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The Economics of Corporate Social Responsibility

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THE ECONOMICS OF CORPORATE SOCIAL RESPONSIBILITY

by Lorenzo Sacconi

1. INTRODUCTION

Over the past two decades, corporate social responsibility (CSR) has been a focal subject for scholars in management studies, business ethics, and the law. More recently, however, economists have also started to pay attention to CSR in both popular newspapers and academic journals. As early as 2005, *The Economist* acknowledged the spectacular growth of company CSR initiatives throughout the world, involving companies, business associations, stakeholders representative groups, NGOs, universities, international organizations, and yet others. What struck *The Economist* as especially disturbing– in line with a famous Milton Friedman's famous dictum of the 1970s – was that Boards of Directors, insufficiently committed to making profits for their shareholders, were instead engaging in 'pernicious benevolence' by being philanthropic with money taken not from their own pockets but from those of the corporate shareholders.

What in fact this view entailed was that CSR is a philanthropic activity that 'altruistic' managers undertake by misusing corporate money, which as such, is in contrast with profit maximization. According to this view, CSR was a peculiar manifestation of managerial self-dealing: managers used company funds for the self-satisfaction of their own arbitrary moral preferences.

Barely three years later, however, *The Economist* took a very different view on CSR. It now stated that "done badly, [it] is just a fig leaf and can be positively harmful. Done well, though, it is not some separate activity that companies do on the side, a corner of corporate life reserved for virtue. It is just good business" (*The Economist*, 19 January, 2008, p. 3, *Special Report*). Hence CSR was no longer deemed to be merely philanthropic, but rather a part of the core business strategy of any large company operating in the turmoil of the global economy. In fact, companies worldwide are engaged in a series of challenges with their stakeholders that may crucially affect their business and economic operations , . with the consequence that CSR may be considered as the appropriate way to address those challenges. Once it was recognized that CSR was no longer alien to the proper business and economic operation of a company, however, also the second tenet had to be to changed: henceforth, CSR could be reduced to being just a tool (according to an *instrumental* view) for achieving the traditional objective of shareholder value maximization – which is the function of a corporation – namely, as an effective *tool* of the overall strategy of making as much profit as possible.

At the same time also academic economists began publishing papers on the subject matter. Baron (2007, 2009) viewed CSR as a rational supply of philanthropy in response to a market demand for "private politics" required by consumers and to the pressure exercised by NGOs - which are not in principle antagonistic to profit maximization. This becomes clear once it is recognized that some consumers do not simply have a preference for material goods, as they press for product differentiation in terms of the 'moral' characteristics of companies' output.

Even more recently, renowned micro-economists (Benabou and Tirole, 2010), drawing on recent developments in economic psychology, observed that pro-social behaviours at the individual level enable us to understand the increasing interest in CSR shown by company managers. This attention translates into corporate philanthropy initiatives for the benefit of stakeholders, even though the authors' conclusions reveal a certain scepticism about the efficiency of these corporate policies in relation to the economic function of the firm. By contrast, other authors have attempted to give a more substantial account of CSR in terms of environmental externality prevention and unfairness avoidance by showing that these CSR programmes are consistent with the traditional aim of business corporations to maximize shareholder value, at least when it is conceived "in the long run" (see Heal 2005, 2008).

It must be admitted that the explanations that economists are providing neither penetrate the surface of the long-standing CSR phenomenon, nor contribute significantly to the lively debate on the deep reasons why corporations should embrace socially responsible conduct, and why CSR is considered to be an increasingly important management standard for corporations. Reflecting either a preservationist attitude towards existing economic models, or attempts to make this new research topic acceptable to economists who persist with a 'normal science' view of the profession, they continue to believe that the standard micro-economic understanding of the firm's objective-function and corporate governance structure (the principal-agent model recognizing shareholders' priority) is correct. They then try to tame recalcitrant facts about the spread of the CSR movement throughout the world, and its emphasis on what companies are obliged to do for the benefit of stakeholders other than shareholders, in order to accommodate them within the mainstream view of the capitalist business company. To sum up, since the importance of CSR as a global phenomenon cannot be ignored, the recent wave of papers by economists tends to deal with it by reducing CSR to "corporate philanthropy" or a strategic tool in line with, and instrumental to, profitability.

To gain a proper understanding of the global CSR movement, would require to question more in depth the nature of corporations as social and economic institutions. On the battleground of corporate governance models, 'corporate social responsibility' denotes a movement that affirms a social norm relating to the range of obligations owed by corporations to their stakeholders. It challenges rival social norms, such as that the one which avows shareholder primacy and the principle of 'shareholder value', which has also emerged in the last three decades, and has progressively gained support. CSR struggles against these concepts, and strives to gains its own settlement through the continuing expansion of its level of acceptance in the behaviour and self-organization of companies in response to the demands and actions of their stakeholders. CSR is thus an emerging social norm or convention which is shaping the mutual expectations and reciprocal behaviours that agents in the interaction domain of corporate governance tend to accept progressively.

This picture can easily be understood by anyone (but especially economists) that has even a superficial idea of the evolutionary dynamics taking place in games that are played repeatedly by populations of players. From this perspective, competing social norms (concerning corporate obligations) tend to establish themselves as regularities of behaviour resulting from equilibrium selection dynamics that essentially reflect how many players (companies and stakeholders, in our case) adopt the corresponding behaviour as a consequence of how many of them embrace mutual (descriptive and normative) beliefs consistent with that behaviour (Schotter 1981, Sugden 1986, Young 1998; for an application to the evolution of corporate governance institutions as equilibrium conventions, see also Aoki 2010).

In order to understand this picture, however, it must be acknowledged that neither is CSR about philanthropy (although it may include corporate giving) nor is it a strategy with the narrow purpose of profit maximization. The lively debate on the range of fiduciary duties owed by corporations to their shareholders and stakeholders or to society at large dates back to the 1930s (recall the famous Dodd vs. Berle controversy). Widening the perspective from America to other national models of capitalism, the rationale for that debate was further confirmed by the persistence of various institutional models of corporate governance whereby many stakeholders, and certainly not shareholders alone, were deemed to be sources of obligations owed by entrepreneurs and managers. The German co-determination model and the Japanese management model, with its distinctive extensive interpretation of managers' fiduciary duties - first of all towards employees - are typical examples of this.

