January 2003

State Regulatory Competition and the Threat to Corporate Governance

Ronald Daniels
University of Pennsylvania, president@jhu.edu

Benjamin Alarie
University of Toronto

Reprinted from *The Art of the State: Governance in a World without Frontiers*, edited by Thomas Courchene and Donald Savoie (Montreal: Institute for Research on Public Policy, 2003), pages 165-184.

Note: At the time of publication, the author Ronald Daniels was affiliated with the University of Toronto. Currently, he is Provost of the University of Pennsylvania.

State Regulatory Competition and the Threat to Corporate Governance

Abstract

The subject of this paper is the impact of the new globalized order on the integrity of corporate governance. Corporate governance is the system of laws, markets and institutions that seeks to control and discipline corporate activity in the service of the public interest. Over the last several years, many critics have bemoaned the growing integration of various economic markets across national boundaries because it is seen to lessen the capacity of states to regulate corporate behaviour. Essentially, the claim is that in a setting of reduced barriers to factor and product mobility, corporations are rendered much more effective in their capacity to extract regulatory concessions from host governments, and these concessions have the effect of lowering social welfare. The argument is that in a setting of high international corporate mobility, footloose corporations will relocate their operations to whichever jurisdiction offers the most congenial (meaning least stringent) regulation.

In the face of certain corporate migration in response to more stringent regulation, states will have no choice but to refrain from adopting socially optimal regulation. This is because states fear the loss of benefits associated with corporate activity: namely, employment, investment and tax revenue. The effect is an international "race to the bottom" in which states are rendered helpless in countering the effect of heightened corporate mobility.

Disciplines

Law

Comments

Reprinted from *The Art of the State: Governance in a World without Frontiers*, edited by Thomas Courchene and Donald Savoie (Montreal: Institute for Research on Public Policy, 2003), pages 165-184.

Note: At the time of publication, the author Ronald Daniels was affiliated with the University of Toronto. Currently, he is Provost of the University of Pennsylvania.

State Regulatory Competition and the Threat to Corporate Governance

Introduction

THE SUBJECT OF THIS PAPER IS THE IMPACT OF THE NEW GLOBALIZED ORDER ON THE integrity of corporate governance. Corporate governance is the system of laws, markets and institutions that seeks to control and discipline corporate activity in the service of the public interest. Over the last several years, many critics have bemoaned the growing integration of various economic markets across national boundaries because it is seen to lessen the capacity of states to regulate corporate behaviour. Essentially, the claim is that in a setting of reduced barriers to factor and product mobility, corporations are rendered much more effective in their capacity to extract regulatory concessions from host governments, and these concessions have the effect of lowering social welfare. The argument is that in a setting of high international corporate mobility, footloose corporations will relocate their operations to whichever jurisdiction offers the most congenial (meaning least stringent) regulation.

In the face of certain corporate migration in response to more stringent regulation, states will have no choice but to refrain from adopting socially optimal regulation. This is because states fear the loss of benefits associated with corporate activity: namely, employment, investment and tax revenue. The effect is an international "race to the bottom" in which states are rendered helpless in countering the effect of heightened corporate mobility.

Equally clear is the obvious prescription: an enhanced role for multinational or supranational state regulators in constraining the scope for welfare-reducing regulatory arbitrage. This is necessary to counter the efforts of corporate migration, and to ensure the integrity of the corporate regulatory regime.

Despite the frequency of these claims in favour of eviscerated state capacity to regulate corporate behaviour, we are sceptical of the case in favour of wholesale adoption of new supranational institutions or multilateral agreements that seek to ensure corporate fidelity to the public interest. We do not argue that there is no prospect for welfare-reducing state competition emanating from increased economic integration nor that initiatives designed to control destructive state competition in the regulation of corporate behaviour are perverse. Rather, we seek to develop a more nuanced analysis of corporate mobility in an increasingly globalized world that recognizes the benefits of state competition in certain circumstances, as well as the challenges that policy-makers face in devising principled constraints on corporate behaviour through multinational agreements.

We embark on this task in several distinct stages. First, we set out the case that has been developed against unfettered state competition in the production and enforcement of corporate regulation. Then we evaluate these concerns by considering the capacity of stakeholders to protect themselves through a variety of contractual and non-contractual mechanisms. We also assess how footloose corporations really are in changing jurisdictions in response to more lenient regulation. Against this backdrop, we discuss the scope for competitive states to ensure the production of socially valuable regulation and then identify those cases in which state competition is unlikely to produce outcomes that compromise social welfare. Here, we will identify those cases where state competition will be inimical to social welfare either because of interstate externalities or shortcomings in the political institutions of the regulating state. Having recognized that state competition in the provision of corporate regulation is not always conducive to the maximization of social welfare, we then discuss different instruments to correct this problem. Interestingly, we find that the problems that lead to a destructive race to the bottom in interstate corporate regulation are manifest in the context of efforts to develop multilateral agreements that restrict the scope for destructive competition.

