

**CORPORATE GOVERNANCE AND THE PUBLIC INTEREST**

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## Corporate Governance and the Public Interest\*

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## **Corporate Governance and the Public Interest**

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**Abstract:**

*A theory of the firm based on strategic decision-making highlights governance as a central issue. Preferences vary over strategy but not all interests are currently being represented, resulting in a failure to govern in the public interest. As solutions, we consider the design of company law and also more immediate ways forward, focusing on regulation and democratically controlled public agencies, but stressing the fundamental significance of active, effective citizens. Throughout, the arguments are illustrated using examples from various countries and industries, including education, information technology, football and public utilities in Europe and the US.*

## I. Introduction

In modern market economies the desirability of ‘good governance’ is often advocated or given lip service. Who governs and in whose interest is central to economic development. However, what is typically not appreciated is that governance in the public interest requires a form of market economy that is not found in the ‘free market’. Whereas the free market implies interest groups pursuing their own objectives, despite the resistance of others, governance in the public interest requires participation by those affected by the economic process and a constant search for effective democracy. This is the argument that we advance and explore in this paper, which culminates in a discussion of requisite public policy.

The idea of good governance refers to public and private activities, and consequently to governments, public agencies, corporations and other organisations. Our focus is the modern corporation and this paper is therefore a contribution to the long-running debate first raised by Berle and Means (1932). Seventy years has not dimmed the controversy and topicality of this subject for economies throughout the world. For example, antitrust actions, privatisation policies and take-overs routinely raise disputed and fundamental issues that are central to peoples’ wellbeing. These are essentially issues of corporate governance. To mention two examples out of any number of possibilities: is Microsoft governed with the interests of internet users appropriately taken into account, given that it denied equipment manufacturers the option of selling with a browserless version of Windows?<sup>1</sup> Are users suitably represented in the governance of railways, given that recent safety problems on Britain’s privatised network arguably stem from a structure of industry governance based on the track and trains being controlled by different, sectional interests?<sup>2</sup>

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<sup>1</sup> See the findings of fact reported in *United States of America v. Microsoft Corporation, Civil Action Number 98-1232 (TPJ), United States District Court for the District of Columbia.*

<sup>2</sup> Following a train crash because of worn rails, *The Financial Times* reported: “So now we know the main causes of worn rails, the new epidemic on the railways. An engineers’ report ... blamed more frequent, faster and smoother-running trains, wheels and rails that do not fit, and less maintenance. Though no single factor is the sole cause, the issue goes to the heart of fears about safety following privatisation. The problems occur at exactly the point where the

In revisiting corporate governance, our particular interest is to incorporate recent developments in understanding the theory and impact of the firm, and therefore of public policy. It is our contention that positioning governance in the context of a broader appreciation of the theory of the firm provides insights into its implications. The paper's particular focus is on strategic decisions. We suggest appropriate outcomes cannot be achieved within free market processes because of fundamental imperfections, and although regulation might furnish immediate ways forward it is unable to provide an optimal solution in the longer term. This requires the need for purposive public policies emphasising active and effective citizenship.

To pursue these arguments, the next Section outlines and discusses corporate governance and the strategic decision-making approach whilst Section III centres attention on democracy and the public interest. Throughout, our comments are illustrated from various industries and countries, depicting the generality of the argument. The illustrations are necessarily brief and somewhat arbitrary but they provide indicators to possibly significant empirical investigations.

## **II. Governance of a centre of strategic decision-making**

### *II.i Strategy<sup>3</sup>*

In mainstream economic theory the firm is conceptualised using a market centred approach, implying a market centred view of policy. The starting-point for this and perhaps all economic analysis of the firm is Coase (1937). He sees 'markets' and 'firms' as alternative ways to co-ordinate production. Coase defines a firm (in a pure sense) as the means of co-ordinating production without using market exchange, and explores why markets are sometimes "superseded" (p.390). This definition is in accord with analyses of firms' impact that are also market orientated

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industry was divided – where the wheels, owned by the train operating companies, meet the track, owned by Railtrack" (20<sup>th</sup> January 2001). A more recent report traces the crash to a strategic decision by Railtrack to defer track renewals by introducing a just-in-time approach (*The Financial Times*, 8<sup>th</sup> May 2001).

<sup>3</sup> See Cowling and Sugden (1998a) for more details.

and leads to policy conclusions based on market failure. Corporate governance is not a centre of attention in these conclusions.

In contrast, a different reading of Coase (1937) recognises that his ideas are rooted in microeconomic planning within firms. Although he observes that co-ordination by markets entails “planning by individuals” who “experience foresight and choose between alternatives”, Coase is particularly interested in “planning within our economic system which is quite different from ... individual planning ... and which is akin to what is normally called economic planning” (pp.387-388). Indeed, he sees firms as islands of economic planning.

