A NORMATIVE THEORY OF THE FIRM

SPECIFIC INVESTMENTS AS LEGITIMATION FOR RESIDUAL CLAIMS: CONSIDERATIONS ON ETHICAL INTEGRATION FROM THE PERSPECTIVE OF GOVERNANCE THEORY

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Abstract: The spectrum of corporate governance is extremely broad: it extends from a traditional variant (centered on principal-agent theory) to an efficient, resource-optimized form of leadership directed toward all stakeholders. This paper will promote the following thesis: in addition to shareholders, other stakeholders (especially employees) also bear the risk of residual income. The risk of residual income, which arises due to specific investments, presents a valid and legitimate basis for residual claims and thus demands that corporate leaders be more strongly oriented precisely toward those interest groups which bear the uncertainty of residual claims. An extension to stakeholder management and an expansion of the definition of corporate governance will then follow. Specificity presents a moral basis of legitimation for stakeholders. In presenting this argument, academic theories and methods of New Institutional Economics are used.

1. The Crisis of Corporate Governance

> "Why do we not fundamentally rethink the corporate governance issue? Why don't we actually acknowledge in our theories that companies survive and prosper when they simultaneously pay attention to the interests of customers, employees, shareholders, and perhaps even the communities in which they operate?" (Ghoshal 2005, 81)

Although the issue of corporate governance has enjoyed a long tradition within the field of management sciences, the recent spate of business scandals involving Enron, Worldcom and Parmalat continue to provide ample cause for concern. Since the exposure of these events (at the latest) international corporate governance has been at the center of critique for many social parties. Some critics have been demanding extensive management responsibility that would incorporate all stakeholders into the managerial decision-making process. On the other hand, others appear to see the solution as a return to the economic core of corporate governance. In any event, even a tight interpretation of corporate governance as *regulation within the framework of the principal-agent relationship* does not at first seem very clear.[1] Despite innumerable written contributions on this issue, the economic sciences have failed to provide a clear definition of the concept or even to demarcate the underlying object of consideration.

A possible reason may be the fact that the topic is exceptionally complex and far from trivial: namely, (1) it picks up the traditional question regarding *the primary goal of a corporation* (What is the primary aim to be pursued by corporate leadership?), and thus discusses (2) the question of *legitimate claimant groups* (Who possesses justified claims in relation to the corporation?), (3) it exposes *differing influential variables* (What do ownership structures, branches, cultural groups etc. look like?) and leads thus (4) to the question of *universal validity* or *local relevance* (Do we need "standardized" corporate governance?).

Thus it is hardly surprising that the spectrum of corporate governance is extremely broad: it extends from a traditional variant (centered on principal-agent theory and thus reconstructed within [new] institutional economics) to an efficient, resource-optimized form of leadership directed toward all stakeholders. The question which needs to be clarified — a question which appears at first sight to be self-contradictory — is whether a broader understanding of corporate governance might not bring more *clarity* to the discussion. This paper will promote the following thesis: *in addition to shareholders, other stakeholders* (*especially employees*) *also bear the risk of residual income.* The risk of residual income, which arises due to specific investments, presents a valid and legitimate basis for residual claims and thus demands that corporate leaders be more strongly oriented precisely toward those interest groups which bear the uncertainty of residual claims. An extension to stakeholder management and an expansion of the definition of corporate governance will then follow. In presenting this argument, I will make use of the academic theories and methods of New Institutional Economics. *An economic argument will be used to reconstruct ethical claims.*

This paper will lay *the economic bases for a normative expansion of corporate governance*. It starts with an explication of the foundations of corporate governance (part 2), moves on in part 3 to present a critique of neoclassical economics and propose the research program of New Institutional Economics as the starting point for corporate governance. The core of New Institutional Economics — namely, the agency theory and the principal-agent problem — will then be applied to the current issue (part 4). Part 5 will attempt to introduce employees' specific investments as a foundation for the legitimacy of residual claims. In a brief overview, I will propose to connect stakeholder management with agency theory, namely as the economic bases of normative corporate governance (part 6). Finally, the paper will close with a short conclusion and a look toward future prospects (part 7).