Here, however, we can confine our reconstruction of the knowledge that permits us to appreciate the true nature of CSR to more recent strands of literature, both outside and inside economics. First of all, the stakeholder approach to strategic management and business ethics (Freeman 1984, Freeman and Gilbert 1988 Donaldson and Preston 1995) provided the intuition that a proper normative and explanatory model of the corporation needed to include the idea that those in a position of authority in the firm must discharge various responsibilities to many stakeholders in order to elicit mutual cooperation. Later, the heterodox law and economics model of the Board of Directors as a "mediating hierarchy" among corporate stakeholders was suggested as an appropriate interpretation of how American corporate law traditionally responded to the problems surfacing within the economic theory of team production and incomplete contracts (Blair and Stout 1999). In parallel, Masahiko Aoki (Aoki 1984) developed a branch of the new institutional economic theory of the firm that provided a cooperative view of corporate governance based on bargaining game theory, and then developed a theory of institutional complementarity between corporate governance and other social institutions, within which 'external' social responsibility also has a place (Aoki 2010).

Thus, by combining stakeholder thinking with insights from social contract theories developed by both philosophers and economists (Rawls 1971, Buchanan 1975, Gauthier 1986) and a critical reading of the new institutional economic modelling of the firm (Williamson 1975, Aoki 1984, Grossman and Hart, 1986, Hart and Moore 1991, Kreps 1990a, b), a social contract view of the firm was ready well before the recent wave of economists' explanations of what CSR is, and it was able to explain why corporations must fulfil an extended range of obligations toward their stakeholders (see Sacconi 1991, 1997, 2000, 2006, 2007a, b).

This chapter continues this line of institutional-economics reasoning, which sees CSR as the emergence of a social norm that backs forms of corporate governance that extend fiduciary duties from those owed to proprietors and shareholders to those ranging over an enlarged set of properly defined corporate stakeholders. CSR is an additional component of corporate governance that complements residual control – providing that owners or appointed managers make discretional decisions that support the appropriation of profits by financial capital investors - with the additional duty of enabling even non-controlling stakeholders to participate in the distribution of corporate surpluses created by the investments and cooperation of all stakeholders. Thus, CSR is what provides (or denies) the institution of corporate governance by its (moral and social) legitimation on the part of all the stakeholders affected by the exercise of corporate authority.

CSR embraces a multi-fiduciary perspective on corporate governance, and must, therefore, respond to criticisms levelled against the idea that fiduciary duties can indeed be multiple (Jensen 2001, Marcoux 2003). This paper provides a restatement of the social contract foundation of the multi-stakeholder and multi-fiduciary model of corporate governance that also answers all these criticisms. First, it provides a behavioural model of the reasoning and decision-making processes of an impartial board of directors that may be employed for mediation among different stakeholders. In this way, 'impartial mediation' acquires a well-defined meaning.

Second, it explains how the governance structure of the firm, including both residual rights of control and social responsibilities, can be chosen from behind a 'veil of ignorance' in a decision position precedes strategic interaction among corporate stakeholders. It specifies the distributive justice principle for surplus allocation among different stakeholders. In fact, a proper modelling of the social contract, employing both bargaining theory and non-cooperative repeated games, in accordance with Binmore's reinterpretation of the Rawlsian maximin principle (Binmore 2005), shows that stakeholders under a veil of ignorance would choose a 'socially responsible' principle of a corporate constitution that entailed an egalitarian surplus distribution. In this way, a corporate objective-function that includes a fair balance among different stakeholders is well-defined and perfectly calculable.

Moreover, based on the same formal analysis, a principle of fairness such as this proves to be a social norm that satisfies the typical stability property of game equilibria (and hence conventions), which emerges from an equilibrium selection process starting from an *ex-ante* impartial mode of reasoning (the veil of ignorance). Thus, what is fair is also stable: CSR cannot be accused of being wishful thinking, or of failing the test of incentive compatibility. Hence the CSR social norm supports the emergence of a self-sustaining institution in the domain of corporate governance. Finally, a two-step model of the firm's social contract also explains what fiduciary duties the Board of Directors owes to whom within the set of the relevant corporate stakeholders - shareholders included. This also provides a priority ordering of stakeholder claims that may be made against the company.

The chapter is organized as follows. Section 2 critically considers recent 'additional' and 'instrumental' economic explanations of CSR. Section 3 contrasts them with a 'constitutive' definition of CSR as an extended model of corporate governance, and provides the related definitions of stakeholders and fiduciary duties. Section 4 critically reviews the new institutional economics literature that, although it may not be normally related to CSR, is much more useful than standard microeconomic theorizing for the purposes of gaining deep understanding of CSR. This Section suggests, therefore, that economists should draw from it in order to understand why fiduciary duties must be expanded even for mere economic reasons of efficiency, and also why corporate reputation cannot leave aside the explicit settlement of an ethical norm of CSR. Section 5 presents the full-fledged social contract theory of multi-stakeholder corporate governance, which entails multiple fiduciary duties and a fair distribution of corporate surpluses. It also provides an explanation of CSR as a self-enforceable social norm. This Section replies to the main criticisms levelled against the stakeholder model of corporate governance, while at the same time developing analytically the model's foundation. Section 6 concludes by making this new view of corporate objective-function intuitive, and adds comments on the limitations of this approach, as well as further research that has not been reported here in detail.

2. 'ADDITIONAL' AND 'INSTRUMENTAL' APPROACHES TO CSR

There are few views of *Corporate Social Responsibility* (henceforth CSR) put forward in economic theory. Some of them do not require any major change in the notion of the firm as an institution and in its objective function. One of these views has been developed in response to the classic criticism set out by Milton Friedman, who sought to discredit CSR by describing it as an improper form of philanthropy carried out by self-dealing managers arbitrarily using their shareholders' money to satisfy their own philanthropic caprices (Friedman 1970). According to this first view, by contrast, CSR consist of policies adopted by managers and entrepreneurs which use part of the company profit in order efficiently to satisfy the philanthropic desires of shareholders and consumers (Baron 2007, 2009).