In modern language, the idea of firms as units of planning translates into that of corporations making strategic decisions that give rise to their corporate strategies. Moreover, Zeitlin (1974) links strategy to the debate on corporate governance. He argues that the power to control can be equated with the power to make strategic decisions, which includes the ability to plan a corporation’s relationships with other corporations, its relationships with governments and employees, and its geographical orientation. Microsoft, for example, made a strategic decision to charge different prices to different corporations manufacturing personal computers, so as to maintain barriers to entry.<sup>4</sup> Similarly, strategic decisions underlie “Microsoft’s corporate practice to pressure other firms to halt software development that either shows the potential to weaken the applications barrier to entry or competes directly with Microsoft’s most cherished software products”.<sup>5</sup> It is also strategic

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<sup>4</sup> A finding of fact in the recent US antitrust case is that “the firm charges different [personal computer manufacturers] different prices for Windows, depending on the degree to which the individual [manufacturers] comply with Microsoft’s wishes. Among the five largest [manufacturers], Gateway and IBM, which in various ways have resisted Microsoft’s efforts to enlist them in efforts to preserve the applications barrier to entry, pay higher prices than Compaq, Dell and Hewlett-Packard, which have pursued less contentious relationships with Microsoft” (*United States of America v. Microsoft Corporation, Civil Action Number 98-1232 (TPJ), United States District Court for the District of Columbia*, p 33.)

<sup>5</sup> *United States of America v. Microsoft Corporation, Civil Action Number 98-1232 (TPJ), United States District Court for the District of Columbia*, p.47. The “applications barrier to entry” refers to “the overwhelming majority of

decisions that determine relationships with governments, thus, for example, the way in which corporations respond to antitrust pressures by seeking political assistance. It is said, for example, that Microsoft (like AT&T before it) hoped to avoid break-up by awaiting the arrival of a new President (Bush).<sup>6</sup>

This focus on strategy points to the modern corporation being viewed as a centre of strategic decision-making. Although everything that is done in a corporation is not determined solely by strategic decisions, these are especially important because, by definition, they determine a corporation's broad direction. The importance of this argument is that the strategy approach to the theory of the firm is not associated with a market-centred analysis of impact and policy. Rather, it leads to an understanding of impact and policy based on strategic decision-making, and it includes corporate governance as a central policy issue.

In the strategy-centred approach, the impact of corporations turns crucially on who governs and on what basis they make their decisions. This outcome is a direct result of adopting the typical economists' assumption that decisions are made in the interests of the decision-makers. It implies that a corporation's strategy will be designed and implemented in the interests of those making its strategic decisions. It therefore follows that the impact of corporations is very much dependant upon who makes such decisions. It is to that issue that we now turn, before looking more specifically at the implications of who governs and therefore at the policy conclusions of the strategic decision-making analysis.

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consumers" insisting on a personal computer "operating system for which there already exists a large and varied set of high-quality, full-featured applications, and for which it seems relatively certain that new types of applications and new versions of existing applications will continue to be marketed at pace with those written for other operating systems" (p. 14).

## *II.ii. Who governs?*

In one respect, literature on the question of who governs a modern corporation provides various answers and considerable debate. In another respect, there is a consensus; control rests with a subset of those having an interest in a corporation's activities.

Most recent literature on corporate governance considers the exact nature of this controlling group by centring the debate on the relationship between shareholders and managers. It seeks to analyse if shareholders can and do exert sufficient control over the managers to ensure that it is their (and not the managers') agenda that the company follows. Many authors (for example, Jenkinson and Mayer (1992), Shleifer and Vishny (1997), Becht and Röell (1998), Scott (1999), Yafeh (2000)) highlight the differences between the Anglo-US type of corporate governance and that observed in Japan and Continental Europe. In reality, however, these different structures have only superficial effects on the make-up of the controlling group and the overall conclusions reached are broadly the same; *de facto* control of the corporation rests between a group of (large) shareholders and the company's senior managers/board. (However, this is not to deny that countries differ in how the groups behave, because of variation in influence with the group and/or because of constraints on the groups' freedom for manoeuvre).<sup>7</sup>

In Japan and many Continental European countries, corporate ownership is perceived as being more concentrated than that in the Anglo-US economies (Franks and Mayer (1992a), Prowse (1990), Sheard (1994)). This is argued by Becht and Röell (1998, p.1049) to result in, an "extraordinarily high degree of concentration of shareholder voting power in Continental Europe relative to the USA and the UK" (p.1049). Indeed, a similar picture can be observed in Japan, and such concentration of power is further increased by the preference for dual-class shares with different voting rights in

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<sup>6</sup> *The Financial Times*, 8<sup>th</sup> November 1999.

<sup>7</sup> For example, the Anglo-US system is often argued to suffer from short-termism compared to Continental European and Japanese models, see for example Cosh *et. al.* (1990).



many Continental European Countries. In Denmark, for example, class B shares cannot have less than one-tenth of the voting rights of class A shares, with 75% of quoted firms having dual-class shares (Rydqvist, 1992). Large shareholders in these economies are therefore more able to exert a significant amount of control. Indeed, La Porta *et. al.* (2000, p.15) frame the agency problem of corporate governance in terms of the relationship between “controlling shareholders and outside investors”, instead of the conventional Berle and Means (1932) conflict involving “outside investors and managers”.

