firm a more attractive target for a buyout. Such a change usually results in a consolidation of ownership, which gives the new shareholders both the power and the incentive to dislodge the old management, and then profit from the subsequent increase in the value of the firm.

These levers, however, are far from foolproof. Several factors contribute to the difficulties that shareholders have exercising effective discipline over management. The first is the magnitude of the information asymmetries that exist between the two groups, and the sheer cost associated with acquiring the information needed to assess managerial performance. There is also, as the "Enron" scandals reveal, ample opportunity for managers to conceal this information, or to frustrate the attempts of shareholders to gain access to it (not least by corrupting the auditing process that is supposed to give the board an independent assessment of crucial financial information).[14] Compounding the problem is the fact that shareholders often face their own collective action problem when it comes to oversight and discipline. Keeping an eye on management, and challenging certain decisions, requires an investment of time, energy and resources. When there is a single dominant shareholder, that person will usually find it to be in his or her interest to take on these charges. Yet when ownership is extremely diffuse, the cost to each individual shareholder of managerial excess tends to be quite small, while the costs associated with disciplining management remain high. So absent some cost-sharing arrangement, no single shareholder will have an incentive to "mind the shop."

Understanding that the relationship between shareholders and managers is one fraught with agency risks helps to shed some light upon the importance that profitability plays in traditional corporate governance. Standard principal–agent models are one-dimensional: they assume that just one agent is relating to one principal, and is performing only one task on his or her behalf. In reality, agency relationships are almost always multitask. Managers, for example, are expected not only to make profits, but also to cut costs, maintain or improve product quality, increase market share, project a good corporate image, and so on. When there are multiple tasks, it becomes extremely difficult – often impossible – to design incentive schemes that will motivate the agent to produce an optimal performance (Laffont and Martimort, 2002: 203–226). Sometimes tasks will be complementary: investing effort in one task will reduce the marginal cost of investing in some other (e.g. in manufacturing with economies of scale, increasing market share may lead to increases in productivity). Here there is no difficulty. Problems arise when the tasks are substitutes; when investing effort in one increases the marginal cost of investing in another (e.g. in retail, "cannibalization" of sales may mean that increasing market share leads to decreased productivity). In such cases tradeoffs will be necessary.

To give just a sense of the problems that this may create, consider what will happen if the effort invested in one task is more observable than the effort invested in some other. In principle, it is possible to design a much "sharper" set of incentives for the task that is more easily observed. And yet if one were to do so, managers would tend to invest a disproportionate amount of energy into performance of that task. Thus it is necessary, in a multitask environment, to provide "dull" incentives across the board, even though the information conditions actually permit sharper incentives in certain domains. Several theorists have speculated that it is precisely because of this multitask problem that most middle managers simply receive a flat salary, with only slight variance for annual performance (Dixit, 1997; Holmström and Milgrom, 1991; Williamson, 1985).

The incentive problem becomes even more acute if the principal lacks the information necessary to determine how the various tasks should be balanced against one another (in cases where they are substitutes). If the agent is given discretion in this regard, then accountability becomes almost impossible. The agent can always explain away poor outcomes in one task as a necessary consequence of better outcomes in some other. This is what explains the importance of the "bottom line" in traditional corporate governance. It provides the equivalent of a composite index, a common metric for evaluating the performance of management across all of the important dimensions. It also provides broad boundaries on the tradeoffs that managers can make between shareholder return and other objectives, such as growth or product quality. It provides, in other words, a single "metatask" for which upper management can be held accountable.

The reason that it is possible to impose such a concern for profitability is that there is only one group of principals, the shareholders. The existence of multiple principals complicates matters further. Assuming that the various principals have different preferences over the set of possible managerial tasks, the overall effect will be to dull incentives yet again. Each principal will encourage the agent to perform best in the task that he or she (the principal) views as the most important, and to discourage the others. Thus any incentives provided by the various principals will have a tendency to cancel each other out, leaving the agent free to pursue his or her own interests (possibly to the detriment of them all).

Lessons from public management

It should be obvious from the above summary that strong CSR or 3BL proposals would significantly complicate the agency relationships that exist within the firm. The precise modalities vary, but in general one can say 3BL proposals – which ask managers to improve social and environmental "bottom lines" in addition to net income – would exacerbate the multitask incentive problem, while responsibilities to multiple stakeholder groups could generate multiprincipal problems. Thus we are naturally led to inquire how corporate governance structures would need to be modified in order to reflect such a conception of managerial responsibility. Again, recent corporate scandals have shown that if such obligations cannot be effectively institutionalized, mana-

gerial malfeasance could easily undo any of the "social" gains achieved through the introduction of a broader concept of corporate social responsibility.

