Chapter 9
The Social Responsibility of the Firm:
A Corporate Governance Perspective

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ABSTRACT

This chapter pursues a normative approach to corporate governance, bridging economic theory on the nature of the firm and corporate management strategy. It intends to show that from a welfare economics perspective there is room for improvement if governments are willing to revisit the legal framework and redesign the institutional boundaries of the firm. In concrete, echoing concerns being put forward by the World Economic Forum and other international organisations, it is proposed that the social accountability of the modern corporation and its institutional boundaries should be revisited on legal grounds. A new role for top management is advanced in the context of principal-agent theory.

INTRODUCTION

The usually stakeholder-shareholder rhetoric of opposites is a false dichotomy. When managers take into consideration other stakeholders' interests, they are not acting against rewarding owners of capital with a fair financial return given the risks. Neither, when undertaking a holistic approach to the firm, they are necessarily sacrificing productive efficiency. A new definition of corporation is needed. One that does not contradict profit maximisation but encompasses the way organisations adapt to social and technological ever-changing environments.

A combination of theories explaining the boundaries of the firm, and how the modern corporation is organised internally is needed to shed some light on how resources and capabilities interact with each other, and help managers to take better decisions, while delivering optimal performance. The emphasis on shareholder value is a simplistic representation of a complex mesh of social relationships having the firm as stage, that one cannot but agree.

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Financial investors are being cursed for extreme income inequalities and economic instability. As a result, internationally, corporate governance codes of best practices mirror OECD (2020) guidelines on board independence and diversity, and large companies gradually adapt governing structures and strategies to achieve broader economic objectives. The World Economic Forum preaches a shift from the dominant shareholder value maximisation to responsible capitalism, fostering the theme of 'purpose' as to motivate stakeholders around a common social and environmental goal[1]. In the news, Larry Fink, Chairman and CEO of BlackRock, pressures chief executives to have a sense of purpose, and achieve company's full potential.[2]

Technology and social norms play a pivotal role in the way corporations organise themselves. Uber and corporations alike are weaving a new mesh of relationships, directing the use resources in completely new ways, highly unthinkable before. Platform capitalism is challenging the institutional view of the firm and its boundaries as defined by existing norms. For many, volatile market relationships are substituting stable and long-lasting contracts with suppliers and customers, having implications for management, regarding sustainability and firm survival.

One needs an overarching theory that links concepts such as agency theory, transaction costs, asymmetric information, stewardship theory and human relationships: i.e., what one could label freely as "economics old school", on philosophical and normative tradition. The economic and legal definition of a corporation is as much a matter of academic curiosity as it has nonnegligible implications for strategic management, but also for competition policy, regulation and corporate governance issues alike.

The rest of the paper is organised as follows. Next section presents briefly the theoretical background, before moving into a critical review of transaction costs economics and the nature of the firm. Then, we introduce the market value of the firm concept, supporting the generally adopted capital market practice of corporate managers as agents of shareholders and acting on their only interest. Section four is about how shareholder primacy fails to represent adequately the modern corporation, and the merit of stakeholder and stewardship theories. The firm is presented as a social vehicle, with its own internal set of rules and regulations, paving the way to discuss the governance of the corporation (in section 5). Suggestions and recommendations regarding stakeholder representation and the role of management are offered. Section 6 concludes.

THE NATURE OF THE FIRM

Without controversy one can say the firm is a social arrangement for production. The seminal view on the nature of the firm proposed by Coase (1937) perceives the firm as a nexus of contracts and offers one of the most influential contributions to corporate governance. Transaction costs, used to draw a dividing line between the firm and the market, opens a role for managers which Williamson (1973, 1975), Holmstrom (1977) and Hart (1995), among many others, explored. The cost of setting up a hierarchical structure to coordinate production has to be analysed vis-a-vis the costs of trading in the market.

In a recent paper, Kay (2019) argues that economic theory fails to account for a correct representation of the firm, missing the very social nature of the corporation, and the fact that a stakeholder approach is currently dominant in corporate strategy. Yet, if Kay (2019) is correct, it is puzzling why we do not see more corporations concerned with social welfare and taking all stakeholders' views into consideration. Quite likely, the principal-agent theory introduced by Jensen and Meckling (1976) still dominates the financial world, explaining much of what one sees as corporate behaviour.