However, this does not mean to say that shareholders in the diversely owned Anglo-US companies have no means of influence. Discussing the British system, Holland (1995, p.28) highlights the fact that “institutional influence and intervention is normally conducted through co-operative relationships with investee companies. Much of this process of influence and intervention ... was conducted away from the public gaze”. Rubach (1999, p.34) reports a survey of equity fund managers and institutional owners in the US by Russell Reynolds Associates. It found the practice of relationship investing to be widespread; nearly half of the surveyed “managers conveyed their organisation's point of view to a board of directors, either verbally or in written form”. Indeed, Rubach observes that “institutional owners have a major ownership presence in United States corporate governance” (p.101). It therefore seems that, although less obvious, the Anglo-US system functions along similar lines to the Japanese and Continental European models, albeit at a lower level of intensity. Large shareholders can, and do have contact with and influence over the boards of the modern corporation. Indeed this is often explicitly recognised in companies’ annual reports. Vodafone Airtouch plc, for example, reports that it “holds briefing meetings with its major institutional shareholders in the UK, the US and in Continental Europe”,<sup>8</sup> and The Coca-Cola Company has a special telephone inquiry line for institutional investors.<sup>9</sup>

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<sup>8</sup> *Vodafone AirTouch plc Annual Report and Accounts 2000*, p 19.

It cannot be denied that take-overs are a more important influence on the corporate governance landscape of the Anglo-US economies than elsewhere. Franks and Mayer (1990), for example, document that in the UK there are approximately double the number of take-overs as there are in France or Germany. Indeed, hostile bids are commonplace in the US and UK but Franks and Mayer (1998) report that there have been only three hostile take-overs in Germany in the post war period, although it was said that Vodafone's bid in 2000 for Mannesmann would usher in a new era.<sup>10</sup> Many authors (for example Shleifer and Vishny (1997), MacLean, (1999)) indicate that take-over is important for Anglo-US corporate governance because the threat of such action will have the effect of disciplining management and encouraging them to focus on shareholder value, rather than pursuing their own interests. Where managerial failure actually occurs, take-overs are said to facilitate the replacement of poor management.<sup>11</sup>

This might initially suggest that there is greater pressure on management in the Anglo-US economies to follow the agenda of the shareholders. However, many authors (see for example, Kester (1992), or Schneider-Lenné (1992)) suggest that the take-over market is not so vigorous in other markets because it is not needed; by their direct and official involvement, large shareholders in Japanese and Continental European firms have sufficient control of the company. In contrast, it is often argued that because of more dispersed ownership in Anglo-US corporations, the real threat of take-over is needed to ensure that the management is effective and that contacts between the larger owners and management prove productive in guiding the long-term path of the corporation.

This means that in the Continental European, Japanese and Anglo-US systems, the end result is that shareholder power rests with an elite, through concentrated ownership, restricted voting practices,

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<sup>9</sup> *The Coca-Cola Company 1999 Annual Report.*

<sup>10</sup> See, for example, *The Economist*, 25<sup>th</sup> January 2001.

<sup>11</sup> Franks and Mayer (1992b) (cited in Jenkinson and Mayer (1992)) report that, two years following a hostile take-over in Britain, nearly 90% of directors (both executive and non-executive) will have been replaced.

and active take-over markets.

However, does this elite group of powerful shareholders control the firm? In some respects the answer must be that it does, in other respects that it does not. In theory the group of shareholders enjoys formal control of the company. However, as Tirole (2001, p.17) puts it, “the allocation of formal control ...cannot be the full story”. The modern corporation is an immensely complicated (and indeed large) entity and so has to make many strategic decisions. It is unrealistic to expect that all of these decisions are (or can be) made with the understanding of the ‘controlling’ shareholders. This would seem to indicate that “players without formal control rights actually enjoy substantial control over their organisations” (Tirole, 2001, p.17). Shareholders will only be involved (either directly or indirectly) with the most important strategic decisions, which leaves senior managers/the board with a high degree of autonomy and thus *de facto* control. Only when these individuals deviate significantly from the elite shareholders’ wishes will the shareholders pull them back into line and exercise their formal power. Therefore it is likely that *de facto* control of the modern corporation rests somewhere between a subset of (large) shareholders and the company’s senior managers/board.

### *II.iii Implications*

The significance of identifying those who govern a corporation lies in the fact that interests vary across those concerned about, and affected by, a corporation’s activities. This variation would be reflected in differences in the impact of corporations because it would be reflected in different strategic decisions. Zeitlin (1974) recognises variation in interests when he argues that controlling a corporation actually implies the ability to determine broad corporate objectives *despite resistance from others*, and the consequences have been explored at a systemic level as regards issues

concerning (amongst other things) employment, trade and technology.<sup>12</sup> The variation and consequences can also be illustrated by specific cases.