2. The Bases of Corporate Governance

The concept of *Corporate Governance* has been used in the English-speaking world since the 1990s (Witt 2000, 41). In broad terms, one understands corporate governance to be the effective direction and control (more precisely: leadership) of an organization with the aim of securing the long-term survival and viability of that organization.[2] Thus the unified question is now: *what should a normative, underlying order for the leadership and directive systems of large corporations look like — especially if they are to be theoretically sound as well as both applicable and workable?*[3]

The goals or legitimacy of corporate activity will be critically examined. While corporate governance — even in the narrow sense — must be effective and efficient, it should also offer a self-critical reflection of its own aims. In this way, corporate governance itself becomes an *agenda setter*, and thus economically relevant both *within* the system as well as *beyond* it. Purposefully limiting one's perspective on reality and transforming one's method into dogma (whether it be neoclassical or new institutional economics) brings with it the danger of false conclusions or the wrong recommendations for action. Some people are surprised when the neoclassicists, who assume the existence of complete information (reconstructing managers and stockholders as completely informed *homines oeconomici*), simultaneously draw upon the principal-agent theory (which conversely presupposes a precise lack of complete information and assumes the existence of information asymmetries) in order to establish the neoclassically-influenced concept of shareholder value management. It seems that contradictions in the modeling have arisen — contradictions which lead to far-reaching and dramatic misunderstandings in management practice. On the one hand, there is supposed to be a one-to-one relation between the value of a corporation and its stock market valuation (which assumes here *complete information* for participants in the capital market). On the other hand, managers are given, and authorized to take advantage of a discretionary leeway, not in their own interests but in the interests of stockholders — which amounts to the exploitation of *information asymmetries.*

3. Critique of Neoclassical Economics as the Starting Point for Corporate Governance: The Research Program of New Institutional Economics

Corporations do not play a significant role in classical economic theory — which was shaped by and since Adam Smith (among others). However, the Scottish economist and philosopher did see such institutions as the law and moral regulations as important components for the functionality of markets. From an economic perspective, and following the classical liberal thesis, the wealth of nations is increased through the pursuit of one's own interests within the limits of existing regulations and through the invisible hand of the market in an open and functioning competition. Quite early on, Adam Smith already recognized a general tendency concerning the division of labor and motivation, namely that managerial inefficiency was caused by a *deficient motivational structure*. Later, this idea would be adopted and solidified by Berle and Means (1932) in regard to stock companies.

Thus long before R. Coase, Adam Smith had referred to the development of institutions. In the first book of his *Wealth of Nations,* Smith (1776/1999a/b) wrote on the development of organizations, that:

> "As soon as stock has accumulated in the hands of particular persons, some of them will naturally employ it in setting to work industrious people, whom they will supply with materials and subsistence, in order to make a profit by the sale of their work, or by what their labour adds to the value of the materials." (Smith 1776/1999a, 151)

The first and fifth books even refer to the principal-agent problem, to moral hazard and shirking:

> "A man commonly saunters a little in turning his hand from one sort of employment to another. When he first begins the new work he is seldom very keen and hearty; his mind, as they say, does not go to it, and for some time he rather trifles than applies to good purpose." (113)

> "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." (Smith 1776/1999b, 330-31)

It is possible that Smith was an early representative of liberal corporate governance, stressing, as he does, phenomena similar to management:

> "The profits of stock, it may perhaps be thought, are only a different name for the wages of a particular sort of labour, the labour of inspection and direction." (Smith 1776/1999a, 151)

At first, neoclassical economics also neglected the meso-level of corporations.[4] The concept of the *economic man*, described by Anglo-Saxon economists, was first introduced in a systematic way at the end of the 19th century by Vilfredo Pareto (who used the Latin expression *homo oeconomicus*) (Manstetten 2002, 48, note 12). In economic theory, the *homo oeconomicus* in so-called *methodological individualism* is the basic component of neoclassical theory (Katterle 1991). It became known as an idealized *model* of the human being and has been utilized primarily by economists for reconstructing and modeling particular constellations of economic problems and decision-making processes (Eurich and Brink 2006). Despite its astounding pervasiveness, the *homo oeconomicus* (which is the central theoretical model of neoclassical economics) has experienced exceptionally strong criticism.[5]

At the center of neoclassical economics we find the *general equilibrium theory*: supply and demand meet at market and prices alter until demand is satisfied and the market exhausted (Erlei, Leschke, and Sauerland 1999, 44ff.). The *equilibrium price* is sufficient just to cover production costs — under otherwise equal conditions, corporations no longer make a profit. Yet in addition to these assumptions, this theory is based upon a wealth of other presuppositions, such as the homogeneity of goods and services, a completely informed market (perfect market transparency), complete contracts (with total specifications, no fraud, no uncertainty), no transaction costs, etc. The neoclassical premises were criticized as being severely reductionistic and not reflective of reality. Translated to corporations, neoclassical economics assumes that those contracts signed with business agents are complete: there are no implicit contracts.[6] As such, neoclassical economics did not recognize institutions.

