DYNREG
Dynamic Regions in a Knowledge-Driven Global Economy
Lessons and Policy Implications for the EU

WORKING PAPERS

Institutional Diversity, Agency and Governance for Sustainable Value

Christos Pitelis

39 / 2009

Institutional Diversity, Agency and Governance for Sustainable Value

by

Christos N Pitelis

Director
Centre for International Business and Management (CIBAM)
Judge Business School
University of Cambridge
and
Fellow in Economics
Queens' College
University of Cambridge

Email: c.pitelis@jbs.cam.ac.uk
Tel: 0044 1223 339618
Fax: 0044 1223 766815

Biography:

Christos Pitelis is Director of the Centre for International Business and Management (CIBAM) at Judge Business School, University of Cambridge, and Director of Studies in Economics at Queens' College, Cambridge University. He has published and consulted extensively on the areas of international business and sustainable competitiveness strategy, is the editor of *The Collected Papers of Edith Penrose* and at the Editorial Board of Organization Studies.

Dr Pitelis has researched, consulted extensively and co-ordinated projects for governments, the European Commission, the United Nations, the Commonwealth Secretariat USAID and the private sector. He is an Honorary Research Fellow at the Birmingham Business School, Fellow of L'Institute (a joint venture between the universities of Birmingham, Wisconsin-Milwaukee and Università degli Studi di Ferrara), Associate Professor at the University of Athens, Fellow of the Athens Laboratory of Economic Policy Studies, a non-executive Director of the Medical Group of Companies, Athens.

Abstract:

Extant views of (shareholder) value, (corporate) governance, and competitiveness have a narrow view of 'agency', a poorly developed theory of value and pay little attention to sustainability. In this paper we develop a perspective on the determinants of value-wealth creation at the firm, meso-, and national levels, explore the limitations of extant theory of the firm, concerning governance and value in its context, and discuss some prerequisites of sustainability. We conclude that the pursuit of value is not antithetical to, but it derives from, the notion of sustainability, that sustainability requires both internal and external controls and that institutional diversity can help effect mutual 'stewardship' and monitoring. Moreover, for sustainable value creation, corporate governance needs to be aligned to national and global governance.

Keywords: institutions, agency, governance, sustainability, value

I. Introduction

Despite long-standing and often heated debates on shareholder value and sustainable economic growth, as well as the role of corporations and their governance in effecting both, the relationship between all of these has been little examined. The very terms involved are inadequately developed and thus often misunderstood, misinterpreted or perceived differently by different economic agents. We try to address these problems in this short essay. In section II, we discuss the meaning of value in general and shareholder value in particular; the relationship between value and economic growth; and extant views on the role of firms and corporate governance in effecting these. Having pointed out limitations in section III, we build on these views to provide a perspective on the determinants and agents of value-wealth creation, and discuss the role of shareholder value, (corporate) governance and economic growth in this context. Conclusions follow in section IV.

II. The Nature and Determinants of Value and Wealth and the Role of Corporate Governance

Two major theories have been developed on the nature of value. The classical theory of Smith, Ricardo and Marx, which attributes 'value' to cost of production, in particular labour power expended to produce a commodity ('labour theory of value'); and the 'neoclassical', marginalist notion of 'value' of Jevons, Menger and others, who consider value the perceived 'utility' provided by a good to an economic agent. 'Utility', in turn, is affected by 'scarcity'. (see Dobb, 1973).

The determinants of value-wealth creation was the theme of the founding father of economics, Adam Smith. In his *Wealth of Nations* (1776), Smith attributed the wealth-creating abilities of market economies to the "visible hand" of the firm and the "invisible hand" of the market. In analysing his "pin factory", Smith observed how specialisation, the division of labour, teamwork and invention, create value and generate dramatic productivity enhancements. The marvels of the "visible hand" are enhanced further by the "invisible hand" of the market – the free interplay of demand and supply by economic agents in pursuit of their own interest. The invisible hand helps provide information, incentives, co-ordination, and realise value through

exchange. Competition can ensure that “natural” prices will tend to emerge. Restrictive practices by, for example, “people of the same trade” will endanger this result, calling for restraint and/or regulation.

In this tradition, Joseph Schumpeter (1942) later emphasised the role of innovation and creative destruction as a determinant of economic performance. Edith Penrose (1959) reinvented but also extended the classical tradition, by explaining firm endogenous growth through intra-firm knowledge-creation, leading to “excess resources”, an incentive for growth. Building on Penrose, Richardson (1972) has pointed to the ubiquitous nature of inter-firm co-operation, in forms other than price-collusion.