There is no reason in principle why these agency problems should be unmanageable. As we noted above, CSR does not create entirely new agency problems, it simply exacerbates existing ones. Managers are already obliged to grapple with multiple tasks. Furthermore, shareholders do not all have exactly the same interests, e.g., some are concerned with short-term profits, others with long-term growth, some are institutional investors, and others participate through "ethical" investments funds. Thus one can already think of managers as balancing the needs of multiple principals. "Enron" notwithstanding, existing governance structures seem to be capable of doing a tolerable job of keeping these agency problems under control. Could they not just be extended to handle a strong CSR program?

The prospects of this seem dim. The grounds for such an assessment stem from the experience of state-owned enterprises (SOEs) in the late 1960s and 1970s. The governance challenges that would arise out of the implementation of a strong CSR program in a private enterprise are structurally quite similar to the challenges that were faced by nationalized industries during this period. The experience in the public sector shows that it is extremely difficult to design governance structures under such conditions. The experience of SOEs shows that giving managers a "social responsibility" mandate, combined with the freedom required to carry it out, can lead not only to massive financial losses, but may not even result in improved social responsibility. SOEs have often done a worse job of serving the public interest than privately owned firms in the same industry. While there are a number of different factors that combine to produce this outcome, most analysts agree that agency problems *created by the social responsibility mandate itself* figure among the primary causes.

In the period following the Second World War, many firms were either nationalized or created under state ownership, not because of monopoly or market failure in the private sector, but out of a desire on the part of governments to have these enterprises serve the broader public interest. Consider the case of Canada, a country with a business culture and governance tradition similar to that in the United States, but with an interventionist state inspired by the European model. As in many countries, Canadian SOEs were (and in some cases continue to be) involved in the standard activities of electricity generation and distribution, telecommunications, postal services, water and sewage, ports and airports, etc., primarily because it is (or was) difficult to organize a competitive market in these sectors. But the Canadian state has at various times also owned an airline (Air Canada), a railroad (Canadian National), and an oil company (Petro-Canada), not to mention numerous mining operations. It has been involved in shipbuilding, aerospace, forestry, oil and gas exploration, nuclear-reactor building, agricultural land ownership, inter-urban bus service, and automobile insurance. These SOEs competed directly against privately owned firms, either domestically or in international markets. The standard "public goods" rationale for state involvement is absent in these cases. The reason that the state was involved in these sectors followed primarily from the thought that, while privately owned firms pursued strictly private interests (i.e. profitability), public ownership would be able to ensure that these enterprises served the broader public interest. Thus managers in these SOEs were instructed, not just to provide a reasonable return on the capital invested, but to pursue other "social" objectives. Of course, this story was played out in just about every Western European country in the 20th century – in many cases to an even greater extent than in Canada.

The social responsibilities that have often been imposed upon SOEs by the state can be summarized under four general categories:[15]

1. *Macroeconomic.* SOEs were at various times called upon to engage in counter-cyclical spending or to maintaining employment during recessionary periods, in order to smooth out the business cycle; to promote full employment by creating excess capacity and engaging in "make work" projects; and to help control inflation by instituting wage and price controls. SOEs have also been called upon to assist the government in meeting specific fiscal objectives.
2. *National interest.* SOEs were often expected to bolster national industry by providing subsi-

dized goods and services (especially energy) to domestic firms. They were expected to provide guaranteed markets for the product of these industries, by favoring domestic suppliers over foreign. They were often expected to serve the national interest by channeling investment into sectors that were deemed to be national priorities by the state, or to assist in the ''incubation'' of industries intended to bolster international competitiveness. They were also intended to keep under national ownership and control industries, information, and productive technology that were regarded as essential to national security.

3. *Redistribution*. SOEs played a significant role in helping the state to achieve redistributive goals. Most often, they were expected to abstain from any of the price discrimination that profit-maximizing private firms would engage in, and thus to provide the same services at the same price across the nation (e.g. postal service). In Canada, SOEs have also been heavily involved in regional development, either directly subsidizing across regions (e.g. rural passenger train service or flight service to relatively remote regions or small centres), or through region-specific investments.
4. *Model employer*. SOEs were expected to serve as model corporate citizens, in order to put pressure on private firms to follow suit. Thus they were often expected to pay higher wage rates, to offer superior benefits (e.g. on-site daycare) and better job security, or to hire more women or members of disadvantaged minorities.
5. *Reduction of externalities*. While most of the ''social'' responsibilities of SOEs could be described as the production of positive externalities, it is worth noting that certain SOEs are held in the public sector purely for the sake of controlling negative externalities. Most notably, liquor sales and gambling are often under state monopoly, out of concern that private enterprises in this domain would produce ''too much'' of the relevant good. Similarly, there is often a call for public ownership of industries that have the potential to create catastrophic environmental externalities (such as uranium mining and refinement, nuclear energy generation, etc.).