The recent US\$1 billion attempt to take-over Manchester United plc (an English football club) by BSkyB (a satellite TV broadcaster) illustrates differences amongst shareholders. The argument was essentially that BSkyB's interest in selling entertainment would take Manchester United down a strategic route that other shareholders with a different interest focused more narrowly on football would resist.<sup>13</sup> As for employees, there are countless instances of objections to a strategic decision on geographical orientation (in particular, a decision to close a plant in a particular country). Employee interests also go further than whether or not they have jobs, as shown by strategic decisions to require confidentiality agreements. These might put employees in positions that they would avoid if they were making the decisions themselves. This is suggested by the case of Jeffrey Wigand, once Vice President for Research and Development at Brown and Williamson, one of the largest US tobacco corporations. He was subject to four confidentiality and non-disclosure agreements but violated these by testifying that the tobacco companies were aware of the harmful effects of nicotine. Before providing his testimony, Wigand was sacked by Brown and Williamson, and apparently subjected to extreme personal pressures.<sup>14</sup> This case also illustrates the interests of consumers in making strategic decisions; presumably smokers who care about their own health would prefer a strategic decision that did not stifle evidence on the harmful effects of a corporation's products.

Consider also the activities of a corporate university, an educational organisation established by a corporation as part of the corporation, typically operated like other parts and intended to serve the

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<sup>12</sup> See, for example, Cowling and Sugden (1998b, 1998c), exploring the consequences not of a split between owners and managers, rather of the exclusion of most interested parties.

<sup>13</sup> See Shareholders United Against Murdoch, "BskyB and Manchester United plc. An Analysis of the Offer", distributed as part of a press release, 20<sup>th</sup> October 1998.

strategic objectives of the corporation. Craig *et. al.* (1999) suggest that the “compatibility of corporate strategies and academic enquiry is contestable; in the corporate university one might well imagine conflict between what scholars consider ought to be enquired into, and what the corporate strategy dictates to be the current action plan. Consider, for example, the obvious conflicts between corporate strategies in the tobacco industry and the conduct of research into the health effects of smoking”(p.513). As yet another example of varied concerns, concentrated strategic decision-making in the communications sector challenges society’s interest in political, economic and social democracy; Williams (1966) observes that the extension of communications is central to increased democracy but that the twentieth century saw the communications sector governed by ever more sectional interests.

#### *II.iv The challenge for public policy*

From recognising that there are varied interests in a corporation’s activities, and that this would be reflected in different strategies, it follows that corporate governance is a central issue for public policy. It has been argued in this Section that the modern corporation is governed by a subset of those with an interest in its activities. This group governs in pursuit of its own objectives, opting for strategies that other groups would not implement if they were making the decisions. This raises a serious problem if, as a matter of public policy, it is seen as desirable that corporations’ activities serve the interests of people in general, that is, if it is considered desirable that corporations serve the public interest. The problem is one of strategic failure; concentration of strategic decision-making power implies a failure to govern production in the interest of the community at large. To avoid such failure, an obvious possibility is to search for ways of appropriately involving more and more people affected by strategic decisions in the process of making those decisions, to design ways

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<sup>14</sup> *The Courier-Journal*, 25<sup>th</sup> May 1997.

of democratising governance.<sup>15</sup> An aspect of the latter is to seek more participation and an effective democracy within the strategic decision-making processes of corporations.<sup>16</sup>

For market-centred approaches to economic welfare the basis for public policy is market failure rather than strategic failure, and the public interest may be served even if corporations are governed by sectional interests which are left ‘free’ from government ‘interference’. An argument underlying such a view can be seen in extreme form in an Arrow-Debreu type general equilibrium model (see, for example, Debreu (1959) and Arrow and Hahn (1971)). In this case, the presence of ubiquitous perfect competition ensures Pareto optimal outcomes in situations where producers and indeed all actors pursue their own interests. Less extreme would be the situation where a corporation is governed by sectional interests but where those with other interests can make take-over bids in a competitive capital market or can establish new, competing corporations. The strategic failure analysis, in contrast, is founded on the significance of imperfect competition, a position justified as realistic in the context of modern corporations and the theory of the firm in Cowling and Sugden (1998a), and explored more generally as regards transnational corporations in Cowling and Sugden (1994).

In addition, market-centred and strategic failure approaches differ in their respective emphases on exit and voice. This has important implications for the policy challenge. Hirschman (1970, pp.15-16) refers to exit as “neat”, “impersonal” and “indirect – any recovery on the part of the declining firm comes by courtesy of the Invisible Hand, as an unintended by-product of the customer’s decision to shift. In all these respects voice is just the opposite of exit. It is a far more ‘messy’ concept because it can be graduated, all the way from faint grumbling to violent protest; it implies

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<sup>15</sup> Evidence in Frey and Stutzer (2000, p.918) suggests that widening involvement in strategic decision-making might directly increase people’s wellbeing. According to evidence from interview data in Switzerland, “individuals are *ceteris paribus* happier, the better developed the institutions of direct democracy are in their area of residence” .

articulation of one's critical opinions rather than a private, 'secret' vote in the anonymity of the supermarket; and finally, it is direct and straightforward rather than roundabout". However, again in line with Hirschman (1970), voice is at the heart of concerns with democracy and therefore with strategic failure; the democratic process of its essence entails "the digging, the use, and hopefully the slow improvement" of channels of voice, "essentially an *art* constantly evolving in new directions" (Hirschman, 1970, p.17/43). The challenge is to design specific policies that recognise and nurture this constantly evolving art, and that maintain an appropriate mix and balance of voice and exit processes.