In the classical tradition, international wealth creation and convergence may follow from David Ricardo's theory of “comparative advantage”; a result predicated, however, on the absence of increasing returns (see below).

In the neoclassical tradition, the focus shifts from value-creation in production and realisation in markets, to exchange relationships, subjective value and efficiency in resource allocation. The aim of economics becomes one of “economising”, of rational choices between ends and scarce means which have alternative uses, (Robbins, 1935). Given scarcity, rationality and the need for economising, the economic aim becomes one of achieving an efficient allocation of scarce resources when time, then add for innovation-value creation.

Efficient allocation has a static and an inter-temporal dimension. The former can be achieved through perfectly competitive markets. The latter through innovations. Unlike static efficiency, however, perfect competition or perfect contestability (a market with free entry and costless exit) need not lead to intertemporal efficiency, as it removes the incentive to introduce innovations – the Schumpeterian reward of (transient) “excess profits”, see Baumol (1991). For Baumol (1991) the best type of market structure from the point of view of intertemporal efficiency is big-business competition. The potential presence of increasing returns, originally pointed to by Allyn Young (1928), suggests that imperfect market structures could well be inevitable, too.

Despite such and other challenges, neoclassical economics and economists seem to share a belief that perfectly competitive markets and free trade can deliver the goods, eg Washington consensus, and lead to sustainable wealth-creation and convergence.

Such challenges to neoclassical theory and the absence of an integrated classically flavoured conceptual framework requires, we feel, an attempt to put together static and inter-temporal efficiency, resource allocation, growth and co-ordination, to explain value and economic performance, see below. Before we turn to the issue of corporate governance.

The (capitalist) firm, especially the joint stock, public limited corporation, is the organisation *par-excellence* in the history of humankind, in its ability to create and appropriate value and wealth. Who controls, or should control, it; how they do so; for what reason; and with what effect, in terms not only of their own objectives, but also those of the firm, and national and global economic prosperity, is accordingly of paramount importance.

Extant economic debates on corporate governance have been surprisingly narrow in focus, dealing with the issue of intra-firm alignment of incentives between shareholders and managers, in the context of a separation of ownership from management. Management-oriented theories, such as ‘stakeholder’ and ‘stewardship’ theories (see Clarke, 2004, for readings) have dealt with broader issues, yet have failed to adequately draw on extant theory of the firm, value-creation and (thus) (shareholder or stakeholder) value; we address this limitation here.

Three major theories of the firm have been developed within economics. First, the mainstream neoclassical theory, in which the firm itself is a ‘black box’, a transformer of inputs into outputs. In this approach, the objective of ‘the firm’ is to maximise profits by equating marginal costs to marginal revenues. As the firm has no “insides” ‘and full information and productive efficiency are assumed, the only corporate governance issue is ensuring that profits are being maximised.

In his classic article on transaction costs, Coase (1937) defined the firm as a multi-person hierarchy, its nature lying in the 'employment contract' between employers and employees, and went on to explain the 'employment contract' in terms of transaction-costs-related market failures. He regarded savings in transaction costs by firms as the reason why labourers 'agreed' to work under the authority or direction of the employer.

Coase's analysis complements the neoclassical view of value by pointing to 'governance-mix' related cost saving, thus efficiency gains. However, similar to the neo-classical perspective, transaction costs analysis takes technology and innovation as data. It thus fails to explain long-term value creation.

In Penrose's (1959) resource-based perspective, firms are seen as real **organisations**, consisting of human and non-human resources, under administrative co-ordination and authoritative communication. Human, and especially managerial, resources are most important. Resources provide multiple potential *services*. Firms use their resources to perform *activities* that result in products for sale in the *market* for a *profit*. The performance of activities within firms creates knowledge through specialization, division of labour, teamwork and learning. The cohesive shell of the organisation is of essence in facilitating learning. These increase productivity, giving rise to 'excess resources'. As excess resources can provide services at (near) zero marginal cost, they motivate managers- entrepreneurs to apply them to new activities, engendering *endogenous innovation and growth*, thus value creation. This can be seen as an efficiency/production-based complement to the Coasean insight.

In all, transaction costs and resource-based theories help explain value generation by firms. But why *shareholder* value? This is explained by Alchian and Demsetz (1972). They observed that in any team effort, where individual output is difficult to measure, team members may 'shirk'. This requires a monitor, who better be self-monitored (to avoid needing a monitor of the monitor, etc.) by being a residual claimant (receiver of profits). Owners (shareholders) are best suited for this purpose, as they have invested in firm-specific assets. Therefore shareholder value is of critical importance. It is threatened by the alleged separation of ownership from

control, which leads to the need to align incentives between owner-shareholders and managers.