Fundamental criticism (Göbel 2002, 29; Furubotn and Richter 2005) of neoclassical economics was also the birthplace of New Institutional Economics, which understands itself essentially as a further development of neoclassical doctrine. Economic transaction continues to occur in markets, however in carrying out their transactions, market actors now take advantage of institutions.

New Institutional Economics must be separated from (old) Institutional Economics. In the nineteenth and twentieth centuries, representatives of the "Historical School" (such as Roscher and von Schmoller), the "Austrian School" (such as Böhm-Bauwerk and von Hayek) and the "Freiburg School" (such as Eucken), together with followers of American Institutionalism (such as Veblen, Commons) also criticized neoclassical methods (Erlei, Leschke, and Sauerland 1999, 28ff.). As mentioned above, New Institutional Economics depends to a much larger degree on neoclassicism, to the point that it can be represented, in its *normative* variants, in mathematical models. To this day, new and old Institutional Economics continue to run in parallel, though clearly the former has been much more successful. Common to both is the concept of *institution*. According to Furubotn and Richter (2005):

> "An institution is understood (...) as a set of formal or informal rules, including their enforcement arrangements (the "rules of the game"), whose objective it is to steer individual behavior in a particular direction." (560)[7]

Under the rubric of "Institutions as regulative systems" we find not only the state, operational codetermination, marriage and the law, but also tradition, customs and norms.[8] Institutions can be an exogenous given; yet they can also develop out of a system as an endogenous variable. Thus institutions have a governance function, and in some cases a *self-governance* function. Additionally, *opportunism* is systematically integrated into the research program and thus represents a further differentiator to traditional price theory. In neoclassical economics, opportunistic behavior was still excluded, not because the actors behaved morally but because the market was complete, making opportunistic behavior impossible by definition. Thus the essential differences between New Institutional Economics and neoclassical economics lie in the following altered assumptions:

Criterion	**Neoclassical Economics**	**New Institutional Economics**
Rationality	Complete Rationality	Incomplete or Bounded Rationality
Institutions	No	Yes
Opportunistic Behavior (moral hazard)	No	Yes
Information Distribution	Complete Information	Asymmetric Information (incomplete and unevenly distributed)
Transaction Costs	No	Yes

Diagram 1: Assumptions of Neoclassical and New Institutional Economics in Comparison

In the following, I would like *to present a management reconstruction of corporate governance theory from the perspective of New Institutional Economics*. Yet first, one needs to assign corporate governance to a particular form of institution. This will make use of Williamson's model which distinguishes between the following *four levels* (Williamson 1998, 25ff.):

1. *Embeddedness:* informal institutions such as norms, customs, traditions or religions.
2. *Institutional environment (formal rules of the game):* formal institutions such as the judiciary, constitutions, laws, property rights, etc.[10]
3. *Governance (play of the game):* monitoring and enforcement systems such as corporate constitutions or employment contracts.
4. *Resource allocation and employment:* occurs under the demands of 1–3.

Corporate governance, as it is understood in this article, corresponds to Williamson's third level. Williamson himself coined the term *governance* or *governance structure* in this context.[11] This position has been strengthened by Davis and North (1971) among others:

> "An institutional arrangement is an arrangement between economic units that *govern* the ways in which these units can cooperate and/or compete." (7, emphasis added)

In the management sense, corporations are portrayed much more realistically in New Institutional Economics than in neoclassical economics. Three research areas can be identified: (1) *transaction cost theory* (Coase 1960; Williamson 1979, 1985), (2) *property rights theory* (Coase 1960; Grossman and Hart 1986; Hart 1995; Hart and Moore 1990), and (3) *principal-agent theory* (Ross 1987; Jensen and Meckling 1976).

Ronald H. Coase, the founder of transaction cost theory, can also be considered the father of the *New Institutional Economics of corporations* due to his work on *The Nature of the Firm* (Coase 1937). Coase examines a foundational question: *why do corporations exist if markets are the most efficient form of trade activity and economic transaction?* Furubotn and Richter (2005) formulate the task of New Institutional Economics as follows:

> "(…) central to the New Institutional Economics is the solution of the coordination problem of economic transactions between individuals by mutual agreement under the assumption of transaction costs." (291)

Coase argues that corporations come into existence in order to reduce transaction costs (of which he lists information, search and bargaining costs as well as the costs of contract enforcement; Coase 1937, 390). Thus we are presented here with two alternatives: *market* (*contract*) and *hierarchy* (*direction; corporation*). In markets, one finds only individuals, whereas hierarchies are characterized by order or direction through superiors (vertical integration) (Schneider 1993, 250). The hierarchical solution (e.g. corporations) form when the transaction costs of using the market are too high. In this instance, authority is transferred to superiors (while this occurs, admittedly, via a contract, the relationship between employees and employers is not regulated by the conditions of the contract but by the directive rights of superiors) (Göbel 2002, 37). The concept of "transaction costs" can be traced back to Commons (1931), who used it to refer to the creation and transferal of property rights as the fundamental, underlying concept of economic analysis.