The Role of State Competition in the Production of Corporate Regulation: Normative and Positive Perspectives

Normative perspectives

Does intense interjurisdictional competition for corporate patronage necessarily mean a loss of social welfare? For many critics of globalization, the answer to this question is in the affirmative. As described earlier, interjurisdictional competition invariably forces states to adopt weak laws that secure corporate patronage (and resultant benefits), but which nevertheless impose targeted losses on sundry stakeholder groups. In the absence of the threat of credible exit, states would refrain from adopting suboptimal laws, and corporations would have no choice but to comply. The state's powers would be restored and global welfare would increase.

Nevertheless, in sharp contrast to this analysis, proponents of competitive governments have long argued for the value of state competition (typically at the subnational level because this literature was developed in the context of the theory of federalism) in promoting responsive and innovative government. This analysis recognizes that although the state has extensive and coercive powers, its accountability to the citizenry in relation to how it exercises those powers is subject to endemic accountability problems. Politicians, for instance, worry more about re-election and short-term "credit taking" than the long-term welfare of society. Risk-averse bureaucrats worry more about their job security and scope of authority than the quality of policy and regulatory products for which they are responsible. Compounding problems is the fact that it is difficult for the public to ascertain individual responsibility for government decision-making.

Forcing governments to compete with one another to secure citizen patronage ensures that governments produce and enforce laws that are responsive to citizen preferences. Under the Tiebout model of competitive government (Tiebout 1956), highly mobile citizens will opt to reside in the jurisdiction offering the regulatory product that most closely satisfies their individual preferences. So long as states differentiate their regulatory programs and these programs do not entail externalities, the resulting equilibrium will be superior to that available in a setting of monopoly government where citizens lack credible exit options, thereby hobbling their voice.[1] Not only does this model promise more innovative and responsive government, but more specialized government as well. Governments, like firms in private product markets, will be forced to specialize so as to differentiate their product offerings from competitor states. In this way, all stakeholders whose interests are bound to the corporation are better served in a competitive marketplace for regulatory products than if there were only a single monopoly supplier of rules (or, alternatively, a producer cartel offering the same basic regulatory bundle).

In the case of national governments "competing" to attract corporate patronage, in the form of jobs, investment and tax revenue, the question is whether there is any *a priori* reason to expect that the conditions for optimal state competition will not obtain. In the received economic model of the corporation, the corporation stands as a "nexus of contracting relationships." In this model, parties only enter into explicit or implicit contractual relations with the corporations if it is in their rational economic interest to do so. Further, parties will have reasonable *ex ante* opportunities to secure appropriate protections from the corporation that safeguards their interests. So, for instance, employees will not agree to make significant firm-specific investments unless the corporation provides credible assurances that their up-front investments in the corporation, in the form of firm-specific human capital investment, will be protected through higher compensation or through long-term contractual commitments (security of tenure bonded by generous severance payments). The same is true for other stakeholder groups who enjoy opportunities for value-enhancing bargaining.

So long as parties have cost-effective opportunities for informed bargaining, the prospect of interjurisdictional corporate mobility should not be problematic. Corporations will not opt for the "consumption" of a new regulatory bundle, obtained through interstate migration, that will breach either explicit or implicit undertakings to existing stakeholders, in the current jurisdiction, or that will diminish their ability to attract new stakeholders (in the destination jurisdiction). Doing so would have the certain effect of imposing costs on the corporation emanating from deflated stakeholder expectations. Alienated shareholders, for instance, can discipline corporate management by working to remove them from office by invoking the corporation's normal governance processes. Further, they can sell their shares in the corporation, thereby lowering the value of stock-based managerial compensation.[2] Employees can commence legal actions against the corporation based on breach of contract, and can impose losses on the reputations of the firm's managers that will hobble them in their future negotiations with other stakeholder groups. The same is true for other stakeholder groups like suppliers and creditors. Indeed, as exemplified by the recent Enron scandal in the US, not only are corporations and their direct principals subject to discipline in the event of failed expectations, but so too are their professional advisers (lawyers and accountants) whose reputations are intimately linked to the corporation's conduct.

In light of the scope that stakeholders enjoy in being able to secure effective *ex ante* or *ex post* constraints on welfare-reducing corporate relocations by corporate managers, what is the case against reliance on the competitive framework for ensuring socially optimal corporate regulation?

The first concern relates to externalities. To the extent that certain stakeholder groups are unable to bargain effectively with the corporation because of a variety of information, coordination and bargaining difficulties, then the scope for the corporation to "jurisdiction shop" in a way that inflicts targeted costs on these groups is increased. The classic example is dispersed downstream or downwind residents who are injured by effluent discharged by an upstream or upwind polluter. Collective action problems and information asymmetries prevent the residents from bargaining directly with the corporation, thereby justifying the role of the state in imposing protections that fully informed parties negotiating in a transactions cost-free world would have adopted on their own. If the regulatory regime imposed by governments does not adopt these environmental protections owing, for instance, to the fear that affected corporations will be relocated to competitor jurisdictions, then concentrated losses will be visited on identifiable stakeholder groups.