It should be clear from inspection that this set of objectives has many points of contact with the ''wish list'' of stakeholder obligations that proponents of CSR have been advancing over the years. This is no accident. The prevailing view among social-democratic political parties during the 1960s was that the ownership structure of private enterprise was responsible for failures of corporate citizenship. The solution was therefore to nationalize these firms, and then instruct the managers to behave in a more responsible fashion. Stakeholder groups could articulate their interests through the democratic political process, and SOEs could then be directly instructed to address these concerns. In a sense, an attempt was made to use the state (and public law) as a governance mechanism to institutionalize stakeholder capitalism.

This experiment, however, is now widely regarded as a failure, and not only on the right of the political spectrum. The ''public interest'' mandate of SOEs was abandoned by socialist, conservative and Christian Democrat governments alike, long before the wave of privatization that swept through Europe and North America in the 1980s. The heady days of the 1960s, in which SOEs were encouraged to pursue a variety of social objectives, were followed by a long period of ''commercialization,'' primarily during the 1970s, in which SOEs were instructed to abandon or curtail these activities, and to restructure their operations in accordance with more traditional business principles (Ferner, 1988). In fact, the managers of firms in competitive industries were often instructed simply to maximize profits. Thus in 1974, for instance, a government directive instructed Canadian National Railroad to be profitable, and a new director was appointed with an explicit mandate to implement the necessary changes (Stevenson, 1988). The 1978, the Air Canada Act instructed the airline (with comical understatement) to run its operation with ''due regard to sound business principles and, in particular, the contemplation of profit'' (Langford and Huffman, 1988: 99). Both of these decisions were made by the left-of-centre Liberal government of Pierre Trudeau, long before there was any discussion of privatization.[16]

Similar stories unfolded in France and Spain, where socialist parties imposed ''commercializing'' reforms upon the state sector. In fact, one of the

reasons that it was so easy for subsequent right-wing governments to privatize state firms is that in most OECD countries they had already been restructured in such a way that their behavior was no different from that of private enterprises. As Joseph Stiglitz has observed (1994: 173), by 1994 there was essentially no difference in the behavior of Texaco (private), Petrofina (public) and BP (mixed). In cases where SOEs operated in competitive sectors, commercialization relieved them of their social-responsibility mandate, and thus eliminated the primary reason for holding them in the public sector.

The basic reason for this commercialization of the SOEs was the realization that, not only were they consistently losing money, but they were often doing a worse job of promoting the public interest, under the explicit mandate to do so, than privately owned firms were. In several countries, governments suffered an almost total loss of control. In France, state oil companies freely speculated against the national currency, refused to divert deliveries to foreign customers in times of shortage, and engaged in predatory pricing policies toward domestic customers (Feigenbaum, 1982: 109). In the United States, SOEs have been among the most vociferous opponents of enhanced pollution controls, and state-owner nuclear reactors are among the most unsafe (Stiglitz, 1996: 250). Of course, these are rather dramatic examples. The more common problem was simply that the SOEs lost incredible amounts of money (Boardman and Vining, 1989). These losses were enough, in several cases, to cast doubt upon the ongoing solvency of the state, and to prompt currency devaluations. The reason that so much money was lost has a lot to do with a lack of accountability.[17]

The most widely accepted explanation for this perverse outcome is that the structure of public enterprise made it extremely difficult for the state to exercise effective discipline over its managers. Some of these agency problems are intrinsic features of public ownership, but some were produced by the specific character of the "social responsibility" mandate that managers were given during the 1960s. It was the latter that commercialization was intended to correct.

The idea that agency problems in the public sector are more acute than in the private is widely accepted. In some cases, this is due to the peculiar character of the state as an owner. For example, the public sector cannot give its managers an ownership stake in the operation that they run. The top end of the pay scale is also significantly lower than in the private sector, for a variety of reasons, and this may make it difficult for SOEs to attract or retain top managers. There is also the well-known problem of the "soft-budget constraint." If the managers of a privately-owned firm cannot keep it in the black, shareholders will eventually withdraw their investment, regardless of the social consequences. Because of this, private owners are able to issue much more credible threats to their managers. Politicians, on the other hand, would never allow a major public corporation to go bankrupt, and the managers know it. Thus public-sector managers have much less fear of losing money. They sometimes intentionally run deficits in order to secure budget increases.