According to *property rights theory*, the owner of an *asset* can determine its use and is also to receive the fruits of that use. Furthermore he has the right to change its form, substance, or location. On this point, Grossman and Hart (1986) write:

> "(…) the owner of an asset has the residual right of control of that asset, that is, the right to control all aspects of the asset that have not been explicitly given away by contract." (695)

At this stage, it remains unclear who, from all possible stakeholders, would then possess property rights in this sense (Jansson 2005, 2). Although the textbook opinion assumes to assign these rights only to owners, a new academic trend has been promoting the opinion that it is not merely the shareholders (as owners) who possess property rights within a corporation. Such a position can be found, for example, in the works of Kay (1996), Blair (1995) and Blair and Stout (1999).

One could further argue that with the increase in complex corporations, whose *main asset* is knowledge, the "know-how" of a corporation, or soft factors such as the "skills of its employees, the expectations of customers and suppliers, and its reputation in the community" (Jansson 2005, 3) become central.

Out of the three directions taken by New Institutional Economics, I would like in the following section to examine *agency theory* and the *principal-agent problem* in particular.

4. The Core of New Institutional Economics: The Agency Theory and the Principal-Agent Problem

The agency theory dominates research in corporate governance. In contrast to the origins of New Institutional Economics (as an economic theory), we encounter here an application in *management*. At one point, Jensen (1983) notes: "(…) the foundations are being put into place for a revolution in the science of organizations." (319). And a few years later Ross (1987) emphasizes that the agency theory is the central theory for the explanation of managerial behavior. Within the bounds of economic imperialism, use of the *homo oeconomicus* model influenced other social sciences (e.g. in the *economic theory of politics* or *economic theory of law*) in a similar way, the agency theory has also gained a foothold in other social sciences, such as sociology and the political sciences (Eisenhardt 1989). The principal-agent theory distinguishes between two differing theoretical branches (Jensen 1983, 334ff.; Furubotn and Richter 2005):

1. *The normative principal-agent approach* (Hart 1989, 1758; Bamberg and Spremann 1987; Stiglitz 1989): mathematical continuation on the basis of the neoclassical apparatus yet with a new model of the actor. The creation of an efficient incentive design in the interests of shareholders is central here.
2. *The positive principal-agent approach:* neither mathematical nor empirical.[12]

The agency theory deals with the problematic relationship between principals and agents which has arisen with the separation of ownership and control. To take a broad definition, one could describe the relationship as follows:

> "Whenever one individual depends on the action of another, an agency relationship arises. The individual taking the action is called the agent. The affected party is the principal." (Pratt and Zeckhauser 1985, 2)

If one adds here the perspective from contract theory, then the corresponding definition by Jensen and Meckling (1976) seems most appropriate. According to this definition, one can reconstruct the agency relationship as a

> "(…) contract under which one or more persons (the principal[s]) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent." (308)

At the same time, one sees in this definition the importance of *decisions*. Owners have *ownership rights*, managers however have (*delegated*) *decision rights*. While it is true that owners (i.e. shareholders in our case) do have decision rights, in the sense that they vote in general meetings on issues such as mergers and acquisitions or the determination of dividends, the majority of the decision-making is delegated to management (Jansson 2005, 1-2). Ghoshal (2005) writes:

> "In courses on corporate governance grounded in agency theory (…) we have taught our students that managers cannot be trusted to do their jobs — which, of course, is to maximize shareholder value — and that to overcome "agency problems", managers' interests and incentives must be aligned with those of the shareholders by, for example, making stock options a significant part of their pay." (75)

The shareholder (principal) employs the manager (agent) to act in his or her interests, namely so that the capital invested by the principal might bear as much interest as possible. Thus, according to capital market theory, neoclassical economics and the shareholder value concept, management is faced with the task of directing the entire corporate strategy toward the benefit of shareholders and their interests. The shareholder bears the residual financial *risk* since it is broadly assumed that the manager will act rationally and attempt to increase his or her own advantage by taking benefit of the lead in information. Normally, this advantage is incompatible with the interests of shareholders. As such, the agency theory distinguishes between two resulting agency problems.