The issue of the separation of ownership from management has been considered by Berle and Means (1932). Jensen and Meckling (1976) discussed the issue of 'agency' between owners and management. The problem is that both ideas (of owners being the residual claimants, and of the separation of ownership from control) are dubious. Workers also invest in firm-specific assets. And a 'managerial revolution' may be non-existent or of no significance.

In the work of Berle and Means (1932) and subsequent (managerialist) literature it was suggested that, given high ownership dispersion through the issuing of shares, owners are left without sufficient shares to warrant control, which is now left with the managers. Assuming that managers maximize a different utility function to the owners (who are assumed to maximize profits), firms' objectives might have been changed, thus shareholder value threatened. This need s a solution to the 'agency' issue involved, to re-establish shareholder value.

There are various problems with the above argument. They concern for example, the empirical validity of the phenomenon, what ownership percentage suffices to give control to a cohesive group, how do we identify such cohesive groups, to what extent does dispersion imply a lower share ownership percentage for owners' control? Such considerations did raise doubts on the importance and extent of management control (Scott, 1986).

A second problem concerns the constraints managers face in pursuing their aims. A number of such constraints have been suggested in the literature: the market for corporate control (Manne, 1965), the managerial compensation market (Fama, 1980) as well as the monitoring and bonding by shareholders and debt-holders, etc. The implication is that there may be sufficient constraints to ensure that managers interests will be closely aligned with those of the shareholders.

A third line of criticism comes from observation of the dramatic concentration of share ownership in the hands of financial institutions, pension funds, merchant banks

and insurance companies (Scott, 1986). Such concentration is claimed to constrain managerial objectives further since, unlike small level shareholders, institutional investors can have the knowledge, the ability and the size of ownership stakes required to restrain management. All these point to the idea that companies are controlled by a subset of top-level management and large shareholders with largely common objectives(Pitelis, 1987).[1]

The above discussion leads to some uncomfortable conclusions. First, the focus on ‘agency’ between ‘owners’ and ‘managers’ is far too narrow. Second, the ‘agency’ between ‘employers’ and ‘employees’ is hardly mentioned. Given extensive discussion of the importance of human resources in wealth-creation in economics and management (see, for example Pfeffer, 1998, for extensive evidence), this is unsatisfactory. Third, the link between corporate governance and shareholder value is also tenuous, as it is predicated on the assumption of an exogenous profit maximisation objective on the part of all owners (assumed to be residual claimants), and the related heroic assumption that this is reflected in sustainable share price and dividend growth.[2] Fourth, there is no satisfactory theory of intertemporal value creation (notably through innovation) and capture in the neoclassical literature, while Penrose’s theory of innovation and value-creation ignores ‘agency’ – we try to address these problems below.

III. The Determinants and Actors of Sustainable Value-Wealth Creation and the Role of Governance

Wealth is realised value, expressed in price terms. In a capitalist economy, value is created at the level of production by firms. It is then realised in exchange through the sale of commodities in markets for a profit. Scarcity affects value, but so does the cost of production. The efficient use of scarce resources, notably time, can be instrumental in increasing productivity. The (infra)structure of the firm (organisation management, systems), and its strategy (corporate governance), its technology and

[1] The recent (institutional) “shareholder revolt”, notably the Carlton case, is a case in point!

[2] For example, *The Economist*, 28 June 2003, recently also summarised the problems with this assumption.

innovativeness, the quantity-quality, and relations of its human resources (managers, entrepreneurs, labour), its ability to exploit unit cost economies (such as economies of scale, scope, learning, growth, transaction costs and external) are other important determinants of productivity, see Pitelis (1998). They are affected by the external environment. This comprises three layers. First, the meso-environment, which is industry conduct and structure and the consequent industry "degree of monopoly". The 'degree of monopoly' serves to realise value by determining the price-cost margin of the industry, see Cowling (1982). The meso-level also includes locational aspects and the regional milieu to include the regions' "social capital", see Putnam (1993). The four determinants at the firm level in their interrelationship with the 'external meso environment' determine productivity-value at the industry, sectoral and regional levels.

Figure 1 ABOUT HERE

Moving outwards, the macro-environment, which includes the macroeconomic policy mix and the nature and level of effective demand, impact upon the context within which firms and industry operate and determines the current "size of the market", and (thus) the value that can be realised at any point in time. The very outer ring includes the institutional context and in particular the "governance-mix", which is the "market-hierarchy-cooperation" mix of economic governance. The institutional environment is crucial. It provides "sanctions and rewards", culture and attitudes and the overall "rules of the game" (North, 1991). The "governance-mix" determines the overall efficiency of the mode through which the whole economy operates.