Whether or not certain stakeholder groups will suffer losses from state competition in the production of regulation turns on a number of different factors: first, the quality of information that stakeholders receive respecting new or impending regulations; second, stakeholder expertise in understanding and responding to the risks to their interests created by the corporation; third, the scope for coordination among similarly situated stakeholders; and fourth, the opportunities for meaningful citizen voice in the political processes used to vet prospective legislative or regulatory changes. In respect of this last point, where stakeholders adversely affected by corporate behaviour are afforded transparent opportunities to participate in public rule-making, then there is less opportunity for corporate interest groups to steam-roll dissent in the regulation-making process.

In the context of international jurisdiction shopping, concern over externalities is most acute when prospective jurisdictions lack basic democratic institutions that would normally permit certain adversely affected interests the opportunity to temper the rules deemed desirable by corporate managers (presumably, but not always, related to the advancement of shareholder wealth). What is of concern here is *not* that states will in some cases decide to adopt rules that entail costs for certain corporate stakeholder groups that are more than offset by the benefits realized by other corporate stakeholder groups. After all, this is the essence of law-making in liberal democratic countries, where legislation is often the by-product of complex negotiation processes in which different interests are weighed and balanced in the pursuit of improved social welfare. Indeed, assuming basic human rights have been respected and that the process of regulation-making is procedurally robust, the argument is that states have the right to adopt regulatory outcomes that differ from outcomes adopted in other—often more advanced—countries, and which reflect their own unique preference functions. Rather, the more pressing concern relates to those states that systematically deprive certain corporate stakeholder groups (e.g., employees) of the opportunity to have their interests accounted for in the policy development process in favour of other stakeholder groups (e.g., shareholders). These concerns are exacerbated by the specter of non-transparent bribes and other side-payments to public officials that will further skew the regulatory process against less powerful stakeholder interests.

Although the task of determining whether a state's institutional framework passes democratic muster is a difficult one, it is not insuperable.[3] What is required is not the widespread adoption of a standard template of legislation or rule-making that duplicates the institutions and processes extant in one particular state, but rather regard to whether affected interests have opportunities to participate meaningfully in the deliberative processes surrounding regulation-making. These "bare conditions of democracy" have previously been invoked to inform the accession of certain countries to such international agreements as the General Agreement on Tariffs and Trade (GATT). There is no reason to expect that similar standards could not be established in this area. A similar approach is appropriate in relation to human rights standards. Again, the enterprise is not one of forcing countries to adopt the precise tapestry of human rights protections found in the one national context, but rather to ensure that the basic conditions of humanity and dignity are respected by prospective regulators.[4]

While attention to the character of domestic political institutions and human rights regimes is responsive to concerns over the impact of prospective laws on the welfare of certain domestic interest groups whose welfare might be affected by competitive regulation, it is deficient in addressing the impact of state competition on interests who are outside the regulating jurisdiction. Returning to the environmental example discussed earlier, the concern would arise when the stakeholders who are principally affected by prospective regulation, say, downstream/downwind residents, are located outside the regulating jurisdiction, and they have only limited (and costly) opportunities to participate in a fulsome manner in the regulation-making process.[5] No doubt, these problems are exacerbated by the relatively weak voice they would have in any domestic regulation-making process. In the absence of full rights to public participation, such as the ability to vote in public elections, foreign interest groups will not have the same public salience as domestic interest groups. One possible response to this problem is for adversely affected foreign interests to forge coalitions with domestic interest groups. However, issue-specific alliances are often highly fragile, and, from the perspective of the foreign citizen, unreliable. This discussion suggests that the concern over externalities is most compelling in the context of foreign citizens who are adversely affected by prospective regulation, and casts doubt over the efficacy of state competition's capacity to produce socially desirable outcomes in these contexts.

One final externalities-related problem is that of paternalism, namely what kind of importance should we accord to the *indirect* impact on the preferences of foreign citizens from seeing citizens in another country being harmed by the regulations of that country. Take, for example, the decision of country A to adopt laws that adversely impact workers in country A by restricting collective bargaining rights. Quite apart from the impact on domestic citizens of that country, citizens in country B observing these rules and knowing their impact on the welfare of least-advantaged members of country A may suffer consequent reductions in welfare. From a global welfare perspective, domestic regulators *should* take account of these reductions in the welfare of foreign citizens, but as discussed above, in the absence of institutionalized opportunities for participation by these citizens, are unlikely to do so.

A further complicating factor with intervention based on paternalism is the problem of revealed preferences, namely that citizens will be prone to exaggerating the impact on their welfare of foreign regulations because it is not costly to do so. This gives rise to concerns that citizens will express disaffection with foreign regulation in order to achieve protectionist goals. Concern over the open-ended (and malleable) character of paternalism-based claims translates into a need to find ways of disciplining these claims. One option is to treat paternalism claims seriously only when they are accompanied by demonstrable evidence of disregard for the core tenets of individual autonomy and dignity. Further, to the extent that domestic policy-makers can demonstrate that affected interests were afforded meaningful opportunities for participation in the regulation-making process, the force of foreign complaints will be dulled commensurately.