### **III. Increased participation and effective democracy**

#### *III.i New legislation on corporations*

One possibility that might reveal steps in the appropriate direction is to consider the provisions of company law. To pursue this we examine English experience as an illustration.<sup>17</sup>

Existing literature places *economic* control of the typical large, modern corporation between a group of (large) shareholders and senior managers/the company board. In the English *legal* system this is reflected in certain shareholders being a company's 'members', who elect and in theory monitor the board of directors (see, for example, Farrar and Hannigan (1998), Mayson *et. al.* (1999) and Keenan (2000)). The prime duty of directors is to act in the interests of the company but this is essentially equated with shareholders' interests. In theory, directors also have duties towards company creditors and employees but these are very much secondary. For example, Keenan (2000, p.617)

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<sup>16</sup> For a discussion of the policy implications of strategic failure more generally, not only as regards the governance of large corporations, see Cowling and Sugden (1999).

<sup>17</sup> Examination of one country does not deny the possibility of countries co-operating over change. This option might be interesting in the European Union, building on the history of the Vredeling directive, see European Commission (1980). Indeed, a directive has recently been accepted in the European Union that will require management to consult with employees in certain circumstances. Such consultation clearly falls well short of the democracy that we envisage, although it is perhaps an appropriate move forward. See *The Guardian*, 12<sup>th</sup> June 2001.

suggests that the statutory duty towards employees “appears to be a declaration of good intent and little more”.<sup>18</sup>

In its broad principles the legal situation is similar in the US,<sup>19</sup> although there is a contrast with elsewhere. According to Mayson *et. al.* (1999, pp.16-17), England's “shareholder-centred vision of the company is not universally held among advanced economies. In Germany companies are seen as serving both shareholders and employees, and in German company law this is reflected in the ‘co-determination’ principle ... In Japan a company is seen as a long-term coalition of investors, employees and trading partners, who are all concerned with the company’s continuing prosperity. Japan’s company law is modelled on Germany’s”. This is not to contradict the argument in Section II.ii that *economic* control rests with an elite in Germany and Japan, rather it is to comment upon the formal *legal* duties of those elite and on the *legal* constraints that the elites face. Whilst these formalities and constraints need not be irrelevant, our focus is the possibilities for democratising governance, for moving away from governance by an elite towards effective participation by all interested parties. An English *legal* system in which directors owe a duty to shareholders does not mean that all shareholders are effectively participating in *economic* governance, a point to which we subsequently return. Similarly, a German or Japanese *legal* system ‘serving employees’ does not necessarily mean that employees have *economic* control.

One possibility for change in England is to build on the requirement that senior management act in the interests of members. The idea is to widen membership beyond shareholders, including others

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<sup>18</sup> Keenan (2000, p.617) also suggests that the existing duty to employees “will clearly become of importance if legislation is ever passed requiring companies to have some worker directors on the board, since their central interest would in many cases be that of the employees”.

<sup>19</sup> For a general discussion of the US case, see Clarkson *et. al.* (2001). We are not disputing that, for example, statutory regulations regarding discrimination and a litigious environment imply that obligations to employees are influential in the US. Strategic decision-makers wary of being sued need to take this into account when making their choices. Similar factors are also at play in England, however, and in both countries the situation regarding both legal and economic control is broadly the same.



with an interest in the corporation's activities.

This sort of development has been discussed in earlier literature. Consider, for example, Farrar and Hannigan (1998) and Mayson *et. al.* (1999) on the debate regarding the interests of 'stakeholders'. Also Sternberg (1997) and Tirole (2001) on the definition and use of this concept, and Kelly *et. al.* (1997), clearly revealing the very narrow conceptualisation of stakeholding that is adhered to by many.<sup>20</sup> Moreover, the prospect of senior management having a duty towards all interest groups with a stake in a company has recently been rejected by the Hampel Committee on Corporate Governance. The Committee concluded that to make directors responsible to various groups would imply that they "were not effectively accountable to anyone since there would be no clear yardstick for judging their performance. This is a recipe neither for good governance nor for corporate success" (paragraph 1.17).

Nevertheless, in the light of the economic argument outlined herein, this issue is far from closed. In addition, it is curious that whilst some consider it appropriate for a corporation to be governed in the interests of only one amongst a set of stakeholders, the same is not considered appropriate for a nation. Despite the Hampel Committee's conclusion, it is commonly argued that a national government is in some sense accountable to a national electorate, an electorate made up of many varied and diverse interests.

