

Corporate Governance – Between Freedom and Total Control

Summary

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Recent corporate scandals such as Enron, Worldcom, and Parmalat have made corporate governance one of the most controversially debated topics in the past decade. In academia, most research has centered on the question of how the disciplining forces of financial markets, optimal contracts, or the presence of controlling shareholder can align the interests of management with those of shareholders. In contrast, the broad public has been more concerned with “just” compensation and ethical aspects of high managerial salaries.

With the workshop in Schwarzenberg, the Progress Foundation wanted to focus on neglected aspects of the debate and shed some light on the area of conflict between entrepreneurial freedom, which is believed to be a cornerstone of innovation and social progress, and control mechanisms, which are necessary to prevent the misuse of discretionary power. New insights were also expected to be gained from selected pieces of the Public Choice literature. Although this field of research has been mainly concerned with agency problems in the public sector, the question was raised whether presumed analogies between the institutions of government and corporate governance could also prove valuable for the current debate.

Why do corporations exist in the first place?

In the first session, the participants were invited to identify the reasons for the emergence of corporations in the marketplace. Coase’s seminal article made everyone aware that the existence of corporations is by no means trivial. Of course, Coase, by pointing out the importance of transaction costs, found a simple explanation for the phenomenon. The second article by Alchian and Demsetz characterized the firm as a framework that allows efficient monitoring by the residual claimant, i.e. the owner of the corporation. It was criticized, however, that “monitoring” seemed to include only the control aspect of governance but neglect supportive and stimulating factors.

With the help of the term “coordination”, discussants were able to draw a clear line between the concepts of hierarchy and the marketplace. Hierarchy coordinates human action and makes the pursuit of a common goal possible. This is feasible as long as coordination costs remain low. Market forces fulfill a similar function of coordinating human action, although the process itself is not aimed at a particular goal. The natural limit of the size of the firm is defined by the price ratio between coordination and market transactions. It was noted that the recent reduction of coordination costs due to technological advances appears to have altered the organizational boundaries of the corporation. Internet and other information technologies have led to a “fraying” of business organizations.

Reflections on the nature of the firm also gave rise to the idea that corporations possess a “life of their own”, which means that the mere existence of a hierarchical structure and a goal orientation breed a corporate culture, which is separated from the norms of the organization’s individual members.

The core of the corporate governance problem

The second session was based upon Fama and Jensen's "Separation of Ownership and Control" as well as Berle and Means' "The Modern Corporation and Private Property". The first paper was welcomed by the participants for its clarity and precise description of the problem that lies at the heart of the corporate governance issue, which is the agency relationship between owners and managers of the firm. It was pointed out that Fama and Jensen did not view this constellation as a problem, but rather as an example for efficient specialization. The book of Berle and Means (i.e. the parts of it which had been distributed to the participants) was received with more skepticism because of alleged fascist elements and a possible affinity with New Deal ideology. In spite of these reservations, Berle and Means were appreciated for their emphasis on problems associated with the increased dispersion of ownership and their analysis of possible consequences for the concept of private property. It was noted that, in addition to the developments observed by Berle and Means in the 1930's, the recent emergence of passive investment strategies have led to a further widening of the cleavage between owners and managers of a corporation. In this connection, the term "universal owner" was brought up. Traditional and universal owners seem to face different incentive structures with regard to enhancing profitability of a single company and the entire market. This, in turn, has important implications for the shareholders' stance on competition and regulations.

Passive investment strategies, however, were not universally viewed as endangering the relation between ownership and control. A more optimistic view was founded on the observation that, while many investors have indeed become more passive, the importance of active investment strategies has by no means lessened. Recent trends have merely led to a sharp distinction between the two approaches. The continuous search for excess returns guarantees that managers are still provided with incentives to maximize firm value. The rise of new financial instruments and strategies, such as short selling, have strengthened the importance of financial analysts, which otherwise would have become redundant. This optimistic view was embedded in a more general debate on the effectiveness of the financial market as a control mechanism. It was suggested that these forces are the primary institution of corporate governance, whereas the board of directors constitutes the second most important element.

Analogies between corporations and the state

The inclusion of the pathbreaking articles of Charles de Montesquieu and James Madison concerning the division of power in a debate on corporate governance was met with surprise by some discussants. Although both, the corporate and the political system, are characterized by multiple principal agent problems, the analogy between corporations and the state was nevertheless perceived as being weak. Differences exist regarding the target systems and the performance measurement, the less strict adherence to the principle of the division of power in corporations, the distribution of voting rights as well as the design of minority rights for shareholders and citizens.

The opposite view was that, in both institutions, the fundamental problem consists of the insufficient enforcement of the will of the sovereign vis-à-vis its authority. Competition, which was the subject of the article of George Stigler, plays a pivotal role in overcoming enforcement problems. Again, the central question was raised whether competition is sufficient to eliminate this fundamental problem or whether there is a need for supplemental administrative rules.