The basic idea is that, alongside the goods market and the typical business activity of companies, there is a 'market for private politics' in which citizens/consumers decide how to allocate their supply of donations among initiatives for the common good that are left unimplemented by "public politics" because of state failures. Citizens/consumers can choose whether to pay their donations directly to charities (nonprofits) or to pay companies (by buying their products) if these are committed to giving corporate donations to charities and to supporting campaigns for the common good, social welfare, environmental protection, etc.

Under certain conditions (among which the assumption that consumers derive a 'warm glow' from financing charities through their market consumption of goods), at least some groups of citizens/consumers would rationally and efficiently use companies as means to maximize their satisfaction from charities.

From the point of view of companies, CSR would thus be seen as a policy of product differentiation such that, in addition to their standard supply of goods, at an additional cost, charities that satisfy the warm glow preferences of consumers would also be supplied. Although such companies can be seen as having *moral management* (as opposed to companies that pursue social performance for merely instrumental motives), the firm's behavior does not require any substantial deviation from profit maximization under the hypothesis of consumers' warm glow, insofar as a proportion of consumers prefer to buy from companies that support charities corresponding to their charitable preferences rather than make donations directly.

'Private politics' can thus be seen as entailing CSR as an addition to the traditional business activity. But it is an addition that does not change the overall objective function and nature of the business firm (i.e. maximizing profit) to any significant extent. Although understanding the true meaning of 'moral management' (Baron 2009) seems difficult within this perspective (could it be a technology rather than a motivation?), it is clear that this line of thought assumes that private politics are compatible with the standard view of the firm as a profit maximizing machine. I call this perspective the *additional* view of CSR.

Another recent economic approach to CSR is the purely *instrumental* one (Heal 2005, Heal 2008). The *additional* view sees CSR as a genuine additional activity by the corporation. CSR is costly and *per se* inconsistent with business objectives; nevertheless, it too can be reconciled with profit maximization through the disposition of consumers to pay more for a differentiated product (containing charities) because of their warm glow preferences. By contrast, the *instrumental* view seeks to reduce CSR to a strategy entirely *functional* to the traditional business goal of shareholder-maximization pursued within the corporation's core business activities (without seeing it as a parallel line of production added by product differentiation). According to this explanation, a wider set of policies and programs are incorporated into CSR - not just corporate charities or financial support for nonprofits. Such CSR programs consist in some level of externalities prevention and reduction of the economic and social unfairness engendered *prima facie* by the rational selfish conduct of business.

Thus, CSR seems to fall within the scope of the company's core business, rather than adding a further dimension of activity. And this seems to be a clear improvement. But the idea is basically that these programs or corporate policies can be accounted for without any change in the basic nature of the corporation as a shareholder-value maximization machine, and without any reference to diverse motives to act among consumers, managers or investors. The reason is that, in order to pursue the same selfish objective as usual, the company must change its strategies. The decisive conditions for this to come about are that business strategies are undertaken under the threat that new regulations may be enacted by public authorities concerned with environmental issues; or that activism by stakeholders that may impinge on the company's reputation (related to both externalities or unfairness). If the strategic environment of the firm contains these more stringent constraints, it can maximize profit only by adopting a CSR strategy.

In fact, it is not clear whether – also according to this line of thought – it would not be better to state the point differently. The objective function of the company (as a normative principle of conduct concerning what the company aims to maximize) could be understood as having changed so as to include broader goals like unfairness and externality reduction, whereas the argument about profit could be seen as working at the different level of incentives compatibility, i.e. what induces owners and managers to carry out such an enlarged objective and institutional function. It is clear, however, that those who work within this perspective want to reverse the most logical order by maintaining the priority of profit-maximization as the corporate goal and reducing CSR to a means to achieve it, or at most to an external constraint on the firm's behavior.

However, it is quite obvious that one of the main incentives that the firm may have in carrying out a CSR strategy – i.e. reputation effects – would not be effectively pursued if CSR policies were recognized by the stakeholders concerned as purely instrumental means to capture their benevolence. Under conditions of imperfect information, where stakeholders are incompletely able to disentangle truly responsible behavior from ones only apparently so, or to understand the true nature of the company's behavior, this form of strategic CSR would be open to many forms of opportunistic behavior.

As we shall see later in this chapter, an instrumental view of CSR is self-defeating; whereas a reformulation of the normative objective function, governance structure, and managerial strategy in line with CSR principles would give much more credibility to CSR commitments and hence would improve the company's reputation to a much greater extent. In one way or another, CSR seems to entail a broadening or a restatement of the traditional profit motive.

Hence, the instrumental doctrine seems to be a rhetorical argument offered to CEOs so that they can convince their shareholders that furthering CSR policies pays; much less does it seem to stem from a deep understanding of how CSR reshapes the corporation's view, nature and goals. Given that the instrumental perspective begins by recognizing the shareholders' priority for the justification of CSR as it is stated in the shareholders' model of corporate governance, then the model of governance itself cannot be at issue in this view of CSR.

3. A 'CONSTITUTIVE' VIEW OF CSR AS A MULTI-FIDUCIARY MODEL OF CORPORATE GOVERNANCE

The perspectives on CSR discussed in the previous section seem to be better explained as attempts of orthodox economics to regain control over a phenomenon – the CSR movement involving managers, corporations and many groups of concerned stakeholders – that has been growing rapidly for at least the past two decades without being convincingly accounted for by mainstream economics.

A much deeper understating of CSR however has been provided within new institutional economics, unorthodox law and economics, the stakeholder approach to management studies and business ethics, that relate it to the very economic nature of the corporation (Aoki 1984, 2001, 2010; Blair and Stout 1999, 2006, Stout 2011b, Freeman 1984, Evan and Freeman and 1988, Freeman and Velamury 2006 Freeman et al. 2010, Donaldson and Preston 1995, Donaldson 2012, Clarkson 1999, Sacconi 1991, 2000, 2006a,b, 2007, 2010a,b, 2011).