The exact way that the widening of membership is achieved and how company directors are bestowed with attainable duties towards all those members is something that would need

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<sup>20</sup> Recently, Will Hutton continued his commentary on the stakeholder idea, arguing that "shareholders property rights are not absolute, that those shareholders live in society too, and the exercise of their rights is subject to the claims of others". To this end he suggests that "corporate law should widen the number of stakeholders who have a legitimate claim on decision-making" (*The Observer*, 9<sup>th</sup> April 2000). Hutton is also a contributor to Kelly *et. al.* (1997). He favours social and economic inclusion but then argues that the big question is where the market should end and the

imaginative consideration, and it is likely something that would need to be developed and evolved over time, learning from experience. The same process could not be uniformly applied to every corporation; each sector - and perhaps corporation - has unique considerations that need to be taken into account. In general, however, it would be infeasible to attempt to provide all interests with an appropriate voice in the strategic decision-making process simultaneously, and one option is to focus attention consecutively on particular sectors and groups. For example, the effective democratisation of governance requires appropriate communication amongst interested parties, itself necessitating a communications sector that is democratically controlled. Perhaps communications should therefore be a prioritised sector.<sup>21</sup> As for different groups, one possibility might be to concentrate in the first instance on employees or, depending on the sector involved, the initial focus might be on consumers. Within this there could be further narrowing by concentrating on interests especially committed to a particular corporation, or especially dependent. Perhaps employees who have a long association with the company or those who rely heavily on the company's services, for example railway season ticket holders or those captive to a monopoly, such as a water supplier.

There are practical difficulties in developing appropriate processes. One of the most significant is the allocation of votes for electing the board of directors, since this needs to be done in a way that enables real power sharing while ensuring workability. This also needs to take into consideration the possibility of buying votes. Existing English law means that buying shares generally implies buying votes and therefore, perhaps, a degree of control over the strategic decision-making process. Again, this is strikingly different from what is widely perceived as appropriate for the governance of a country; the use of money to buy votes in British parliamentary elections was eradicated in the

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relationships of inclusion begin. Our analysis does not recognise this border, instead suggesting that inclusion needs to be the fundamental determinant of the nature and form of all relationships, *including market relationships*.

<sup>21</sup> Democratisation of communications is explored in Cowling (1985). The sector includes television, newspaper and internet activities.

nineteenth century.

Another difficulty is to determine the criteria by which new members are identified. This would not be an easy process. A significant membership fee might be desirable as this might be seen as a cost that only those with a significant interest in the corporation would incur.<sup>22</sup> The fee could take many different forms, for example a one-time payment returnable on the decision to cease being a member. To reduce the exclusion of those with relatively less wealth, the fee might be paid over time, perhaps via a monthly salary contribution. The fee could then be placed in an interest bearing trust to act like a bank account, giving a guaranteed return disparate from company performance and profits. In this situation, the fee is acting as a bond between the new member and the corporation, whilst maintaining the distinction between shareholder and other members.

It is, however, unrealistic to assume that every interested party would immediately want to become a member of a company. Although the numbers would differ from sector to sector, in many cases only those few with a special interest would exercise their right. This might be seen to imply broad satisfaction, or at least low levels of dissatisfaction, with the company's existing governance. In times of public dissatisfaction we envisage the right to become members being more highly utilised. This shifting balance would be a process that helps affect change; following Hirschman (1970, p.32), "a mixture of alert and inert citizens, or even an alternation of involvement and withdrawal, may actually serve democracy better than either total, permanent activism or total apathy".<sup>23</sup> The

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<sup>22</sup> On first impression, requiring a membership fee might be seen as little different to defining company membership exclusively in terms of those buying a share in the company. If both customer and shareholder members are defined (in part) by their willingness to make a financial commitment, why not simplify matters by requiring all company members to have a shareholding, whether or not those members are customers? The reason why not is that customers have interests as customers and as distinct from shareholders. There is a similar argument against the view that employees who are also shareholders – a significant and growing group in, for example, the US – are appropriately accounted for merely by reason of their shareholdings. See Knight and Sugden (1990) for more details on this and related issues.

<sup>23</sup> "One reason ... is that the ordinary failure, on the part of most citizens, to use their potential political forces to the full makes it possible for them to react with unexpected vigour – by using normally unused reserves of political power and

ability to become a member is important for giving a voice to those who currently have none, even if it appears (at least superficially) that it is not always utilised. For example, it is unlikely that many customers would become members of British electricity supply companies at this time, since there are low levels of public dissatisfaction with their service. There were just 0.05 complaints (customer account complaints excluding direct selling and transfer complaints) per 100,000 customers in January 2001.<sup>24</sup> However, given the same rights, customers of the private rail companies in Britain are far more likely to be active in seeking membership, reflecting the almost universal public dissatisfaction with the performance of these companies; Train Operating Companies registered 154 complaints per 100,000 passenger journeys in the third quarter of 2000-2001 (Strategic Rail Authority, 2001). It is also the case that the choice to become a member might be influenced by the quantity and quality of available ‘performance’ indicators. For electricity, consumers mainly rely on price and the reliability of service but for rail travellers there are far more criteria on which to judge - price, delays, cleanliness of rolling stock, journey times and so on. On this basis, electricity customers in California, who have recently faced uncertain supplies, power cuts and steep price rises, would be highly likely to be actively seeking membership.

This example also highlights the significance of information, commented upon as concerns shareholders in Section II.ii and taken up subsequently in our comments on the communications sector. Membership cannot be effectively widened if information continues to be restricted; interest groups need information so that they can appropriately access the strategic decision-making process. Policy therefore needs to be directed to ensuring that the appropriate information is widely available. As part of this change one possibility is implied by the proposal for a ‘transnational corporations monitoring unit’ (Bailey *et. al.*, 1994). It is suggested that countries introduce monitoring units “designed to collect information on transnationals’ performance and impact, to

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influence – whenever their vital interests are directly threatened” (Hirschman, 1970, p 32). Another reason he suggests is that voice needs to be followed by a period in which representatives have time to act.