These problems are all quite specific to the public sector, and of no particular interest to proponents of CSR in the private sector. Furthermore, because these problems are tied to structural features of the public sector, the commercialization of SOEs during the 1970s did nothing to correct them. The same can be said for SOEs that are monopolies, whether they be "natural" monopolies or artificial ones created by through legislation. Obviously the state could not issue a directive to the managers of such firms, telling them to start maximizing profits, since doing so would defeat the purpose of having them in the public sector. The cases that are relevant are ones in which SOEs operated in competitive industries. These are the firms that were commercialized during the 1970s.

The primary reason for commercializing these SOEs was to discontinue the practice of issuing multiple objectives to managers. Anthony Ferner summarizes the essential problem when he writes that, for SOEs:

> The way in which their objectives are defined through the political process and then 'transmitted' into the enterprise raises fundamental problems. First, the political demands on public enterprises lead to objectives that are confusing, changeable and often mutually at odds. Second, partly for this reason, but for others as well, the relationship between the state and public enterprises is dogged by difficult questions of enforcement: how can the political authorities ensure

> that the objectives set for state enterprises are effectively pursued? (1998: 30).

The reaction to this difficulty, in states throughout most of the Western world, was to give up on the goal of giving SOE managers multiple social responsibilities. This should be a cause of concern among proponents of CSR. In a sense, the history of nationalized industries in the 20th century suggests that CSR was tried, and turned out to be a failure. At very least, proponents of CSR must learn from this experience, and think about how private corporations might institute governance structures that would allow them to avoid the problems that plagued the public sector. In this respect, it is helpful to look at these problems, and to divide them up into the categories of multitask and multiprincipal problems.

Multitask problems

The history of SOEs in the 20th century makes it perfectly clear that firms cannot simply give managers multiple tasks, and then tell them to do "the best they can" in all dimensions. As Stiglitz argues, this sort of vagueness created serious agency problems in the public sector:

> [T]he ambiguity of objectives provides the managers further discretion to pursue their own interests. In the private sector, there is one over-riding concern: profits. In the public sector, there may be a multiplicity of objectives – economic (such as employment) as well as non-economic (national security). Managers can always claim that the reason they are losing money is not that they are inefficient or incompetent, but that they have been pursuing other goals. And it is virtually impossible for an outsider to judge the validity of those claims (1989: 32).

Whenever there are trade-offs between different objectives, managers can explain the failure to meet one target as the "cost" imposed by their attempts to meet some other. Revenue shortfalls can be explained as a necessary consequence of maintaining employment. Layoffs can be justified as a necessary precondition for profitability. This makes it impossible for the principal to lay down any unambiguous performance criteria for the evaluation of management, which in turn leads to very serious agency problems. As long as the manager is determining how the various objectives should be balanced, assigning managers multiple objectives gives them something equivalent to a "get out of jail free" card – an automatic ticket to escape accountability for their own professional failings.

It should be noted that the multitask agency problem is not just an incentive problem, one that can be resolved through good will or more effective "internal" controls. Even managers who are willing to make a good-faith effort to do the best they can may find themselves lacking the information that they need in order to determine how well they are doing, or whether they could be doing better. Competition in the private sector not only creates incentives; it also provides important information about how firms are doing. In the early 1970s, for example, the big three automakers in the United States for the most part were simply unaware of how inefficient their operations had become. It was not until they were exposed to competition from the Japanese that they realized how much better they could be.

In order to make these sorts of comparisons across firms, however, managerial objectives must be commensurable. Having the single directive of profit-maximization permits comparisons across firms, because all managers are trying to do roughly the same thing, in a similar economic environment. But if managers have the freedom to balance objectives as they see fit, then the basis for comparison disappears, because any differences can be dismissed as a consequence of the opportunity cost of the specific type of balancing undertaken. A firm that puts more emphasis upon regional equality, or employment security, would simply not be comparable to a firm that put more emphasis on profitability. Thus the information needed for managers to assess even their own performances would, in general, be unobtainable.

Thus from a governance perspective the only really feasible arrangement is for the principal to specify the balance that he or she would like to see obtain between the various objectives. Unfortunately, information asymmetries will often prevent the principal from doing so. It is generally impossible for an outsider to know what opportunities for profit are available, what internal efficiencies might be

achieved, what level of risk-taking is appropriate, etc. Even a very hands-on senior manager would be lucky to have such information.

There is considerable precedent on this issue in the history of public management. In France, it was decided early on that managers could not be given the discretion to balance objectives as they saw fit. The initial solution proposed was to explicitly calculate the cost that "social objectives" imposed upon the firm, then to measure performance on the basis of profitability after full compensation for these costs. The 1967 *Rapport sur les entreprises publiques* (or "Nora report") concluded that:

> Unless we can clearly distinguish the potential for profit specific to a particular economic activity from the costs imposed by the public interest constraints, there are no standards for these enterprises: no criteria of good management, no incentive to improve management, and no penalty for bad management. How then can we expect balanced finances from these enterprises, along with the innovative, autonomous and responsible action that constitutes its guarantee? (Nora, 1967: 25).