According to these views, CSR is a form of corporate strategic management; moreover, it is a model for governing transactions among the firm's stakeholders. It is clear that here 'governance' is no longer the set of rules simply allocating property rights and defining the owners' control over the company's management. Instead, it relates to the new-institutional economics view whereby firms, like contracts and other institutional forms, are 'governance structures' which establish diverse rights and related responsibilities in order to reduce 'transaction costs' (Coase 1937, Willamson 1975, 1984, Grossman and Hart 1986) and the negative externalities related to economic transactions so as to approximate social welfare (Coase, 1960).

This view is *constitutive* because it sees CSR as a trait inherent to how the corporation functions and to its goal: that is, it sees CSR as the governance model on the basis of which a company pursues as its objective-function the joint interest and mutual advantage of all its relevant corporate stakeholders. Insofar as CSR is defined as a governance model entailing a multi-stakeholder definition of the corporate goal, it concerns less the sphere of corporate *means* than the domain of corporate *ends (the corporation's goals)* and *constitutional rules,* i.e. it is *constitutive*.

I hence submit the following definition (see also Sacconi 2006a, 2006b, 2007, 2010):

CSR is a model of extended corporate governance whereby those who run firms (entrepreneurs, directors, managers) have responsibilities that range from fulfillment of their fiduciary duties towards the owners to fulfillment of analogous fiduciary duties towards all the firm's stakeholders.

Two terms must be defined for the foregoing proposition to be clearly understood:

a) Fiduciary duties. It is assumed that a subject has a legitimate interest but is unable to make the relevant decisions, in the sense that s/he does not know what goals to pursue, what alternative to choose, or how to deploy his/her resources in order to satisfy his/her interest. S/he, the *trustor*, therefore delegates decisions to a *trustee* empowered to choose actions and goals. The trustee may thus use the trustor's resources and select the appropriate course of action. For a fiduciary relationship – this being the basis of the trustee's authority *vis-à-vis* the trustor – to arise, the latter must possess a claim (right) towards the former. In other words, the trustee directs actions and uses the resources made over to him/her so that results are obtained which satisfy (to the best extent possible) the trustor's interests. These claims (i.e. the trustor's *rights*) impose fiduciary duties on the agent who is invested with authority (the trustee) which s/he is obliged to fulfill. The fiduciary relation applies in a wide variety of instances: tutor/minor and teacher/pupil relationships, and (in the corporate domain) the relation between the board of a trust and its beneficiaries, or according to the predominant opinion, between the board of directors of a joint-stock company and its shareholders, and then more generally between management and owners (if the latter do not run the enterprise themselves). By the term 'fiduciary duty', therefore, is meant the duty (or responsibility) to exercise authority for the good of those who have granted that authority and are therefore subject to it (Flannigan 1989).

b) Stakeholders. This term denotes individuals or groups with a major stake in the running of the firm and who are able to influence it significantly (Freeman and McVea 2002). However, from an economist's point of view, most relevant to defining stakeholders is the following distinction between two categories:

(i) *Stakeholders in the strict sense*: those who have an interest at stake because they have made specific investments in the firm (in the form of human capital, financial capital, social capital or trust, physical or environmental capital, or for the development of dedicated technologies, etc.) – that is, investments which may significantly increase the total value generated by the firm (net of the costs sustained for that purpose) and which are made specifically in relation to *that* firm (and not to any other) so that their value is idiosyncratically related to the completion of the transactions carried out by or in relation to that firm. These stakeholders are reciprocally dependent on the firm because they influence its value but at the same time – given the specificity of their investment – depend largely upon it for satisfaction of their well-being prospects (lock-in effect).

(ii) *Stakeholders in the broad sense*: those individuals or groups whose interest is involved because they *undergo* the 'external effects', positive or negative, of the transactions performed by the firm, even if they do not directly participate in the transaction, so that they do not contribute to, nor directly receive value from, the firm.

One can thus appreciate the scope of CSR defined as an extended form of governance: it extends the concept of fiduciary duty from a mono-stakeholder setting (where the sole stakeholder relevant to identification of fiduciary duties is the owner of the firm) to a multi-stakeholder one in which the firm owes fiduciary duties to *all* its stakeholders (the owners included).

4. THEORIES OF THE FIRM BENIGN WITH A STAKEHOLDER APPROACH TO CORPORATE GOVERNANCE.

To give more substance to the economic foundation of the idea that CG consists in an extension of fiduciary duties to all stakeholders and the impartial mediation among them, it may be worthwhile recalling the economic analysis of the risk of 'abuse of authority' in business organizations (Sacconi 2000, 2006, 2007, 2009, 2010). One tenet of the agency view, which reduces corporate governance to the disciplining of the relation between manager and shareholders, is that whilst shareholders suffer from strong asymmetry of information due to the separation between ownership and control, other stakeholders are satisfactorily protected either by contracts or the law. However, were this thesis true we would not have the modern new institutional theory of the firm, which is based on the idea that most contracts are basically incomplete (Coase 1937, Williamson 1975, 1984, 2010, Grossman and Hart 1986, Hart and Moore 1990). It is no accident, in fact, that the most acute economists working on mathematical principal-agent models see incomplete contracts as a secondary phenomenon reducible to asymmetry of information - and hence treatable in agency models - and at the same time are doubtful about the stakeholder approach to CG (Tirole 1999, 2001).

On the contrary, according to Williamson and others, incompleteness is pervasive and irreducible. This is the *first* hypothesis of new institutional economics concerning the firm. It stems from many factors: (i) non verifiability by third parties - i.e. a law court called upon to assess a breach of a contract would be unable to ascertain whether the breach has effectively occurred because it may have happened in states of the world that it cannot observe or verify. (ii) Unforeseen contingencies: cognitive limitations on forecasting genuine new future events, plus the limitedness of the logical and calculative ability of agents. To explain: given a knowledge base expressed in a given language – containing for example N individual variables such as $(x_1,x_2, ,\ldots x_n)$, and M predicates expressing possible properties of any individuals x_i such as $(P_1,P_2, ,\ldots .P_M)$ – players may be unable to infer all the possible states of the world that are in principle describable by a joint affirmation or negation of any predicate about any individual variable contemplated in the knowledge base (this introduces bounded rationality in Simon's sense at the basis of incomplete contracts, see Kreps 1990, Kreps 1997).