<sup>24</sup> <http://www.ofgem.gov.uk/prices/eleccomp.htm>, accessed on 11<sup>th</sup> April 2001.

prepare accounts and to use these to influence economic policy and attitudes of and towards transnationals” (p.316). Following Bailey *et. al.* (1999), these units could act as a ‘clearing house’ where various interest groups pool their information, allowing widespread dissemination and analysis. Such a system could be readily adapted to assist corporate governance in the public interest. It could be invaluable in helping various interest groups gain the information that they need for a real voice in the governance of modern corporations.

This is not to suggest that the passive provision of information is the key issue. Fromm (1941, p.247) argues against the “pathetic superstition ... that by knowing more and more facts one arrives at knowledge of reality”, instead emphasising the fundamental importance of “thinking”.<sup>25</sup> In a related spirit, we argue that governance in the public interest requires that each member of society be able to think about and therefore participate fully in the governance process. Each needs to be alert to the need for certain types of knowledge, to be able to exercise their voice in pursuit of that knowledge, and to be able to use that knowledge in expressing their voice on strategic ways forward. In its turn, such active citizenship necessitates appropriate (informal and formal) mass education and learning.<sup>26</sup>

Another issue that policy would need urgently to address is the role of company directors. This would also need to change. Whereas currently in England directors are effectively responsible only to shareholders, we are advocating that they be responsible to many, more varied interests. In fact we have suggested that in practice it is the directors themselves who, with an elite group of shareholders, currently govern the typical corporation. If instead control is to be in the public

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<sup>25</sup> Fromm (1941) continues: “thinking without knowledge of facts remains empty and fictitious; but ‘information’ alone can be just as much an obstacle to thinking as the lack of it” (p 247).

<sup>26</sup> We are advocating ‘citizen-focused’ or perhaps more accurately ‘citizen-determined’ governance. The development of such governance in practice might usefully learn from the development of citizen-focused activities in other respects. See, for example, the analysis of a “citizen-centric” foreign policy in Escudé (1997), where “citizen-centric” implies “foreign policy at the service of the citizen” (p 20) rather than the service of an elite.

interest, then their role might more appropriately encompass mediation of conflict.<sup>27</sup> In theory directors in existing law might be said to have one master, although we have seen that shareholders differ in their opinions on strategy. But if directors were to owe a duty to act in the interests of all members and these members had different views on strategy, perhaps a director's explicit role and duty should be to mediate. Directors would draw out conflicts, provide arenas for discussion and resolution, elicit compromise and negotiate agreements. They would make preferences endogenous to the strategic decision-making process, since preferences would be evolving within the process as relationships developed between all the different interest groups.<sup>28</sup>

### *III.ii More immediate ways forward*

There are immediate possibilities for regulation, although we would emphasise that these cannot be seen as a replacement for policies that introduce a direct and genuine democracy. Regulation is essentially an arms-length response to failures in arms-length relationships,<sup>29</sup> whereas of its essence economic democracy entails inclusive, dynamic processes for shaping preferences and possibilities. When Hirschman (1970) refers to the development of democracy as a constantly evolving art, he is identifying a process that cannot be attained via regulation of an undemocratic process. The democratic process itself implies evolution, change and consequently different outcomes. No arms-length regulation of an undemocratic process could mirror this, not least because, in its absence, there is no way to know what the democratic process would yield.

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<sup>27</sup> It might remain the case that the prime duty of directors is to act in the interests of members.

<sup>28</sup> This is in stark contrast to the exogeneity assumption characterising Arrow's (1951) impossibility theorem.

<sup>29</sup> In free markets, arms-length does not simply mean relationships between separate parties. It also implies what Fromm (1941, p.118) calls a "spirit of indifference". He argues that this spirit contributes to the desire to "escape from freedom", to react to having 'freedom from constraints' without having 'freedom to do' by turning away from freedom altogether. It might be similarly argued that freedom from governance by an elite without yet having freedom to govern runs the risk of *an escape from governance*, a rejection of participation in the governance process by the mass of people. To secure (negative and positive) freedom, Fromm advocates political *and economic* democracy. This is said to

With this in mind, however, one immediate way forward is to ensure that democratically controlled public agencies have responsibility and ability to monitor firms' strategic activity and to act to secure effective representation of the public interest when corporations make strategic decisions. Even where a corporation is otherwise under the control of an elite few in pursuit of their own interest, the interests of others can be brought into account by appropriate public agencies acting on their behalf. Cost considerations alone would mean that such a process would have limited effect; public agencies could not costlessly monitor all strategic decisions of all companies at all times, and could not on all occasions effectively represent the interests of those otherwise excluded from the strategic decision-making process. But some degree of increased participation in strategic decision making can be provided.