Throughout the 1970s, the French state engaged in a process of "contracting" with the SOEs – developing elaborate arrangements that specified what the enterprise would be expected to achieve in each of the different categories of objectives. These contracts, however, proved difficult to negotiate, and even more difficult to enforce (Lewin, 1982: 65–66).

This is an ongoing challenge for proponents of CSR and 3BL. In a sense, having three bottom lines is equivalent to having no bottom line. Thus, it is incumbent upon partisans of 3BL schemes to explain how they intend to handle the multitask incentive problem that their proposals create. At very least, such an effort should take as its point of departure the experiences of the public sector, since SOEs have at least three decades worth of experience in dealing with these issues. But the prospects are not encouraging. Norman and MacDonald (2004) have argued that there is no common metric that can be used in a 3BL context for evaluating social and environmental performance relevant to other stakeholders. If this is correct, then it is very difficult to see how any reform of corporate law designed to permit managers to purse a 3BL agenda would not also open the door to rampant malfeasance.

Multiprincipal problems

If 3BL approaches to corporate social responsibility involve assigning multiple tasks to managers, the Deontic SHT tradition foresees an arrangement under which managers would be accountable to multiple principals. Consider the following claim from Edward Freeman, who is widely credited with having introduced the concept of stakeholder theory into contemporary management theory:

> My thesis is that I can revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to stockholders with the concept that managers bear a fiduciary relationship to stakeholders. Specifically I include suppliers, customers, employees, stockholders, and the local community, as well as management in its role as agent for these groups… Each of these stakeholder groups has a right not to be treated as a means to some end, and therefore must participate in determining the future direction of the firm in which they have a stake (1984: xx).

From the perspective of agency theory, this gives rise to an obvious objection. As Frank Easterbrook and Daniel Fischel write, "A manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other" (1991: 38).

The problem with treating managers as "agents" of all these groups is that there is often a straightforward divergence of interest among stakeholders. Union wage demands may directly impinge upon profitability, expansion of capacity may have a negative environmental impact, and so on. Consider, for example, an industrial union like the Canadian Auto Workers. Conflicts between this union and the "Big Three" automakers over wages and benefits are well publicized. Less well publicized have been conflicts engendered by the union's constant pressure to expand private automobile production and use, which has put it on a collision course with environmentalists, as well as public

transit users and advocates. The union has also lobbied against the interests of Canadian-owned players in the automotive industry (mostly subcontractors making auto parts for "outsourced" production), not to mention the customers and employees of Japanese and European automotive firms. Under traditional corporate governance, shareholders may face a collective action problem when it comes to disciplining management, but at least they all share the same general interest with respect to the firm. The interest positions of stakeholders, on the other hand, often put them in zero-sum conflict with respect to other stakeholders or the decisions of the firm.

Thus holding managers accountable to the interests of all these different groups can create a serious multiprincipal problem. In the best case scenario, accountability to multiple principals, in cases where each principal has control over some of the incentives that govern the agent, will result in a "dulling" of these incentives. Unions may reward managers for decisions that shareholders will punish. In the worst-case scenario, the incentives imposed by the two groups will cancel each other out completely, leaving the manager indifferent to the concerns of the principals.

The introduction of multiple principals also has a tendency to create a system of incentives that is dynamically unstable. A single principal is likely to have a stable set of preferences. With multiple principals, the system of incentives is likely to reflect a balance of power that may not be stable over time. This instability was a constant complaint of public-sector managers prior to commercialization: they were not only held accountable to multiple objectives, but these objectives would change from month to month, or day to day.

Managers governed by such an agency structure are likely to engage in strategic behavior in order to avoid accountability. They can often play one group or principal off against another. If the principals actually had independent power to sanction the agent, then it would be very unlikely that any workable governance structure could be established. In SOEs, the initial solution was to make the enterprise directly accountable to a single ministry, an industrial board, or a holding company. It was very rare for public-sector managers to be held directly accountable to stakeholder constituencies. Instead, stakeholder groups were given representation in some decision-making body or institution, which was charged with the task of reconciling the divergent interests, and issuing a coherent set of imperatives to management. This in itself was no easy task. In Spain, for example, the state holding company for SOEs initially had "representatives of the ministries of finance, commerce, industry, public works, agriculture, as well as the ministries of the army, navy and air force, on its board of directors" (Ferner, 1988: 31). The result was almost completely unworkable.