The first, and most well-known problem is represented by the *moral hazard*, i.e. the agent's opportunistic behavior *after* signing a contract. After the contract is signed, either the agent receives new information which was not perceived by the principal (hidden information) or the agent's activities cannot be observed or controlled very easily or without high costs (hidden action is equivalent to moral hazard in a strict sense). One type of moral hazard is *shirking:* the agent invests much less time and work into the delegated task, takes too many risks (or too few), wastes resources and generally enjoys his or her advantages. This is evident in so-called *consumption on the job*, where the employer's resources are used by employees for private purposes (e.g. use of the internet). A further form of moral hazard is *hold-up*: this occurs due to the factor specificity of transactions, which Williamson noted. Williamson (1989/1996) understood specificity to be a marker of transaction characteristics relevant to organizations, namely a determinant of economic dependency.

> "Asset specificity has reference to the degree to which an asset can be redeployed to alternative uses and by alternative users without sacrifice of productive value. This has a relation to the notion of sunk cost." (59)

To counter this problem, the principal establishes monitoring systems in order to control management. In Germany, the *Aufsichtsrat* (or supervisory board) has been created precisely to assume this function.

In addition to the "ex post" information asymmetries mentioned above, there are also, secondly, the so-called "ex ante" information asymmetries, i.e. a principal-agent problem that occurs *before* closing a contract. This is also called *hidden characteristics* or *adverse selection* and, according to Akerlof, negative selection in the used car market provides a prominent example (Akerlof 1970).

The agency problems noted above can be reduced in three ways (Göbel 2002, 110ff.):

1. Reducing information asymmetries;
2. Harmonizing the goals of principals and agents; and
3. Building trust.

There are two ways to reduce the information asymmetries: in *screening*, the principal "investigates" the corporation, e.g. by running controls; in *signaling*, management (the agent) gives signals to the principal either in accordance with the law (e.g. through reporting), voluntarily (e.g. through codes of ethics) or in a mixed form (e.g. through the German Code of Corporate Governance). Other control and monitoring systems would include control of shareholders' voting rights, control through capital and product markets (just as the transfer and removal of management is equivalent to a market for corporate control), control through employment and manager markets, or control through liability (Witt 2002, 47ff.). Normally, the principal must invest money into such monitoring which then reduces his or her return — and according to the theory, it is only the principal who is entitled to residuals. Thus, against this background, corporate governance is a form of the efficient leading and direction of a corporation in the interests of its shareholders. A further option might be the unification of principal and agent interests in advanced wage and incentive systems, such as were typical in the 1990s when wages were often paid in shares or stock options (Kürsten 2002). Finally management can build up reputation capital.

Central to the principal-agent theory are so-called *agency costs*. Jensen and Meckling have provided some initial orientation in this respect and have differentiated the following three areas (Jensen and Meckling 1976, 308ff.; Fama and Jensen 1983, 327):

1. *Monitoring costs/expenditures*: costs borne by the principal for controlling and directing the agent (e.g. the costs of closing contracts and monitoring the execution of that contract).
2. *Bonding costs/expenditures*: costs borne by the agent for ensuring his or her performance (e.g. rendering of accounts, reporting).
3. *Residual loss*: monetary losses borne by the principal due to the failure of agents to achieve the first-best solution.[13]

This residual loss represents a risk for the principal and forms the central basis of legitimation for orienting the agent toward the principal's interests.

5. The Specific Investments of Employees

For the remainder of this paper I would like to present the opposite position and suggest the following thesis: *in addition to shareholders, other stakeholders* (*such as employees*) *also bear the risk of residual incomes.* Employees represent stakeholders which have made highly specific investments in a corporation — they have sunk costs which, once in place, can only be reinvested in alternatives at a high loss in value. The employee has made a specific investment so that, in comparison to the second-best alternative (e.g. a different occupation), it becomes a quasi rent. The employee is *locked-in,* since (if she fails to fulfill the contract with her contract partner) she loses this quasi rent. She bears the risk of the costs for the second-best alternative measured in the amount of this quasi rent. Employee *returns* are based predominantly less upon explicit contracts than implicit contracts, due to the incompleteness of the contracts and the high specificity.

Of course the question remains: how does one calculate such a specific investment? Furthermore, the specificity of the investment varies in accordance with the environmental situation. If an employee has specific capabilities or specific know-how — for instance if she can operate a special machine or offer a very particular service — then she has made high specific investments when she is employed by a business which owns this special machine or offers this peculiar service. If a concept is successful, imitators will quickly come to market: the specific investment is reduced and the danger of a hold-up sinks for the employee, since she can now use her competencies and know-how elsewhere.