In a somewhat provocative statement, one participant suggested that the corporate world should learn from and adopt governance mechanisms that have proven to function well in the political sphere. A specific proposal included the introduction of election contests for directors. It was criticized, however, that one should not jump to conclusions and adopt an arrangement without considering its disadvantages. Particularly, it was feared that problems usually attributed exclusively to the political sphere would emerge in the corporate world if election contests were adopted.

The area of conflict between freedom and control

In the fourth session, it was primarily Milton Friedman's classic "The Social Responsibility of Business is to Increase Profits" that shaped the discussion, although with the consequence that Schumpeter's description of the characteristics of the entrepreneur and Weber's description of the characteristics of the bureaucrat were somewhat neglected.

Following Friedman's statement according to which the market system channels the behavior of individuals such that personal goals cannot be reached unless this behavior benefits others, one participant presented a discounted cash flow model showing that especially long term investments serve shareholders as well as stakeholders. However, some discussants argued that assertions of this kind are oftentimes too simplistic and must be refined as to better match the complexity of real world problems. Who, it was asked, should be made responsible if a corporation violates the law? If the concept of methodological individualism is abandoned and it is assumed that corporations, not individuals act, it follows that this responsibility rests with the firm. Of course, penalties (as it is the case for taxes) are always paid by persons and never by organizations. Thus, financial losses resulting from lawsuits are always borne by shareholders. If, alternatively, the final responsibility for any behavior is imposed on management and the board of directors, it becomes more difficult to find candidates that accept the challenge and take the risk of being prosecuted. Since it is also possible for directors to effect insurance at the expense of the corporation and its owners, the risk of a lawsuit might not create the desired incentives.

The role of morality and ethical principles were also discussed in the 4th session. Since market forces cannot entirely prevent the abuse of power and corporate and criminal law leave courts with some scope as to whom they want to hold accountable for a crime, social norms were viewed as an important substitute. Informal institutions make the behavior of principals and agents mutually predictable. As a consequence, they lower the costs of uncertainty and ease the agency problem between owners and managers. Based on this notion, Friedman was criticized for limiting his analysis of the relationships between shareholders, management and stakeholders to market forces and political interactions. A more comprehensive view should include morality and ethical principles as well.

Institutions of corporate governance

The numerous institutions of corporate governance were discussed in the light of Hayek's distinction of cosmos and taxis, i.e. systems that have evolved endogenously and organizations that are the result of human design. On the one hand, it was suggested that innovations (such as the proposal of competitive director elections) do not emerge endogenously in the market even if they are superior to existing arrangements because of collective action problems, the lack of liquidity in financial markets, or difficulties in finding investors that accept unfamiliar corporate charters. According to this view, corporate governance reforms must be introduced by the state. On the other hand, it was argued that the experience with regulatory frameworks such as the Sarbanes Oxley Act shows that political

intervention oftentimes goes too far and, instead of lowering transaction costs, increases the costs imposed on business. For instance, the demand for more transparency and more stringent disclosure requirements has prevented corporations from being more innovative. Total transparency was accused of leading to a zero-tolerance policy which leaves firms with no leeway for experiments and engagements in risky but promising projects. Guidelines such as the Swiss Code of Best Practices were viewed as examples for a middle course that lower transaction costs for firms and investors and at the same time allow firms to choose from a menu of tailor-made solutions. Self-regulation, to a certain extent, prevents regulatory intervention by the state. Most importantly, however, the discussants seemed to agree on the notion that, whenever there is a mismatch between the institutions of human design and the needs of its subjects, spontaneous evolution prevails. The recent tendencies of overregulation in the financial markets have been countered with a flight of capital into private equity vehicles. This flight of capital may be viewed as a form of “exit” as described in Albert O. Hirschmann’s famous book “Exit, Voice, and Loyalty”.

The discussion on “exit” and “voice” was continued in the sixth session, for which no specific topic was given and no academic literature was handed out. Particularly the question of whether institutional investors such as pension funds are legitimized to execute voting rights in the shareholder’s stead gave reason for a lively debate. The problem that these institutions face is that they, in their position as universal owners, are unable to make use of the exit mechanism, i.e. of selling the shares, and thus have no other choice but to voice discontent with the management of a specific firm. Because, however, the pension system e.g. in Switzerland does not allow the insured to choose their pension fund freely, funds lack legitimization to vote in their names without explicit instructions or consent. It was suggested that legitimacy can only be created if the Swiss pension system is made subject to vigorous reform granting individuals more freedom in choosing their preferred pension fund.

As a final comment, it is necessary to point out that, although much attention was paid to “voice” and regulatory intervention throughout the entire workshop, most discussants emphasized the merits of the market mechanism, and thus “exit”, which was viewed as being capable of correcting misguided developments in the long run.

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