Positive perspectives

Given the scope for corporations to relocate their activities to jurisdictions offering more lenient stakeholder regulation than that which currently obtains, how interested are corporations in exploiting these opportunities? The first difficulty in answering this question is to acknowledge that although managers *ought* to pursue shareholder wealth maximization as an overarching goal, it is not clear that they actually do so. Endemic agency costs—namely the costs to shareholders of supervising and disciplining corporate managers—mean that managers enjoy some scope to favour their own interests at the expense of the shareholders. In the context of corporate strategic decisions regarding the location for corporate economic activity, the presence of agency costs lowers the commitment of managers to undertake search, negotiation and, if necessary, relocation activities that serve shareholder interests. Managerial reluctance to do so is heightened by the personal costs sustained by managers if relocation means that they will have to uproot their homes and families by moving to another, less-familiar jurisdiction.[6] Predictably, the personal costs of relocation can be attenuated if senior managers are able to move discrete portions of the corporation's activities to a foreign jurisdiction without having to themselves suffer relocation (and its attendant costs).

However, let us assume that corporate managers are wholly devoted to shareholder interests and are, therefore, committed to continuous review of the location of the corporation's economic activities and to strategic relocation where necessary to realize cost-savings.[7] The question is how footloose corporations will be in response to perceived regulatory differences between the current and the prospective jurisdiction. In discussing this issue, it is important to recognize that any decision to move corporate activities to another jurisdiction faces non-trivial costs.[8] The corporation may have location-specific investments — namely plant and equipment, — the value of which may not be easily be recouped if relocation means transferring existing activities to a more congenial regulatory regime.[9] Of course, the same may be true of firm- and location-specific investments in human capital. Some employees or suppliers having highly specific investments in their relationship with the corporation may decline to relocate, again implying the loss of sunk investments. Alternatively, they may only agree to migrate if the corporation continues to respect, at least insofar as their situation is concerned, existing and perhaps more stringent levels of regulation than that offered by the destination jurisdiction. Indeed, even the relationship, and familiarity, that managers have with existing regulators and regulation is characterized by sunk investments that cannot be recovered in the event of migration.

Even if corporations could recover part of this sunk investment, they still face significant uncertainties in contemplating relocation to another jurisdiction. Can corporations be confident that the regulatory standards offered by prospective jurisdictions will be maintained into the future? This question is of considerable concern to corporations because once they relocate their activities and make sunk investments in the destination jurisdiction, they are vulnerable to "bait and switch" strategies by the destination state. Given the status of regulatory product as consisting of several different elements (namely law, the institutions enforcing the law and the level of enforcement), corporations need to worry about non-trivial adverse changes in regulations that can be effected through relatively informal means (say, for instance, more vigorous enforcement).

Another important dimension of the relocation calculus facing corporations is the tied goods character of a prospective destination's regulatory product. Because corporations cannot consume only certain aspects of the destination jurisdiction's regulatory system and ignore others, managers must worry about the interplay of all of the destination jurisdiction's law and regulations on the profitability of corporate activity. Despite the fact that a prospective jurisdiction's environmental laws, for instance, may be attractive, its labour standards may be much higher than the corporation's current jurisdiction, thereby offsetting the benefits of migration associated with the environmental regulatory regime. Further complicating matters is the fact that regulatory obligations cannot be separated from input factors markets. It is one thing for a state to offer a comprehensive and highly attractive regulatory matrix. It is another for it to combine this structure with an attractive business climate that ensures corporate access to a highly skilled and reliable set of employees and suppliers. Indeed, even beyond the content of specific regulations and the state of a country's factor markets, corporations will be interested in the more general features of a country's political, social and economic climate.

In tandem, these factors suggest that corporations will not be nearly as feckless as some commentators have proposed in relocating jurisdictions in response to marginal regulatory changes. Migrating corporations face certain and non-trivial costs and uncertain benefits from relocation. This does not, however, imply that corporations will never be prepared to relocate in response to perceived regulatory differences, only that the calculus is a complex one, and this reduces the threat value of defection to more congenial regimes.

The complexities of the demand-side for regulation are mirrored by complexities extant on the supply-side. In the highly stylized model of the hyperglobalists, states (through their elected politicians and appointed bureaucrats) seek to retain corporate patronage, and the jobs, investment, and tax revenue that follow in train, through the provision of a more congenial regulatory product. Constraints imposed by ideas, institutions, or competing domestic interests are given short shrift, or dismissed altogether. Simply put, states will do whatever it takes to retain corporate activity, even if this requires abandonment of core democratic values or alienation of salient interest groups.