In future, implicit contracts will increase in importance for employees due to an increase in specificity arising from the progressive division of labor; this is so despite the increased measures in further education and employability concepts. These employees will be faced with multiple risks: (1) if their returns (i.e. the fulfillment of explicit[14] and implicit contracts) are dependent upon the economic situation of the corporation, then (2) there is a danger (due to the hold-up situation) that the corporation may act opportunistically and (3) employees will not be able to diversify due to their high specificity. Jansson, following Prahalad (1997), clearly argued that corporations are markedly dependent upon the know-how of their employees, and employees often make specific investments. As with hold-up scenarios in general, this suggests that the chances and risks of *asset specificities* exist on both sides.

> “When an employee has to make a firm specific investment in human capital it gives rise to dependence between the employee and the firm.” (Jansson 2005, 4)

Thus it falls within the responsibility of managers to motivate their employees, to make use of their specific investments and retain them within the corporation. Furthermore, managers should not exploit their employees — they should not take advantage of their hold-up situation. Against this background, the keeping of one’s implicit promises becomes central. Thus quasi rents create a connection between the specificity of one group and the opportunism of the other. Specificity leads to an economic dependence which can be exploited by opportunism.

> “After a specific investment is made and (…) quasi rents are created, the possibility of opportunistic behavior is very real.” (Klein, Crawford, and Alchian 1978, 298)

It is conceivable that employees could anticipate this opportunistic danger on the side of management and thus attempt to safeguard themselves either contractually or by requesting a risk premium. However, due to incomplete rationality, it becomes impossible to institute a contractual ex ante safeguard against opportunism. An ex post compensation would lead to the re-negotiation of implicit contracts. Furthermore, employees can request a governance system which would prohibit opportunistic behavior. If this were to occur, then the value of the implicit claims which the employee held over against the corporation would have to be reduced. The Management has to pay less compensation. Governance within such an arrangement therefore stresses, once again, the idea of constructing *institutional arrangements* in such a way as to reduce the motivation for opportunistic behavior by management (and of course also on the part of employees). The comparison of risk between shareholders and employees can be summarized in the following diagram:

Risk	**Shareholder**	**Employee**
Diversification	Yes	No (human capital can not be diversified, occasionally: multiple occupations)
Investment Form	Money	Time and Labor
Invested Amount	Normally, partial investment	Normally, fully invested (lower risk for part-time employment)
Risk	Material losses (total losses in bankruptcy yet also e.g. with derivatives)	Total losses (occasionally: reduction of working hours etc.)
Security	Investment risk	Explicit contracts normally secured, high risks for implicit contracts

Diagram 2: Comparison of Risk Between Shareholders and Employees

Therefore, for a manager-directed corporation, the (residual) risk lies not only with shareholders but also (as we have seen) with employees. Thus the decision maker in a corporation is not always the bearer of (residual) risk. The risk of residual income, which arises due to specific investment, presents a valid and legitimate basis for residual claims and thus demands that corporate leaders be more strongly oriented precisely toward those interest groups which bear the uncertainty of residual claims. It is precisely from specific investments that such an ethical justification can be derived.

6. Normative Development: Extending the Principal-Agent Approach to Stakeholder Management

In the previous section, I adopted a very narrow interpretation of corporate governance. Developed from the agency theory and with the aid of the concept of *risk*, the employee was identified as a further central stakeholder on the basis of his or her specific investments. Similar considerations could now also be made for other stakeholder groups, thus extending the method to a stakeholder-agency theory with a focus on specific investments.

The first question that must be asked is whether or not principal-agent problems will be magnified due to this approach, making the tasks of management imprecise or even diffuse:

> "(…) if we broaden managerial responsibility in order to include extensive responsibilities to various other stakeholder groups, we may seriously exacerbate these agency problems, making it even more difficult to impose effective discipline upon managers." (Heath and Norman 2004, 247)

If the original principal-agent problem was already difficult to solve, or could be addressed (one might argue) only through complex monitoring systems, how can this situation improve if the network of connections is extended to other stakeholders? Similar agent problems may then also arise between management and employees or between management and customers.

However, on the other hand, one could argue that the more claims management must fulfill, the more controlling influence stakeholders would have in this network. Employees, for example, have greater possibilities for monitoring management than do shareholders since, at least in Germany, they sit on supervisory boards and have a strong influence in directing the corporation. When they unite, customers can also mobilize the public and have a critical effect on corporate management. If one were to argue such a position, then governance could even improve through an expansion of the agency theory.

How then should management act? Explicit contracts must be handled in the same way as implicit contracts, which have resulted from the specific investments of a stakeholder. *Specificity presents a moral basis of legitimation for stakeholders.* This inevitably means a further reduction of the residuum (note that in the traditional agency-cost calculations, the residuum arises after deductions are made for monitoring and bonding costs and the fulfillment of explicit contracts).[15] In a further step, management can then consider a renewed distribution; completely different criteria (such as necessity or charity) may be expressed here. One would find support for this approach in Jensen and Meckling (1976), who in turn take their orientation from an idea by Alchian and Demsetz (1972): namely that corporations are to be understood as a nexus of bilateral contracts, and also explicitly involve other stakeholders as contract partners (Jensen and Meckling 1976, 310; Fama 1980, 290; Hill and Jones 1992; Boatright 2002).