Firms are *loci* of joint (or team) production, where the cooperation of many agents renders the firm's production function super-additive – i.e. by coordination in joint production they generate a surplus with respect to how much they would globally produce by operating in separate units. The *second* assumption of the new institutional economic theory of the firm is that most of this cooperative surplus derives from successful specific investments, namely investments that are idiosyncratic to the firm or the team wherein they take place, or in relation to specific transactions that one stakeholder expects to complete with other members of the productive team (Williamson 1975, 2010).

The crucial aspect of specific investments is that they generate a potential surplus that the stakeholders responsible for them expect to appropriate at a later stage to the extent that the transaction has been completed within the team. But they lose much of their value if the stakeholders that made them in the past have been excluded from the team before completion of the transaction. Hence, realization of their expected value depends on the completion of transactions with other members of the team. If some of these control assets on the basis of which decisions are taken that are essential for realization of the investment's value (i.e. the completion of the transaction after the investment's date), these further members are termed 'essential' (see Hart and Moore 1990 and with reference to the essentiality of human cognitive assets see Aoki 2010).

A *Third* basic assumption is that economic behavior is opportunistic - i.e. in Williamson's words 'selfish with astuteness'. (This assumption is in fact too pessimistic. A weaker statement could be more acceptable: in non-cooperative contexts - without explicit agreements and reciprocal expectations of conformity with fair principles of justice - economic behavior tends to be opportunistic, that is, tends to circumvent any promise or contractual non-binding agreement if doing so is useful to the agent's material self-interest.)

Taken together, the three foregoing assumptions entail that, after specific investments have been made, when a gap in the contract occurs, renegotiation of the contract becomes possible; moreover, there is also a surplus at stake that gives incentive to renegotiation. Thus ex post to investments a new bargaining situation materializes among the team's members involved in a transaction. Especially those who are essential for the realization of other players' specific investments will *hold up* agents possessing the invested asset (physical or cognitive assets, financial, human or social capital): that is, they will ask them to give up most of their investment's value in order at least to recoup the investment's sunk cost. But the prediction of such an eventuality will necessarily deter the team's members from undertaking their potentially beneficial investments at an efficient level (i.e. the level at which they would invest if hold-up were not possible).

The functional explanation of the firm's emergence is that it provides an institution able to prevent such inefficiency. Put briefly, the firm fills gaps in incomplete contracts by assigning to the party with specific investments at risk ownership of the physical assets of the firm required for completion of any transaction (and related investments). This party thus also acquires residual decision rights on variables that cannot be fixed and inserted ex ante into the contract ('non-contractible' decisions), and hence is also allocated authority over other participants in the team concerning the execution of decisions that cannot be constrained *ex ante* by the contract.

It is in fact a typical assumption of this approach that authority in the firm reduces to a control right over residual decisions if these are to be personally executed by participants different from the right-holder, so that this control right is enforced by the possibility to exclude from the firm (the use of physical assets) a participant declining to execute the ex post required (non ex ante contractible) decision (Grossman and Hart 1986). (Note that there is presumably something lacking in this account of authority, i.e. the positive reasons for acceptance by the subordinate of her/his position in the authority relation. In other words, what are lacking are the reasons for accepting the authority relation in general, not just the threat of exclusion that may support the demand for obedience in a single case but represents simple influence or brute bargaining power, not necessarily authority) .

Residual (ex-ante non contractible) decisions hinge on decision variables that are essential for the completion of transactions necessary to valorize specific investments. Assume that agent A, responsible for an investment even if s/he is not the essential co-party for the transaction to which his/her investment is related, has residual control over the firm. Then s/he also has authority to command execution of a decision essential to the end of guaranteeing the completion of the transaction relevant to his/her investment under the threat of excluding the non-compliant essential agent (admitted that this is separable from the essential asset). Thus specific investments are protected by taking on authority in the firm (Williamson 1984, Grossman and Hart 1986, see also Kreps 1990b) .

But specific investments are normally multiple and relate to assets held by different stakeholders: human capital, skills and knowledge possessed by different workers and managers, financial capital by investors, dedicated instrumental services and technologies by suppliers, information by consumers, social capital by all of them plus the local communities surrounding a company's plants etc. (Blair and Stout 1999, Sacconi 2000). The most idiosyncratic of these assets are firm-specific human capital and skills.

Assume that such multiple investments are interdependent and mutually essential, or that they are symmetric in value. In these cases authority and residual control should be symmetric, i.e. equally shared among all the team's members (Hart and Moore 1990, Aoki 2010). But purely egalitarian sharing of all residual decision rights cannot be feasible, simply because of huge collective choice and coordination costs in a very large and internally differentiated class of owners (Hansanann 1996) Or because physical assets are not perfectly divisible; or because there is no precise measure of the contributions of each investment to the team's value, so that their representation by means of ownership shares may be imprecise or even mistaken.

Moreover, there are cases where one single investment is by far the most important, whilst investments by others are nonetheless relevant to value creation. Or some agent holding some cognitive human asset (knowledge) may be essential for many investments made by others but inseparable from his/her cognitive asset, so that it would be pointless to threaten his/her exclusion from the firm (Rajan and Zingales 1998, Aoki 2010), whilst some other agents may be not essential to the former's investment even though they have important specific investments at stake.

There are consequently many configurations of specific investments and asset essentiality that cannot be translated into a pure symmetrical sharing of control right and authority (of course, the complete sharing of authority would amount to a *perfect* partnership with no authority at all – not even democratically delegated authority.) In any case, assume that, as is legally reasonable, ownership of physical assets is an exclusive right which cannot be dispersed equally among all the stakeholders, and hence entails that someone does not control the firm and someone else is in the position of control and exerts authority.

To explain: there are capitalist firms which are not controlled by the workers. There are also workers' or consumers' cooperatives which capital investors do not control. But there are very few firms which all these stakeholders jointly control (see Hansmann 1996).