Of course, this account is highly implausible. Democratic states are accountable to a number of different constituencies. Although politicians and bureaucrats may yearn for the benefits of corporate activity, they will not agree to paying any price to achieve this goal, particularly when it compromises the realization of other goals and values. A government, for instance, that systematically favours foreign corporate interests at the expense of certain stakeholder groups, even if they lack a powerful political voice, may jeopardize its overall standing with the citizens. The magnitude and timing of that discipline depends on a number of different factors: the salience of the interest groups affected (both positively and negatively) by proposed regulation, the concentration of political power, the role of the media, and the country's political traditions and values. This more nuanced depiction of state behaviour means that ideas and institutions are equally important parts of a country's production process, and will affect the commitment of state actors to providing regulations that seek to attract corporate patronage.

Instrument Choice

IN LIGHT OF THE SCOPE FOR STATES TO SUPPLY SUBOPTIMAL LEVELS OF REGULATORY product in certain circumstances (most particularly, as described above, when states have deficient democratic institutional arrangements and/or support industrial activity that generates targeted transborder externalities), we now direct attention to the various ways in which the propensity of states to supply this regulatory product can be constrained.

Regulatory cooperation via multilateral agreements

To the extent that unfettered state competition is regarded as inimical to social welfare, one obvious option is to effect hands-tying agreements among competing states that seek to limit the scope for competition. Strong movements toward regulatory cooperation (if not outright harmonization) can be currently witnessed in several international institutional contexts, perhaps most obviously in the context of the international trade regime with the steady diminution and elimination of barriers to trade that the GATT/World Trade Organization (WTO) has engendered since its introduction in 1947.[10]

Despite the positive effects that harmonization of international standards using multilateral agreements may engender in some contexts, such as the international trade context, it is not always the best way to ensure that the lack of power felt by nation-states in the presence of large corporations is contained. There are generally two main problems associated with the use of multilateral agreements or conventions for solving what amount to international collective action problems and the race-to-the-bottom. The first of these problems is that states fully retain their sovereignty in the context of multilateral agreements and can decide whether or not they want to adopt a convention or sign onto a multilateral agreement. If corporations exert pressure at this stage of the process (either latently or explicitly), it is understandably much the same situation as if the country on its own were solely adopting the policies because there will almost always be states that are not parties to the agreement, thereby enjoying an accretion in competitive advantage and becoming more attractive to economically driven corporations seeking to minimize costs and maximize profits. The second problem with multilateral agreements as a solution to the problem of countervailing corporate power relates to the reality that being a signatory to a multilateral agreement is not the same as guaranteeing full future compliance. If the stakes are high enough, many states will carve out pockets of exceptions by which they can both accommodate the wishes or needs of corporations and yet, sometimes plausibly, sometimes facetiously argue that they are abiding by the spirit of their international commitments.

One advantage of multilateral instruments as a means of checking corporate power is that multilateral agreements may serve as a credible way for governments to stand their ground against the pressure by corporations for a "better deal." By being able to state that they are bound by international commitments not to legislate, regulate or enforce their laws in a compromised manner (e.g., in a manner prejudicial to environmental protection interests, labour standards or fair tax policies) and to point to the executed instruments that establish those obligations, countries may be able to alleviate much of the pressure they feel to bend the rules in favour of corporations.

Unilateral nation-state actions

Trade and economic sanctions constitute the primary way in which nation-states attempt to unilaterally impose their desires for more humane labour practices on the rest of world, to promote fair tax policy competition, and to endorse reasonable protective environmental standards. However, the effectiveness of these types of sanctions is largely dependent upon the size and importance of the economy or economies imposing sanctions. For instance, American-led sanctions against South Africa for human rights abuses associated with the country's apartheid policies are widely reported to have been of considerable importance in promoting democracy and an abandonment of apartheid, even though the United States was only one of a large number of nations that had imposed economic sanctions on the country. According to Peter Fitzgerald, "The South African sanctions remain the preeminent example, cited by proponents of state and local sanctions, of the value of selective purchasing law and similar measures that essentially force businesses to decide who is the more important customer—the targeted company or the state and local government in the United States" (2001, 7-8).

In addition, trade sanctions imposed against Burma by the US federal government also proved to be effective, at least to a limited extent, by causing some large American-based corporations, such as Apple Computer, Phillips Electronics, PepsiCo and Texaco to abandon their Burmese operations (Fitzgerald 2001, 11). Anecdotal evidence is certainly interesting, but it is not especially compelling. A comprehensive study conducted by Hufbauer, Schott and Elliott examined 115 instances of economic sanctions imposed over a period of approximately 40 years. The authors found that in the case studies examined, a success rate of 34 percent was achieved through the use of economic sanctions—a success that is not extraordinarily high, but certainly significant (Trebilcock and Howse 1999, 450).

One of the main uses of trade and economic sanctions surround the use of the threat of withdrawal of a generalized system of preferences (GSP) to developing countries by the US and the European Committee. The threat of the removal of these benefits has reportedly worked well in persuading small rogue nations of the benefits to be had through cooperation. For example, Trebilcock and Howse refer to changes in labour law in Malaysia, Chile and the Dominican Republic that were at least partly engendered by these types of threats (Howse 1999, 449).