Furthermore, the creation of a unified governance structure "on paper" does not mean that multi-principal agency problems go away in practice. Even though SOE managers were technically accountable to only a single agency, they could usually exercise considerable influence over the process of deliberation that informed the agency's decisions. Thus managers would routinely "play politics" with stakeholder groups, in order change the balance of political power. Managers of public utilities, for example, would often appeal to large industrial clients, who had an interest in maintaining low rates, in order to help them lobby for expanded capacity, or to resist demands for profitability. The ability of management to selectively disseminate or leak information gives them a particularly powerful card to play in these affairs.

Is it plausible to think that such problems might become more tractable within a private enterprise system, with firms dedicated to CSR? It is difficult to see how. The primary problem with stakeholder groups is that, with the exception of trade unions and some environmental groups, they tend to be very poorly organized. Thus it is inconceivable that any such group should be able to exercise any direct control over management. From a governance perspective, proponents of CSR must be committed to having stakeholder groups represented on the board of directors of a firm.

Yet some stakeholders are so poorly organized that it is difficult to imagine them even coming together to elect a representative to the board. For example, when a firm accepts inflationary wage demands, which it then "passes along" through price increases, it creates a significant negative externality for both other workers, and consumers. In certain economic climates, these wage-and-price decisions are far more deleterious to the public than any

environmental externalities produced by the firm. Thus one of the primary mandates of SOEs was always to promote the "public interest" in price stability. Yet does one ever hear about firms refraining from contributing to inflationary pressures in the CSR literature? No, because the victims of inflation are simply too poorly organized to be described as a "stakeholder group." But is the suffering of the pensioner who has her pension wiped out by inflation any less real than that of the customer who winds up buying shoddy goods, or the supplier whose contract is abruptly terminated?

Thus we must be careful not to allow SHT to create an institutional bias that favors the better-organized over the poorly-organized. Yet what resources do the poorly-organized have to press their interests? The traditional answer is that they have *government*. Thus thinking through the institutional implications of Deontic SHT leads quite easily to a SHT of governance that requires the state to take a leading role in appointing directors to the board of directors of firms, in order to make sure that all "stakeholder" groups are represented. Yet this is precisely what the failed nationalization strategy was intended to achieve. Thus it is absolutely incumbent upon proponents of SHT and CSR to explain why the solution that was eventually deemed superior in the private sector – arms-length *regulation* of profit-oriented firms – is not also the best suited to addressing their concerns.

Beyond the false antagonism of shareholders and stakeholders

The argument developed above takes issue with the view that shareholders are "just another" stakeholder group. There are good reasons for according shareholders' interests a priority in corporate governance. This is not because shareholders' interests are intrinsically more important, and certainly not because shareholders themselves, as individual persons, are more important than other persons. Nor has the argument been based on any strong conception of property rights, which accords shareholders priority because they are the owners of the firm. Shareholders do, of course, in some sense own the firm, and are treated as owners in many aspects of commercial law. But the argument presented here is consistent with the now-orthodox view in law and economics that shareholders (especially those with Class-A voting stock) are merely one of many providers of capital and financing for the firm.[18] The argument is based on governance considerations: because of the structure of risks and rewards that attracts shareholders to invest in the firm (or scares them away) – and in particular the fact that shareholders uniquely lack contractual guarantees of a return on their investment – they have the right incentives to be accorded a special role as the watchdogs (or the appointers of the watchdogs) over managers.[19] In effect, only by according shareholders a special role in protecting *their* stake in the firm can we expect managers to run the firm in a way that is in the long-term interests of other groups with a stake in the firm (such as employees, suppliers, customers, bondholders, lenders, etc). It is not greedy shareholders who are the enemies of other stakeholders; it is greedy (or lazy or unethical or unsupervised or simply unqualified) managers. We did not need "Enron" to teach us this; but the recent scandals have provided a textbook illustration of the agency problems that form the heart of the challenge of governance.

This paper takes issue quite specifically with the form of Deontic SHT that contemplates sacrificing profits and shareholder wealth in order to fulfill extra-legal, moral obligations to other stakeholder groups. The two central arguments both involve highlighting the agency risks that make such a corporate strategy likely to be self-defeating.

The first argument considered the prospects of a Deontic stakeholder project within the context of governance structures backed by corporate law. Under the current regime in most market societies, a management-sanctioned (or even board-sanctioned) CSR strategy that sacrificed shareholder wealth for benefits to other stakeholders would likely be self-defeating: in extreme cases, shareholders could sue the managers for neglecting their duties to increase profits; and under a more likely scenario, such a strategy would lead to a drop in share prices that would make the firm easy prey for corporate raiders. In order to permit such a CSR strategy, proponents would thus have to argue for reform of corporate law, and in particular, for reforms that would allow management to fend off hostile takeovers.