> "(E)ach stakeholder is a part of the nexus of implicit and explicit contracts that constitutes the firm." (Hill and Jones 1992, 134)

Accordingly, the corporation can be understood as a type of *network of specific investments* and the success of that network as the sum of the stakeholders' (i.e. the specific investors') returning rents. This network provides optimal regulation of the economic transaction of goods and services via hierarchies (Williamson 1985). The rise in so-called *specific investments* leads to a fundamental transformation in the state of the negotiations.[16]

Would one need to define corporate governance in a more comprehensive way against such a background?[17] This position is not only common in Germany, but can also be found in American approaches (Freeman 1984, 2004; and in relation to corporate governance authors such as Turnbull 1997; Schmidt 1997; Monks and Minow 1995; Demb and Neubauer 1992; Tricker 1994; Donaldson and Preston 1995). For example, Schmidt (1997) writes:

> "Corporate Governance is the totality of the institutional and organizational mechanisms, and the corresponding decision-making, intervention and control rights, which serve to resolve conflicts of interest between the various groups which have a stake in a firm and which, either in isolation or in their interaction, determine how important decisions are taken in a firm, and ultimately also determine which decisions are taken." (2)

Wieland (2005) also stresses the normative dimension in two further definitions:

> "In this context, governance is defined as a company's resources and capabilities, including the moral resources, to take on responsibility for all its stakeholders." (74)

> "I define corporate governance as leadership, management, and control of a firm by formal and informal, public and private rules." (76)

The reconstruction of corporate governance displays a strong contractual influence and is thus a rather *correctively directed* phenomenon. Yet due to the rise in complexity and the tendencies of network organizations, it will be necessary here to emphasize *enabling* arguments rather than *restrictive* arguments: a type of *self-governance of networks*. As such, an argument will be adopted from Williamson, who in turn drew on Chester Barnard (1938), namely, to interpret governance as components of *consensus* rather than components of *power*. The internal hierarchy of a firm results from a mutual agreement on the basis of a contract entered into voluntarily. For his or her labor, and for the "unreasonableness" of the hierarchy or regulative direction, the employee receives compensation: "(…) authority rested on the acceptance or consent of subordinates." (Williamson 1990/1996, 32)

If these specific investments were taken into account by management, then this would mean that managers, on the one hand, would have to pay employees an offset against their specific investments, yet on the other hand, they could also represent the value of quasi rents within the corporation's value. If new competitors appear, then the employees' specific investments sink. The same applies if the corporation provides further education for employees and guarantees their employability. The corporation could then pay employees less due to the reduction in quasi rents.

Thus specific investments represent a risk for both sides: the principal and the agent. However, both are motivated to keep specific investments as high as possible: the employee receives more money, the manager/shareholder gains higher corporate value. Of course, these specific investments must be adjusted (e.g. annually), as is the case with the adjustment and balancing of goodwill. If employees are considered from such a perspective, then it becomes clear that they are not primarily just a cost factor but represent, above all, the wealth of a corporation.

Seen in this way, the relations which exist between stakeholders and management (and also between the various stakeholders) generate corporate value. Thus there is a convergence here of specific investments with implicit contracts, risk and corporate value. Capital markets could display specific investments and quasi rents in the corporate value, e.g. as a premium. If this were to occur, then one could calculate a stakeholder value which resulted from the specific investments of legitimate stakeholders (e.g. through the further development of specific investments: sunk costs here are not in machinery, which is then written off, but in human capital — human capabilities which can be developed and thus yield a return). *Stakeholder value and shareholder value would be identical in this respect.*

This interpretation derives moral behavior from economic theory. Whether or not management or the corporation develop a moral responsibility beyond this point is irrelevant here for the time being. Furthermore, questions such as whether the shareholder should assume social responsibility (i.e. to reinvest the residuum socially) or whether the shareholder, as principal, must explicitly instruct management to be socially committed, are also irrelevant. In this article, social responsibility arises from the fact that complex corporations are to be understood as networks of explicit and implicit stakeholder claims.