The findings of Hufbauer, Schott and Elliott and recent anecdotal experiences with American-led sanctions against Iraq and other states suggest that the unilateral imposition of trade and economic sanctions on rogue states is probably of moderate usefulness. On the one hand, the evidence suggests that trade and economic sanctions can be a powerful tool in causing unjust regimes to collapse (as with apartheid). On the other hand, evidence also seems to suggest that trade and economic sanctions can sometimes backfire on sanctions-imposing states. For example, Thomas Henriksen has observed that

> unintended consequences often flow from sanctions; instead of political shipwreck, they have motivated people to improvise and develop economic self-sufficiency. One classic illustration of this process is the former Rhodesia (now Zimbabwe). When first Britain and then the United Nations placed sanctions on the breakaway Rhodesian government, the landlocked African state found itself almost friendless in the world community. During the decade from 1965 to 1975, Rhodesia transformed its economy from a near-total dependence on imported manufactured goods in exchange for raw materials to a high degree of self-sufficiency. Only oil production and industrial machinery eluded Rhodesian enterprise. Moreover, Rhodesia's economy initially increased its productivity (1999).

One thing can be said for certain regarding trade and economic sanctions: the greater the number of economies participating in the sanctions and the greater the importance of the participating countries' economies to the rogue state, the greater the impacts will be felt and the greater the *prima facie* potential for the success of the sanctions. However, there is always the possibility that sanctions will be felt deeply, but the response, as in Rhodesia, will be stronger nationalism and self-reliance.

Promotion of the adoption of voluntary codes of conduct and self-regulation

Corporations can also be encouraged to respect the rights of workers and environmental standards through voluntary codes of conduct, although it is unclear to what extent such self-regulation is or has been successful in the past. Among the leaders in promoting corporate self-regulation have been the member countries of the Organisation for Economic Co-operation and Development (OECD). In 1976 the OECD first announced the *OECD Guidelines for Multinational Enterprises*. Since then, the OECD has revamped the *Guidelines* three times, most recently in June 2000. The most recent version of the *Guidelines* is intended to "ensure that the operations of enterprises are in harmony with government policies; strengthen the basis of mutual confidence between enterprises and the societies in which they operate; improve the foreign investment climate; and enhance the contribution of multinational enterprises (MNEs) to sustainable development" (Canada 2001). More specifically, the *Guidelines* provide recommendations in these specific corporate operational areas:

- *Disclosure*: covers the public dissemination by MNEs of reliable and relevant information on their activities.
- *Employment and industrial relations*: covers, *inter alia*, the issues of non-discrimination, forced labour, child labour and freedom of association and collective bargaining.
- *Environment*: covers issues such things as MNEs' environmental management systems and contingency planning.
- *Combatting bribery*: aims to eliminate bribery of foreign public officials.
- *Consumer interest*: seeks to ensure that MNEs respect consumer rights, including regarding the quality and safety of products.
- *Science and technology*: recognizes that MNEs can play an important role in improving local knowledge without compromising their intellectual property rights.
- *Competition*: promotes respect for competition rules and avoidance of anti-competitive behaviour.
- *Taxation*: addresses MNE compliance with tax laws and regulations (Canada 2001).

Since the *Guidelines* have been reviewed several times and have benefited from considerable input from interested parties, including member and non-member governments, non-governmental organizations and corporations, they represent a current and comprehensive set of operational recommendations for corporations. This wealth of information and guidance has not been squandered by corporations. According to the OECD, nearly all *Fortune 500* companies have voluntarily adopted firm-wide codes of conduct—many of which have likely drawn heavily from the *Guidelines*. In addition, the OECD reports that over 60 percent of the top 500 firms in the UK have adopted similar codes of conduct (OECD 2000, 8).

Despite the widespread adoption of these codes of conduct by corporations, however, there remains the question of how effective they are at deterring corporations from engaging in ethically suspect behaviour. Unenforced codes of conduct are unlikely to govern behaviour any more than unenforced laws do. Whether corporations monitor their far-flung operations sufficiently to ensure robust (or even marginal) compliance with their codes of conduct is not entirely clear. Given the costs associated with monitoring for violations of the codes of conduct and the gains potentially to be had in operating income from violating codes of conduct, it would not be surprising if compliance with corporate codes of conduct was less than perfect. Given the relatively benign outcome of the posited "race-to-the-bottom" with respect to labour rights and environmental protections, however, it is very likely that these voluntary codes of conduct have imposed at least some positive measure of discipline on corporations.

Social responsibility movement and its impact on the governance of corporations

The rise of the Internet, and the enhanced communication and coordination of private party activities that it allows, has given rise to a new type of corporate lobby group—a grassroots, techno-savvy network of social activists working together to point out the costs and negative effects associated with corporate irresponsibility the world over. One recent example of the new social activism that the Internet has facilitated is the Burmese example referred to earlier. Although sanctions imposed by the US federal government had much to do with some of the large corporations presently in Burma abandoning their operations there, much of the motivation behind the US government's decision to impose those sanctions in the first place was a direct result of strong public pressure to act to denounce the actions of the Burmese authoritarian military government.