Such reform would be ill advised. On its own, it would significantly reduce the accountability of managers to anyone's judgment other than their own. The CEO could explain shortfalls in performance in terms of stakeholder commitments even if the real explanation involved managerial incompetence or even fraud. Of course, another consequence of a corporate law that allowed managers to shield themselves from shareholder wrath in this way might be that equity financing itself would ultimately dry up: people would be unlikely to buy securities with no fixed rate of return if they were not confident in management's ability to earn a profit. Firms would then be forced to offer shares at a discount or to seek financing at high fixed rates of interest from financial institutions that would generally be less than enthusiastic about financing a firm with a Deontic stakeholder strategy. In sum, strong CSR requires radical reform of corporate governance structures and corporate law, and there is no reasons to think that some of the more obvious strategies for doing so would prove acceptable to society at large, or even to those most enthusiastic about promoting corporate social responsibility.

The preceding section provided a brief exploration of some further reforms of governance and corporate law that might be required. In addition, presumably, to allowing managers to shield themselves and the firm from hostile shareholders, such reforms would give other stakeholders a direct role in governance through representation on the board. This might be thought to be an improvement on the situation in which managers were "trusted on their own recognizance" to carry out CSR strategy to the detriment of share values, because at least it would make managers accountable to the stakeholders they are supposed to be benefiting. But as was shown, any confidence in this system of accountability should be undermined by the multiprincipal problems that it creates.

These alternate governance scenarios suggest that we must be cautious about giving managers the means and discretion to carry out profit-consuming CSR strategies (although, again, not CSR strategies that enhance profitability), because such governance structures are open to abuse. This is the *post-Enron lesson* for stakeholder theorists. One cannot justify a system of stakeholder governance on the naïve assumption that managers will always be motivated to act in stakeholders' interests rather than their own. The other, *post-nationalization lesson*, emphasizes the agency risks produced by governance structures that give agents multiple objectives and the discretion to decide the appropriate trade-offs between them. Such scenarios are dangerous with both earnestly committed CSR managers and less-than-earnest managers willing to use this discretion and the favorable information asymmetry to advance their own interests. The basic structure of such a governance regime is a multitask agency problem, and any supporters of a robust CSR program would do well to study the history of largely unsuccessful attempts by democratic governments of all stripes to make multi-stakeholder-friendly SOEs viable.

The analysis in this paper has tried to weave together issues and theories from three fields – CSR and stakeholder theory; governance and agency theory; and public management of SOEs – that, by and large, have been debated by different groups of theorists in mutual isolation. The central conclusion is simply that theorists interested in the flourishing of stakeholder-friendly, socially responsible firms would do well to explore the challenges raised in these other two fields. Of course, given the vast scope of all three of these fields, it has not been possible to present any knock-down arguments about the limits of a stakeholder theory of governance. This paper has not explored all of the permutations of CSR management, all of the possible reforms of corporate law that would favor stakeholders, nor all of the case studies of SOEs to find governance structures that facilitated the efficient pursuit of multiple objectives. Our hope is simply to have presented a case for why stakeholder theory should benefit from a much more thorough exploration of these issues.

The more specific conclusion is that there is a need for a fundamental reconsideration within CSR and SHT circles of the demotion of shareholders to the status of "just another stakeholder group" – at least when it comes to thinking about corporate governance structures and corporate law reform. This should not in any way be taken as a repudiation of CSR, or of business ethics, or of integrity-based management more generally. It is not difficult to make a business case for CSR, and there are many

inspiring examples of corporations that have been financially successful over many years, and even generations, as a result of a thriving, values-based culture. Stakeholder theorists have as much or more to learn from the successes of these firms as they do from the failures of unsuccessful SOEs. But in so doing what they must try to understand is not merely the business case for CSR, but the CSR case for business.[20] This paper is meant as a modest contribution to the latter: a small part of the broader case for the claim that stakeholder theorists should take a second look at the governance advantages of a shareholder-focused, profit-maximizing corporation – or at least, at the pitfalls of certain naïve departures from this model.

Notes

[1] Gibson, 2000: 247. Italics added. Note that Gibson is articulating this claim, not necessarily defending it.