Then add the assumption that authority and residual control entail a right of legitimate appropriation of all the team's produced residual, after contracts have been honored and their costs have been paid. From this it follows that the party in the position of authority in the firm will not only be protected in regard to his/her investment but also able to expropriate all the surpluses resulting from specific investments by other stakeholders, who can be now held up under the threat of being excluded from the firm, given that the contract is incomplete and no proviso exists as to surplus sharing under unforeseen contingencies. This is what is called "abuse of authority", which means the "opportunistic use of authority" in order to hold up other members of the team with specific investments at stake and who are protected neither by a complete contract nor by residual control rights (Sacconi 1991, 2000, 2006, 2007, 2010).

Recall that the theory models authority as residual control on ex ante non contractile but ex post relevant decision variables essential for someone else's investments. Admit that stakeholder A, being given ownership, controls the residual decision essential for realization of his/her own investment. At the same time, in the ex post renegotiation game that starts when unforeseen events occur (ones relevant for another participant B's investments), A can order 'by fiat' a pejorative status quo if B refuses to consent to all the surplus attributable to his/her investment being appropriated by A. Clearly, this enables A to appropriate ex post all the team's produced surplus, and there is no reason ex post for not doing so. Note, moreover, that by such an exercise of authority the controlling party is not blatantly breaching the law or a contract. Admitted that ownership gives him/her large discretion about variables not ex ante contractible, s/he is only exploiting a gap in the law (this is the 'advantage of flexibility', see Kreps 1990c).

Bad effects of abuse of authority are obviously appreciable by taking the ex ante perspective (before investments are carried out). Those who predict abuse of authority have a reduced incentive to undertake their investments. Assuming that abuse can be predicted (which is not always the case if one takes seriously the assumption that unforeseen contingencies open the way to wide discretional decisions), they will refrain from making their investment, exactly as in the case of opportunistic hold-up under incomplete market contracts.

The results is as follows: (a) when authority is concentrated in the hands of only one of the team members, even in order to guarantee his/her investment protection (for example the risk capital invested to buy sophisticated and costly equipment), but (b) at the same time other specific investments are at risk, given their imperfect protection due to incomplete contracts (for example labor contracts are subject to the authority of the entrepreneur, who may order the execution of actions that allow expropriation of the result of human capital investments under the threat of dismissing workers who do not comply with the orders), then (c) the governance structure reveals an important inefficiency in term of disincentives to investment (in workers' human capital).

One could argue that the employer's mere awareness of this risk could by itself deter him/her from abusing his/her authority. For example, when the non-controlling stakeholder's investment is also essential for, or interdependent with, that of the owner, by reducing incentives for the non-controlling stakeholder the owner would also reduce the value of his/her own investment. S/he should therefore rationally refrain from abusing authority ex post (Aoki 2010). Moreover, the owner may understand that by threatening abuse of authority ex post s/he may reduce the company's overall surplus in subsequent transactions with the same team members, since the owner's reputation is damaged and the latter consequently reduce their subsequent investments. This should induce the controlling party to commit him/herself ex ante not to abuse ex post.

But awareness of the bad consequences of abuse of authority is not sufficient to prevent abuse in general; nor is such awareness sufficient in situations where the hold-up of long-run market contracts is possible (outside of hierarchical organisations). It may be the case that refraining from appropriating the overall surplus, thus permitting greater value creation, nevertheless reduces the owner's share up to the point where the absolute amount appropriated by him/her is smaller than the amount s/he would have obtained by abusing other stakeholders. This may happen even though the disincentive of their investments would reduce total value creation. The total of a smaller quantity may be larger than a fair share of a larger quantity.

Moreover, the simple awareness that ex post abuse of authority can be detrimental to the owner's reputation in repeated interactions with stakeholders, who will accordingly reduce their investment in the future, may not be sufficient to dissuade the owner from ex post abuse when unforeseen contingencies make it difficult ex post to recognize abuses (Note that this holds in general when the firm is the subject under discussion, since incompleteness of contracts is a precondition for the firm's emergence as an institution). If ex post abuse is not observable or recognizable against a term of reference (say the contract), because it occurs in an unforeseen state of the world wherein explicit non-abusive provisos are not pre-established, the owner does not lose his/her reputation. Therefore the prospective stakeholder may have no informational basis for reducing his/her investment in successive repetitions of the basic transaction. Or – even worse – reputation effects may be so imprecise that punishment by reducing subsequent investments may hit some entrepreneur who under unforeseen contingences did not really abuse, while leaving untouched those who gravely abused but were not recognized as doing so precisely because of the *vagueness* of the situation (unforeseen events).

Summing up, bad reputation may fail to deter abuse of authority both because (i) the value at stake in each case of abuse can be considerable, and the abuser's share may be larger than the owner's payoff if s/he does not abuse - favoring cooperation, and (ii) unforeseen states of the world make abuse too vague and too difficult to disentangle from non-abuse, revealing the cognitive fragilities of the reputation mechanism (see Kreps 1990, Sacconi 2000) .

In these cases the aforementioned inefficiency can only be eliminated by an institutional CG framework. They may require that - without eliminating ownership and authority - the agent in the position to run the firm also has responsibility for preventing the owners' (for example shareholders') ownership/authority abuse of non-controlling stakeholders (for example employees, suppliers, or consumers). This responsibility can be made effective in terms of compliance with some general and abstract principle of ethics and preventive procedures of behavior whereby the agent is made accountable – as in the case of corporate codes of ethics and CSR management systems (again Kreps 1990, Sacconi 2000, Sacconi De Colle, Baldin 2003).

This would explain the autonomy and primacy accorded to the board of directors in the model of impartial mediating hierarchy (Blair and Stout 1999). On the one hand, the authority attached to ownership is delegated to a board of directors that thus becomes the true residual decision maker. On the other hand, the board uses such power impartially (according to principles, values and procedures explicitly established as reference points and pattern recognition models for impartial mediation), in order to prevent reciprocal abuse of authority (from above) and opportunism (from below) among the team stakeholders. Of course, abstract and general ethical principles and preventive procedures of conduct are also needed to restrain the board itself from abusing its delegated authority, which otherwise might degenerate into mere self-dealing .