Indeed public agencies are already given roles to some extent in line with this suggestion. To continue with the British case, for example, BSkyB's proposed take-over of Manchester United plc is again illustrative. The bid was referred to the (now) Competition Commission. Its remit encompasses "all matters that appear to be relevant in considering the public interest"<sup>30</sup> but domestic competition is the main concern. For such measures to widen involvement in strategic decision-making with real effect, however, it is important that the public interest be explicitly identified in terms of different sub-groups of the public having varied concerns in the strategic direction of a company, where that strategic direction is recognised as the central issue. Serving the public interest needs to be seen in terms of the different interests being represented effectively. Whilst each interest in isolation might prefer a different strategic direction, taking account of all interests requires the search for compromise and consensus, thus a concern with promoting mutual awareness and with mediating a suitable development path.

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include "the elimination of the secret rule of those who, though few in number, wield great economic power without any responsibility to those whose fate depends on their decisions" (pp.270-271).

<sup>30</sup> Farrar and Hannigan (1998), p.615, referring to the Monopolies and Mergers Commission.

These are not the considerations that have thus far preoccupied the Competition Commission. Policy surrounding the likes of the Commission is nowadays typically labelled “competition policy”, and it is perhaps revealing that when the BSkyB bid was referred it was reported as exceptional that there were concerns about the wider public interest.<sup>31</sup> Even with such recommendations, in its report the Commission “based [its] public interest conclusions mainly on the effect of the merger on competition among broadcasters” (Monopolies and Mergers Commission, 1999, p.4). A preoccupation with competition is more in line with the market failure, market-centred approach to policy, and insofar as the Commission has an economic rationale it is rooted in the market failure perspective. Nevertheless, its terms of reference appear quite broad and flexible, the concern with public interest apparently allowing a strategic decision-making approach to economic welfare to be pursued, if there is the necessary political will. Indeed, this is suggested by the Commission in its investigation of the BSkyB proposal: “many of the points put to us went well beyond the competition and consumer concerns that normally arise in merger enquiries. However, in considering this merger we are directed ... to take into account when assessing the public interest ‘all matters which appear to [us] to be relevant’. We have therefore looked at these wider football issues” (Monopolies and Mergers Commission, 1999, p.42).

It also needs to be recognised that a take-over is not the only occasion when a strategic decision needs to be made. More generally, a policy to complement effective merger control would be the evolution of suitable regulatory offices for particularly important sectors in an economy, building on the current practice in a number of countries of having utility regulators. These offices could be charged with safeguarding the public interest in all strategic decision-making (albeit control of the public agencies in the public interest would also need to be ensured, itself no foregone conclusion). On occasions there might be tension between a public body concerned with mergers and the public

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<sup>31</sup> *The Financial Times*, 30<sup>th</sup> October 1998.



interest, versus one concerned with strategic decisions more generally and the public interest. We suggest that such tension could be creative and fruitful, if appropriately managed, and should neither be feared nor necessarily avoided; its presence, accommodation and deliberate stimulation could be a positive dimension in a process for promoting mutual awareness and for drawing out a suitable development path.

Similar to the argument on monitoring, cost considerations alone might mean that it is inappropriate to introduce a regulator for every sector. However, there are precedents, for example the regulatory offices established to oversee aspects of privatised utilities. Although these precedents have a competition focus rather than the broader concerns that we are advocating, they show that our proposals are not so radically different from current practice as to be infeasible in the immediate future.

#### **IV. Conclusion**

Following Coase (1937) and Zeitlin (1974), the concepts of strategy and governance are central to understanding modern corporations (and other organisations, private and public), their essence, their impact and the design of public policies that affect their activities. Corporations are centres of economic planning; to govern a corporation is to plan its overall direction, to make its strategic decisions and therefore determine its broad impact. We argue that interests vary across those concerned about and affected by a corporation's activities and that this variation is reflected in different preferences over strategy. Accordingly, a corporation's impact typically depends upon who governs and on what basis they make their decisions. Our principal conclusion is that it is a matter of public policy to ensure that corporate governance is in the public interest. As a basis for action, our strategic failure approach is clearly different from the literature's more usual market-centred analysis.

We suggest policies that might enable steps to be taken in the appropriate direction. The design of suitable company law is one option. More immediately, democratically controlled public agencies can be vested with the responsibility and ability to monitor firms' strategy, and to secure effective representation of the public interest when corporations' strategic decisions are made. One possibility is the empowerment of appropriate regulatory offices for particular sectors. In the more specific case of mergers in Britain, for example, the Competition Commission appears to have the flexibility to perform an appropriate role. We suggest that in all countries and across all sectors, the willingness and determination to adopt and refine such roles is essential.

However, the public interest in corporate governance goes much deeper than laws and regulations. Democracy of its essence requires a change in the nature of corporate governance from within, ultimately impossible via legal decree or regulation from without. The art of evolving communication channels is fundamental, as is the art of fostering and respecting relationships. What is essential is the nurturing of a civic society in which all people develop and penetrate the processes of governance that impinge on their lives. Enablement through appropriate (informal and formal) mass education and learning, based on the intelligence of each and every person, on the nurturing of active citizens with the ability to think about and therefore participate fully in the governance processes. It is these citizens that can demand and assure that good governance prevails. They are the key to a free economy, to an economy governed in the public interest.

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