Another way in which the social responsibility movement has impacted upon corporations is through "ethical investing" initiatives. One of the leading organizations dedicated to promoting socially responsible investing is a Canadian organization called the "Social Investment Organization" (OECD 2000, 63). According to them,

> socially responsible investing (sometimes known as ethical investing) is the application of peoples' values to their investments. It includes all the financial decision-making processes that are a part of a prudent investment management approach, but it also includes the selection and management of investments based on peoples' ethical, moral, social or environmental concerns (Social Investment 2000).

The socially responsible investment movement not only decreases the demand for shares of firms that are engaged in the traditional "sin" businesses of alcohol or tobacco, but also for companies that have been alleged to abuse labour rights, harm the environment, engage in military contracts, or engage in otherwise undesirable corporate behaviour. Correspondingly, the socially responsible investment movement increases the demand for shares of companies that positively and proactively seek to promote ethical ends such as finding ways to limit environmental damage through recycling of waste. As a consequence of the reduced demand engendered for misbehaving companies' shares resulting from the socially responsible investment movement, even corporations that pay attention only to the share price will receive negative feedback from their unethical deeds.

The extent to which this share-price suppression will occur, however, is highly debatable, and may only represent a very small (a fraction of a percent) discount over what the stock would otherwise trade at. This is the case because investors who are morally neutral will always have an incentive to buy stocks that are underpriced according to expected future cash flows. To the extent that there are enough of these investors in the market to keep the market efficient, the discount engendered by socially responsible investors will approach nil.

Since morally neutral investors will probably bid up the share price of companies who fall out of favour with ethical or socially responsible investors and because social activists' main impacts are on lobbying their own governments to either take multilateral or unilateral action against so-called "rogue states," the primary role of social responsibility movements appears to be in the movement's ability to influence domestic governments. To the extent, however, that social activists can impose considerable market costs on corporations, which is usually restricted to high-profile consumer goods producers such as PepsiCo, social activists can play an important role independently of their influence on the state.

Conclusion

While in a completely compartmentalized international geopolitical system the threat that corporations will continue to erode the power of nation-states and hold societies hostage through their "outlaw" status is considerable, it is not necessarily a *fait accompli* in light of our expanding and developing supranational legal mechanisms for reining in rogue states and impairing the ability of corporations to exercise power adversely. There are several strong mechanisms for constraining the power of corporations in terms of their ability to capture governments to cater to their desires for low taxes, low labour standards and low environmental regulatory overhead. For instance, nation-states are increasingly engaging in multilateral agreements to help promote a united front against corporations willing to take advantage of collective action problems and the implicit gains from defection they involve. This is not a solution for every problem, however, because of the difficulties associated with trying to force other countries to assume obligations under the agreements as well as the issues related to the enforcement of these agreements. Multilateral solutions work best in conjunction with the other mechanisms described above. Unilateral action is somewhat problematic because it gives extraordinary power to large economies such as those of the US and the EU to effect change, whereas most other nations are virtually hamstrung to achieve any sort of momentum for change by imposing sanctions. Voluntary codes of conduct have limited ability to constrain the actions of corporations because it is unclear exactly how such codes of conduct can be policed or enforced. Indeed, this may explain their perverse appeal for some socially irresponsible large corporations—they can stem the tide of public discontent arising from their behaviour in both developed and developing countries by pointing to their voluntary codes of conduct, while turning a blind eye to the actual practice of their operations in far-flung parts of the globe. Finally, the social responsibility movement appears to be a promising source of constraint on corporations, although the extent to which this is possible has yet to be conclusively demonstrated. More research is needed in this area.

Thus it appears that corporations, although constrained to some extent by the considerable costs associated with moving core activities wantonly from jurisdiction to jurisdiction, still do have some mobility and some power to bend nation-states to their will. To the extent that their threats to leave or relocate from developed countries are not credible, the abuse of their power can be mitigated. To the extent that their threats are credible, which they often are in the context of production and manufacturing, their power to influence and capture governments is real. This is especially the case because most corporation manufacturing and production takes place in developing countries which have the most to gain from the presence of corporations, but strangely also perhaps the most to lose. In any event, the multilateral agreements and other international movements working together to contain the adverse effects associated with corporate power and collective action problems represent one of the most promising and potentially effective ways yet devised of dealing with the negative effects of globalization.

Notes

1 The terminology is from Hirschman's famous book, *Exit, Voice and Loyalty* (1970).

2 Shareholders can also rely on a host of other market and legal mechanisms such as shareholder suits (breach of duty of care and loyalty) and hostile takeovers to deal with corporate relocations which reduce shareholder wealth.

3 For a very thoughtful discussion of this issue, see Leebron (1996, p. 72). Leebron expresses scepticism over the capacity of external observers to determine whether a state has sound democratic processes in place that provide confidence in outcomes that are generated.

4 This suggestion is taken from Trebilcock and Howse (1999).

5 We should further assume that these problems are not reciprocal, that is, that neighbouring states do not generate equivalent and offsetting externalities upon each other.