[2] There is of course considerable ambiguity concerning the meaning of profit, shareholder value, and so forth, as well as legitimate doubts as to whether any firm actually seeks to maximize, rather than simply satisfice, with respect to any of these objectives (see Boatright, 1999: 190–1).These debates are not essential to our purposes – we use the term "profit-maximization" simply as a shorthand way of referring to the pecuniary interests of shareholders, however these may be specified. The discussion of principal–agent theory, below, contains further clarification in this regard. Anyone interested in the notion of sustainability for a business should be concerned about *economic* rather than merely *accounting* profits; that is, profits after all inputs, including the cost of capital, have been paid out. "If a company is unable – over the long-term – to earn a return on its capital that covers the cost of its capital, then ultimately, it will fail due to the inability to attract the capital needed to replace its assets." (Grant, 1998: 33) This implies that to be sustainable, businesses must be highly profitable. Even in bull market years, more than half of the largest 1000 non-financial corporations in the U.S.A. can fail to cover their costs of capital.

[3] The most prominent of these is the Sarbanes-Oxley Act of 2002, which tightens up corporate governance and auditing rules. The NYSE and other major stock exchanges have also raised their governance requirements for participating firms. There have been a number of voluntary measures, including an agreement by the "final four" accounting firms to avoid conflicts of interest involved in offering consulting and auditing services to the same clients; and the move by many firms to treat stock options as an expense.

[4] For a quick overview of the financial performance of public enterprises, see Ramanadham, "1991": 117–120. A more detailed meta-analysis can be found in Boardman and Vining (1989). The leader of Ontario's socialist New Democratic Party once described Ontario Hydro as "a demonic, empire-building force unto-itself."

[5] The following set of distinctions expands upon the very influential four-part distinction described in Donaldson and Preston (1995).

[6] Boatright (2003): 391.

[7] Evan and Freeman (1988): 314.

[8] Boatright (2003): 391.

[9] Donaldson and Preston (1995): 67.

[10] It is worth noting that even Chicago-school economists and lawyers can be more receptive to well-designed regulation applying to all firms than to self-imposed "regulation" assumed by one firm. See, e.g., Easterbrook and Fischel (1991): 38, whose argument for some state regulation rather than a looser stakeholder-friendly governance structure emphasizes agency costs associated with the latter option.

[11] It should be noted that Edward Freeman has always taken seriously the implications of his theory for the reform of corporate law. Few other stakeholder theorists, however, have paid much attention to this challenge. See Marcoux (2000) for a concise discussion of the relevance of corporate law to CSR.

[12] It should be clear so far, and below, that we fundamentally reject Neil Shankman's (1999) contrast between agency theory and stakeholder theory. Agency theory as such is neutral about who can be principals and agents; so a stakeholder theory can, and should, be concerned about agency problems that would arise if various stakeholders (and not just shareholders) act as principals. The fact (if it is one) that "most work in agency theory has focused on the relationship between owners and managers" (Shankman, 1999: 322) does not tie agency theory fundamentally to a shareholder-focused conception of the firm. We thus reject most of Shankman's 22 points of contrast between agency theory and stakeholder theory (323–4).

[13] For an especially clear discussion of moral hazard and adverse selection, see Rasmusen (1989), 163–245.

[14] Enron's auditor, Arthur Andersen, arguably had a greater reason to be loyal to Enron's management – who, among other things, were able to extend or withdraw lucrative consulting contracts, include consulting on the accounting schemes supporting the notorious off-bal-

ance-sheet partnerships – than it did to Enron's board or its shareholders.

[15] For a more detailed overview, see Ramanadham (1991): 76–81. Also Lewin (1982): 53–58.

[16] For an overview of the Canadian experience, which puts particular emphasis on the non-ideological character of many privatizations, see Tupper and Doern (1988).

[17] For a fascinating and very careful analysis of one such case, see Palmer et al. (1983). They analyze two intercity bus companies in Canada, from 1969 to 1997, one private and the other public. They attempt to determine why the public firm had the highest fares, yet had an average rate of return on net worth of only 6.3%, compared to 20.6% for the private firm. They conclude that, although the public firm ran some unprofitable routes that otherwise would not have had service, the primary reason for its weak returns was overcapitalization, due to weak political oversight.

[18] This is the so-called ''nexus of contracts'' theory or the contractarian model of the firm, which describes the firm as a set of explicit and implicit contracts. The firm is neither an entity nor a thing capable of being owned. ''It is simply a legal fiction that encompasses a set of contractual relations'' (Bainbridge, 2002: 26). This theory of the firm is widely credited to Ronald Coase (1937).

[19] This rationale for shareholders' special role in governance is defended at length in Jensen, (2001). especially chapters 4, 5 and 8. See also Boatright (1999): 176–194 for a more philosophical exploration of this-model.

[20] There is an extensive literature debating the business case for ethics and CSR. For a brief survey see Gibson (2000), and Paine (2003). For a lengthy critique of the business case, see Henderson (2001). For a concise summary of the convergence of CSR and shareholder-value approaches to business strategy, see Grant (1998): Chapter 2.

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