The attached 'wheel of the nation' is finally influenced by the global context. This is the sum of each nation's 'wheel', their synergies, and the institutions and organisations of global governance. These impact upon the size of the global market, and the overall ability of 'The Earth' to generate value and wealth.

The capitalist firm has centre stage in the wheel for its ability to create value-wealth. Another important 'actor' is the government. It may, and does, influence the institutional and macroeconomic context, through laws, regulations, 'leadership' etc. It can affect the meso-environment through its competition, industrial and regulation policies and the macro-environment through its macroeconomic policies. It can impart upon the determinants of productivity and value and wealth, through education and health policies, the provision of national infrastructure, its policies on innovation and "social capital".
A guide to the institutional and organisational configurations and conducts most amenable to productivity-value creation, can be provided through the identification of each actor's respective capabilities and competences. Firms are relatively "better" in production, markets in exchange and states in ideology, particularly in the forms of legitimacy. Small firms can have advantages in flexibility, large ones in unit cost economies. Inter-firm cooperation, eg in clusters, can enjoy some unit costs economies and induce innovativeness.

Concerning 'governance' and 'agency', our analysis suggests a more complex **hierarchy of 'agencies'** and thus in turn the need for the solution to the problem of objective alignment. Starting first from the controlling group of the firm (here, the 'agent') and the corporation as an entity comprising of the sum of its stakeholders (here, the 'principal'), it can be that the pursuit of personal interests by the former compromise those of the latter. This, for example, is the case when the former pursue strategies that favour short-term, share valuation growth and personal compensation packages and perks, which are beyond those required to provide them with adequate incentives to pursue the interest of the corporation as a whole, that is, sustainable value creation and capture. This undermines sustainability of the corporation as a whole and has legitimately led to the extensive focus of recent corporate governance debates on this issue.

The second layer is that of the corporation as the agent and the government as the principal. The ability of firms to realize value-wealth can, and often does, lead them to attempt to appropriate wealth as 'rent' through monopolistic and restrictive practices. A high degree of market power can thwart incentives to innovation and be inimical to productivity and value-creation.

In this context, the government (and its governance) becomes crucial. Sustainable productivity value-wealth creation requires competition and regulation policies that thwart the creation and use of monopoly power (while allowing for an innovations-inducing "degree of monopoly"), and adopt policies to support small firm creation and survival and regional clusters.

In the third layer, nations themselves (now the agents) can try to capture wealth by adopting strategic trade policies that can harm the process of global wealth creation. The aim of the 'global community' (now the 'principal) should be to require individual governments to adopt policies that enhance global productivity and value-wealth creation. Indicatively, governments of developed economies should refrain from policies that restrain trade, yet recognise the need of developing countries to 'foster' infant firms and industries, for their expected competition, innovation and productivity effects.

Going back to the 'employer' and 'employee' relationship, it is clear that disaffected labour is likely to be less productive (Pfeffer, 1998), which may undermine the very purpose of the corporation and its controllers. In this context, employees become a privileged 'stakeholder'. This is not just because employees too invest in firm-specific assets (as do shareholders), but also notably because they are a crucial determinant of a firm's ability to exist.

The absence of global knowledge (and a global monitor) calls for diversity. In any country or society, a host of other organisations and institutions exist – the family, the church, NGOs, and (even!) state-owned enterprises (SOEs) – that can affect, in their interaction, the ability of firms' and governments' incentives to play the productivity and value-wealth enhancement game. In this context the issue is the specialization and division of labour of alternative institutions and organisations, based on their relative advantages and competencies in production, exchange, legitimacy, ideology and culture, and the identification of institutional and organisational configurations and conducts that promote efficiency in the form of enhanced productivity, value and wealth. Competition and co-operation, self-interest

and altruism, big businesses and smaller co-operating firms in clusters, can all impact on the goal of productivity-value improvements.

Sustainability of productivity and value-wealth-creation has implications for environmental, distribution and social policies, including migration, which also follow endogenously from our proposed perspective. Excessive inequities in distribution, the abuse of the environment, the exodus of educated human resources, can thwart a country's ability to sustainably generate wealth. Policies designed to deal with such problems are also part of a government's remit, with a proviso. Governments should make use of market prices to render the actions of "offenders" expensive (e.g. tax pollutants, require emigrants to developed countries to return public funds-subsidies provided for their education, etc). The use of non-market measures should in general be avoided: it thwarts incentives, and leads to the path of authoritarianism, with predictable consequences. In the absence of a "Dr Pangloss", an approximate way of effecting sustainable wealth creation is through the free interplay, pluralism and diversity of institutions, organisations, individuals, ideas, cultures, religions, norms, customs and civilizations, as each can serve, in part, as a 'steward' or 'monitor' for the others. Having said this, it is crucial that this process is "managed", "guided", and "moulded" through informed agency, so that democracy is married to performance. This brings our discussion of 'governance' centre-stage.