6 Managers, like all citizens, derive benefits from their communal affiliations. This is true for their families as well. A decision to relocate jeopardizes sunk investment in community affiliations and reduces managerial welfare.

7 In considering how a corporation will react to the possibility of lower effective regulation that is achieved through jurisdictional relocation, it is important to bear in mind that corporations will often strategically overstate the costs of complying with existing or higher standards of regulation in an effort to secure immediate reductions in the regulatory burden from the regulating state. But when those efforts fail, they demonstrate remarkable agility in accommodating themselves quickly and at low cost to the disputed standard. More than that, many regulations that corporations publicly posture against at the time of initial introduction later turn out to be value-enhancing from the perspective of the corporation. There is now a significant body of data demonstrating that the adoption of *higher* levels of social and labour regulation by states are consistent with (rather than inimical to) enhanced factor productivity. An insistence, for example, on shorter work hours for labour or more stringent occupational health and safety standards may improve employee performance, and be revenue-neutral, or perhaps even revenue-enhancing to the corporation.

8 The costs are in addition to the personal costs borne by the corporation's managers, which were discussed above.

9 Further, if relocation motivated by reduced regulatory burdens is seen by stakeholders to unfairly exploit certain stakeholder groups by, for instance, managers opportunistically breaching quasi-contractual commitments made by the corporation, then relocation to a less stringent regime could impose significant reputational costs on the corporation and its managers that will necessarily increase the future cost of contracting to them.

10 Regional multilateral agreements have played a key role in harmonizing international legal and regulatory regimes, most prominently in the EU and under the North American Free Trade Agreement (NAFTA). The motivation behind and effects of the operation of each of these multilateral regimes—the GATT/WTO, the EU and NAFTA—are highly controversial. The reason often given for this prevalent discontent with economically driven multilateral regimes is that many observers fear that entering into binding multilateral trading agreements with other nations will erode the legitimate democratic power of the nation-state, and lead to a loss of sovereignty, lower labour standards and poor environmental protection. More specifically, the fear is that countries will lose the ability to address the degradation of the environment, poor labour rights protections and other compelling social issues in a flexible way, and that this will be replaced with international multilateral commitments that are functions of gov-

ernmental fiat thoroughly pervaded and influenced by corporate economic interests. Some suggest that multilaterally negotiated agreements made by elected government representatives are too removed from direct democratic influence and stakeholder lobbying and thus too subject to trade-offs and political log-rolling to be legitimate despite the fact that the majority of the government representatives participating in the negotiations are democratically elected. Fears of this type (admittedly among others) served to spark recent violent public protests, *inter alia*, in November 1999 in Seattle at the eighth ministerial conference of the WTO, in April 2001 at the Summit of the Americas in Quebec City, and in July 2001 at the G8 Summit in Genoa, Italy and seem to suggest widespread public perception that current multilateral agreements do not do enough to provide for the furtherance of labour rights and environmental protection. See Shaffer (2001).

References

Canada. "Canada's National Contact Point for the OECD Guidelines for Multinational Enterprises" (October 2001) digital document available online at http://www.dfait-maeci.gc.ca/tna-nac/ncp-pcn/about_guidelines-e.asp.

Fitzgerald, P. "Massachusetts, Burma, and the World Trade Organization: A Commentary on Blacklisting, Federalism, and Internet Advocacy in the Global Trading Era." *Cornell International Law Journal*, Vol. 34, no. 1 (2001): 7-8.

Henriksen, T.H. "Using Power and Diplomacy To Deal with Rogue States." *Hoover Essay in Public Policy* (February 1999) accessed October 1, 2001, digital document available online at http://www.hoover.stanford.edu/publications/epp/94/94a.html

Hirschmann, A.O. *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States*. Cambridge, MA: Harvard University Press, 1970.

Hufbauer, G.C. and J.J. Schott with K.A. Elliott. *Economic Sanctions in Support of Foreign Policy Goals*. Washington, DC: Institute for International Economics, 1983.

Leebron, D.W. "Lying Down with Procrustes: An Analysis of Harmonization Claims." In *Fair Trade and Harmonization: Prerequisites for Free Trade?*, ed. J. Bhagwati and R.E. Hudex. Vol. 1: *Economic Analysis*. Cambridge, MA: MIT Press.

OECD. *An Update of the 1996 Study "Trade Employment and Labour Standards: A Study of Core Workers' Rights and International Trade."* Paris: OECD, 2000.

Shaffer, G. "The World Trade Organization Under Challenge: Democracy and the Law and Politics of the WTO's Treatment of Trade and Environment Matters." *Harvard Environmental Law Review*, Vol. 25, no. 1 (2001).

Social Investment. "Introduction" (October 2001) digital document available online at http://www.socialinvestment.ca.

Tiebout, C.M. "A Pure Theory of Public Expenditures." *Journal of Political Economy*, Vol. 64, no. 4 (1956): 416-424.

Trebilcock, M. and R. Howse, *The Regulation of International Trade*, 2d ed. New York: Routledge, 1999.