This economic analysis is not only analogous to that carried out by defenders of the mediating hierarchy model of corporate governance (CG) (Blair and Stout 1999); it also provides the efficiency basis for the multi-fiduciary model of CG put forward in section 2, where CSR was defined as a principle of extended fiduciary duties owed to stakeholders.

5. SOCIAL CONTRACT JUSTIFICATION OF THE NORMATIVE MODEL OF MULTISTAKEHOLDER CORPORATE GOVERNANCE

5.1 Challenges

The previous section showed that the CSR model of CG addresses serious efficiency problems in the transaction cost analysis of the business company, and that by solving these problems it may constitute a significant improvement in terms of transactions costs efficiency. Thus, extending fiduciary duties to the protection of all the relevant corporate stakeholders (in both the strict and broad senses) – especially those responsible for specific investments or essential cognitive assets – may be a better CG form than the alternatives from an efficiency point of view. But this is true only if the normative model is defined in a sufficiently clear and convincing way, in terms of both logically consistent normative principles and implementation conditions. Firstly, it requires that fiduciary duties owed to each relevant stakeholder must be well specified, and it must be explained how they are to be balanced one against another if stakeholders claims' are different – maybe conflicting .

In fact, critics of the multi-stakeholder perspective in CG contend that CSR is too vague a notion to be translated into a clearly-defined model of multiple fiduciary duties. Being loyal to one stakeholder who wants a given objective to be pursued may clash with being equally loyal to another stakeholder who wants pursuit of a different, maybe conflicting, objective. Hence, the critics conclude, there is no unique objective function of the firm under the multi-stakeholder perspective. Moreover, there is no criterion that determines the scope of fiduciary duties of due care, and no conflict of interest due? To each stakeholder, under a multi-stakeholder perspective.

According to Michael Jensen, because stakeholders are diverse, the multi-stakeholder firm's objective function cannot but be multidimensional. However, multidimensionality and possible conflicts among stakeholders' claims make any attempt to maximize or pursue such an objective function inconsistent. Thus, the model becomes devoid of normative power and cannot provide managers and directors with a clear-cut bottom line able to impose a restraint on their discretion. But without the restraint of a clear normative principle or goal whereby managers and directors are required to be accountable, they are free to pursue whatever goal they wish, including their mere self-interest. Thus the multi-stakeholder approach opens the way to managerial opportunism.

Other critics (e.g. Marcoux 2003) have brought analytical arguments against extending fiduciary duties to all the company stakeholders. In brief, fiduciary duties are incompatible with a multi-stakeholder perspective because they entail (i) a *privileged relation* (in terms of no conflict of interest between trustor and trustee, due care, accountability etc.) with a *specific* beneficiary – i.e. to make sense of fiduciary duties, one stakeholder is to be privileged over others. (ii) *Vulnerability* (due to power and knowledge asymmetries) of the beneficiary in a contractual relationship is also required. One party has a legitimate interest but must be unable to pursue it. Then s/he enters an *asymmetrical relation* of trust with a trustee (as in professional authority) in the subordinate position of a trustor, enabling the former to make discretionary decisions about the behavior that the latter will be required to adopt or the use of his/her ownership. The trustor's control is weak, and discretion is *shifted* to the trustee so that the trustor (beneficiary) becomes vulnerable to behavior on the part of the trustor. (iii) No conflict of interest with the vulnerable, privileged beneficiary. But if different stakeholders' interests are in conflict, the trustor may not be loyal to one of them, granting him/her the privileged status of beneficiary without contradicting loyalty to another .

In the following subsections these criticisms are countered by developing a social contract justification for CSR as a multi-fiduciary model of CG. Note that the vulnerability problem is by no means a difficulty for the CSR theory of CG since both specific investments and the cognitive essentiality of assets under incomplete contracts render more than one stakeholder vulnerable to abuse of authority and opportunism in the corporate context. Moreover, human capital investments are maximally specific and hence the most vulnerable by managerial decisions in the corporate context under shareholders' ownership. Hence there is no reason on the basis of the above requisite (ii) to exclude stakeholders other than shareholders from fiduciary duties.

5.2 The social contract as impartial board of director's mode of reasoning

In the mediating hierarchy view of CG (Blair and Stout 1999), the board of directors is an arbiter of the cooperative interaction among the various stakeholders participating in team production. But how should directors mediate among different stakeholders? The suggestion is that they should devise the principle for impartial mediation by working out the social contract that all stakeholders would hypothetically accept as a fair term of agreement for the implementation of a corporate joint cooperative strategy and the consequent allocation of rights, duties and payoffs.

The board of directors may construe the stakeholders 'social contract' by the following procedure of impartial reasoning inspired by the Rawlsian 'veil of ignorance'. This is a decision procedure by which the decision-maker accounts for any personal perspective 'as if' s/he were unable to identify it with his/her own personal perspective on the problem (see Sacconi 2006a, 2006b). First, the preconditions for a fair agreement must be established. Hence (i) force, fraud and manipulation must be set aside, and (ii) the only features of each stakeholder accounted for are his/her capability to contribute to team production under different joint plans, and the utilities that s/he can derive from each of them. Since any reasonable agreement must grant some advantage to some stakeholder, a fair reference point for 'advantage' must be set. Thus (iii) the agreement *status quo* must keep each stakeholder immune from hold-up: that is, before discussing the agreement, each stakeholder is granted at least full reimbursement of his/her specific investment's costs.

Then (iv) in order to calculate the legitimate shares that stakeholders can claim, the impartial director will put him/herself in the position of each stakeholder in turn (impersonality) and will assign equal probability to each position (impartiality). Thus, (v) by an effort of sympathy, s/he will accept or reject any available agreement according to each stakeholder's preference. Hence the terms of agreement deemed acceptable are those that *each* stakeholder is willing to accept from his/her own personal point of view. But then (v) solutions acceptable to some stakeholder but not to others are discarded. Thus (vi) the process ends with the non-empty intersection of the allocations acceptable from *whichever* point of view.