For (corporate) governance to contribute towards sustainable value and wealth creation, internal and also external controls are required, including national and global incentives and sanctions. Importantly, it is necessary to eliminate corruption at all levels: intra-firm, intra-country (regulatory capture) between host governments and multinationals, and internationally. All these presuppose a degree of trust, social capital and the 'ethical dimension'. Exclusive focus on self-interest may well be the strongest foe of sustainability. As a recent *Economist* (June 18, 2003) points out, government should be "pro-market, not pro-business". We would also propose 'pro-sustainability'.

IV. Conclusions

Extant views of (shareholder) value, (corporate) governance and competition have a narrow view of 'agency' and a poorly developed theory of (shareholder) value. They also pay little attention to sustainability. We suggested that a more comprehensive theory of value creation and appropriation requires a synthesis of resource allocation and resource creation, and developed a perspective on the determinants of value-wealth creation at the firm, meso-, and national levels. We have then explored the limitations of extant theory of the firm, concerning governance and value in its context, and explored some prerequisites of sustainability. We concluded that the pursuit of (appropriately defined) shareholder (here equals stakeholder) value is not antithetical to, but it derives from, the notion of sustainability. Sustainability requires both internal and external controls, to include the market, but also hierarchy (firm and state), institutional and global controls. Institutional diversity and pluralism can help effect mutual 'stewardship' and monitoring. For sustainable value creation, corporate governance needs to be aligned to national and global governance. Eliminating corruption at all levels is a crucial prerequisite. All these have important implications for policy.

References

Alchian, A. and H. Demsetz 1972 ‘Production, information costs, and economic organization’. *American Economic Review* 62/5: 777-795.

Baumol, W.J. 1991 *Perfect Markets and Easy Virtue*. Oxford: Blackwell.

Berle, A.J. and C.G. Means 1932 *The Modern Corporation and Private Property*. New York: Harcourt Brace.

Clarke, T. (ed.) 2004 *Theories of Corporate Governance*. London: Routledge.

Coase, R.H. 1937 ‘The nature of the firm’. *Economica* 4: 386-405.

Cowling, K. 1982 *Monopoly Capitalism*. London: Macmillan.

Dobb, M. 1973 *Theories of value and distribution since Adam Smith: ideology and economic theory*. Cambridge: Cambridge University Press.

Fama, E.F. 1980 ‘Agency problems and the theory of the firm’. *Journal of Political Economy* 88/2: 288-307.

Jensen, M.C. and W. Meckling 1976 ‘Theory of the firm: managerial behaviour, agency costs and ownership structure’. *Journal of Financial Economics* 3/4: 304-360.

Marx, K. 1959 *Capital*. Vol. I-III. London: Lawrence and Wishart.

North, D.C. 1981 *Structure and Change in Economic History*. London & NY: Norton.

Penrose, E.T. 1959/1995 *The Theory of the Growth of the Firm*, 3rd edn. Oxford: Oxford University Press.

Pfeffer, J. 1998 *The Human Equation: Building Profits by Putting People First*. Watertown: Harvard Business School Press.

Pitelis, C.N. 1987 *Corporate Capital: Control, Ownership, Saving and Crisis*. Cambridge: Cambridge University Press.

Putnam, R.D. 1993 *Making Democracy Work – Civic Traditions in Modern Italy*. Princeton: Princeton University Press.

Richardson, G. 1972 'The organisation of industry'. *Economic Journal* 82/327: 883-896.

Robbins, L. 193) *An Essay on the Nature and Significance of Economic Science*. London: Macmillan.

Schumpeter, J. 1942/1987 *Capitalism, Socialism and Democracy*, 5th edn. London: Unwin Hyman.

Scott, J. 1986 *Capitalist Property and Financial Power*. Brighton: Wheatsheaf.

Smith, A. 1976 *An Enquiry into the Nature and Causes of the Wealth of Nations*. (Campbell, R.H. and A.S. Skinner (eds.); first pub. 1776). Oxford: Clarendon Press.

Young, A. 1928 'Increasing returns and economic progress'. *Economic Journal* 38/152: 527-542.

Figure 1 - The determinants of productivity, value and wealth at the firm, meso and national levels