In this way, *we were able to clarify the economic bases of corporate governance. New Institutional Economics can be connected to stakeholder management, which in turn can be* *connected to the shareholder value concept.* Thus corporate governance can be extended normatively without having to sacrifice its economic core (i.e. the principal-agent problem). Indeed, it gains increased focus via such an expansion of its claimant groups. In this respect, I cannot share Wieland's position when he speaks of an "inadequate and not very fruitful reductionism of agency theory" (Wieland 2005, 88) or when he claims that:

> "Corporate governance codes that focus exclusively on the agency problem and pursue the maximization model [i.e. the shareholder value model] offer no entry points whatsoever for a dimension of business ethics that goes beyond the honoring of contracts on the part of the managers." (87)

Precisely the opposite is true. When we begin with the principal-agent problem, not only can we expose this normative necessity, we can also solve it.

7. Critical Evaluation and Future Prospects

Specific investments and quasi rents for claimant groups should be included in the generation of corporate value. When an employee signs a contract with a corporation, this contract contains numerous explicit and implicit components. Implicit components are commonly specific investments which lead to quasi rents. Corporate management has no desire to see these quasi rents deducted from the corporation, e.g. when the employee leaves. On the other hand, if employees are kept satisfied, then they reinvest their resources back into the corporation — and the quasi rents are retained. *Institutional arrangements* should be arranged in such a way that the specific investments of stakeholders appreciate in value. This only occurs if the quasi rents stay with the stakeholders. In this way, completely new options are opened for the importance of business ethics.

However, a reconstruction from the perspective of institutional economics — beginning with the principal-agent theory and extending to the concepts of transaction cost and property rights theories — should leave enough room for ethics. Business ethics and corporate ethics can be seen as *the* value drive for the generation of quasi rents. Keeping promises (holding to implicit contracts, etc.), the prevention of hold-up situations and the reduction of information asymmetries (and thus moral hazards) through transparency can only be achieved with trust and integrity. If one understands a corporation as a network of contracts, then it is composed of the value of its stakeholders' specific investments. To date, research into shareholder value has failed to consider this dimension. This contribution aims simply to provide a few impulses and to smooth the way for further research.

Notes

1. The goal of such an approach is to "assure themselves [i.e. suppliers of finance] of getting a return on their investment" (Shleifer and Vishny 1986, 462). This pushes the interests of stockholders to the fore.

2. The concept of Governance originally described a form of governmental power, force, rule and control, which is why certain authors prefer to focus on the concepts of corporate constitution or corporate administration.

3. Normative here is used in a *morally normative* sense, and should not be understood *economically* or *legally*. At issue here is the moral *ought*.

4. In economics, the term *Neoclassicism* goes back to Thorstein Veblen, who used it to describe Alfred Marshall's economic theory. Others who promoted neoclassical economics included Léon Walras and Vilfredo Pareto. See here especially Aspromourgos (1996).

5. In the meantime an excessive amount of literature has been produced on the *homo oeconomicus*. For an overview, see Kirchgässner (1991).

6. The terms *psychological*, *incomplete* or *relational contracts* are repeatedly separated from implicit contracts. For example, Furubotn and Richter (2005, 161) distinguish *agency contract theory* from self-enforcing agreements theory and *relational contract theory*. On *psychological contracts*, see Rousseau (1995).

7. On institutions in general, see Göbel (2002), 1ff.

8. Colloquially, *organization* and *institution* are often used synonymously. However, the organization, as a special form of institution, incorporates the individual (Furubotn and Richter 2005, 563).

9. This level changes only very slowly — over a period of approx. 100 to 1000 years, according to Williamson.

10. According to Williamson, changes here occur over a period of approx. 10 to 100 years.

11. Changes on this level occur over a period of one to ten years. The transaction cost theory was the first explicitly to use the term governance.

12. The reader should note that the normative dimension of the principal-agent theory has nothing to do with *norms* and *values in the philosophical sense*, but rather with *calculable entities* (along the lines of those familiar to us from the field of mathematics). The options for normative expansion, argued for in the remainder of this paper, are precisely not mathematical in nature.

13. For a critical analysis of residual loss, see Schneider (1993), 265.

14. Even adherence to explicit contracts cannot always be guaranteed, namely at that point (e.g. in bankruptcy) when these cannot be fulfilled (or are only partially fulfilled) on the basis of contractual or underlying legal conditions (cf. e.g. Shapiro and Titman 1985, 42ff. or Pritsch and Hommel 1997, 673). On calculating these risk premiums, see, among others, Wentges (2002), 162-63.

15. An exception would be when specificity is reduced, e.g. if new, alternative job offers were to arise for an employee, or if further education leads to improved employability.

16. On the re-negotiation of implicit contracts, see also Brink and Karitzki (2003).

17. I have already referred to the inclusion of all interest groups into corporate governance in earlier texts (see Brink 2002; Brink and Karitzki 2003).

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