Note that an agreement acceptable from whichever point of view must necessarily exist since team production is mutually advantageous with respect to an alternative organisation of production where members would split into separate units. If an agreement were not possible, stakeholders would simply organise themselves into separate production units.

The solution of this impartial agreement problem, as it is seen by the impartial director, equates the solution of the stakeholders' social contract with the definition of the firm's objective function. i.e. the objective function according to which the firm will be run by the impartial director.

5.3 A theoretical frame for the social contract choice of a corporate governance structure and objective function

In order to determine a simply calculable solution of this problem (see also the next section), assume for simplicity that there are only two stakeholders – e.g. a worker and a financial capital owner – and that their possible agreements define a convex and compact set of possible outcomes. To make sense of this outcome space, assume that the two stakeholders meet at first in a 'state of nature' structured as a non-cooperative game. Such a state of nature is understood as a formal representation of their interactions in a situation characterized not only by potential mutually advantageous cooperation, or team production, but also by acute incompleteness of contracts and hence by potential reciprocal opportunistic behaviours. The one-shot 'state of nature' precedes the institution of any legal artifice such as the 'corporation' under which they could form a regulated and successful cooperative team. As a one-shot game, it closely resembles an asymmetrical prisoner's' dilemma, so that only one suboptimal equilibrium solution can be reached in it.

But assume that the two stakeholders repeatedly play this game, and that the set of all the possible repeated plays results in a wide set of feasible outcomes. In fig.1 the convex and compact payoff space X_{EA} represents the outcome set of the repeated game played by the poor worker (player 1 = Eve) and the rich proprietor of means of production and capital (player 2 = Adam).

(Insert Fig. 1 about here)

Let these outcomes be all non-cooperative equilibria of the repeated game (i.e., when one player chooses his/her component of one of these repeated strategy combinations the other player has no incentive to deviate from it by changing his/her strategy component).

This statement can be interpreted as follows. By playing any compliance or non-compliance repeated strategy with potentially mutually advantageous incomplete contracts, players allow the emergence of whatever regularity (rule) of behaviour in their contractual interaction. On adding *mutual expectations* (or shared *mutual knowledge*) to such regularity of behaviour, the playing of any combination of repeated strategies corresponds to the emergence of a convention. Consider outcomes positioned on the Pareto frontier of the payoff space or near to it. These outcomes correspond to *conventions* that can be understood as "corporate" constitutions dictating certain levels of cooperation and non-cooperation by means of a certain balance/imbalance in the powers, rights and responsibilities allocated to players.

For example, take an outcome splitting the cooperative surplus quite unevenly. It can be seen as reflecting a very asymmetrical exercise of authority by one of the two parties (e.g. the capital owner), who for many repetitions after having treated the other (the worker) fairly, once in a while "abuse" his authority, while the other party (the worker) continues to abide by a contract requiring him to cooperate with the first party. As far as this convention (or repeated play of the game) is concerned, the worker accepts the proprietor's authority, since she enters the cooperation with him even though he does not symmetrically cooperate with her – which means that he repeatedly responds to her cooperation by reaping all the surplus and only a very few times by sharing it more evenly.

Thus we construe an outcome like this as not only a situation in which the proprietor of financial capital has ownership and control over the resource by means of which cooperation is carried out, but wherein he also exercises the related discretion in a quite extreme way – i.e. abusing it in order to appropriate the largest part of the surplus. This still allows the reaching of an efficient allocation (on the Pareto frontier or close to it) which nevertheless entails a strongly unequal distribution of the cooperative team's? production surplus.

Other outcomes may on the contrary be understood as related to conventions that allow a less asymmetrical distribution of power between the parties, or less abuse of it, so that both players cooperate in a more symmetric way throughout the repetitions of the game, and neither of them resorts excessively to the possibility of defecting from cooperation by exploiting his discretion (abuse of residual decision power). These conventions result in a more even distribution of the cooperative surplus, also positioned on the Pareto frontier of the X_{AE} space. But the institutional interpretation of these regularities of behaviour (much less abuse, much more mutual cooperation and less unequal distribution of the cooperative surplus) may be different.

These further outcomes may be interpreted as cases of constitution dictating a less asymmetric distribution of residual control rights and authority, so that both parties control some resource and neither of them can profit from abusing the amount of power allocated to him/her because the other party holds similar power. More interestingly, however, it may be understood as if the governance structure provided a bundle of rights and responsibilities such that even though one of the two parties is allocated authority and the full right to make residual decisions, he is nevertheless also constrained in the exercise of authority by a responsibility duty telling him that he/she cannot appropriate the entire surplus and is obliged to devolve a fair part of it to the compensation of the non-controlling second party. In other words, the fair payoffs distribution is implemented through a responsibility and accountability duty of the governing party. Also when the game is played in this way by the more powerful player (e.g. the financial capital owner), the weaker one (e.g. the skilled but poor worker) in equilibrium cooperates repeatedly, which means that she accepts this exercise of constrained authority.

Which of the two interpretations of the not-so-uneven-distribution-of surplus outcomes is correct is a question that goes beyond the formal representation of the outcome space. For the purposes of this paper, it is sufficient to warrant hat both interpretations (and many of their intermediate combinations) are admissible. This means that an even or nearly-even outcome, entailing a convention of symmetrical cooperation, does not necessarily entail that the constitution requires that all the members of the productive team hold a nearly even power and residual control rights – which might mean that the corporation has either a strictly democratic control structure whereby any residual decision is taken in common through some collective choice mechanism, or that there is no authority relation at all, since each player separately exercises control rights over some essential resource. This is a possibility for certain types of organisation (for instance multi-stakeholder cooperatives or cooperative networks of nearly independent actors); but more often some hierarchical structure of control and asymmetric allocation of decision power may be necessary.

Thus symmetrical cooperation and even or nearly-even allocation of the cooperative surplus may also result from a constitution such that (i) one cooperating party exercises authority and full decision rights, but does not abuse them since s/he accepts a constitutional constraint not to do so and to share the fruits of cooperation evenly, while (ii) the second player, not being invested with control and residual decision rights but being nevertheless protected by the first party's responsibility rule and accountability, fully cooperates (which corresponds to her acceptance of the authority relation). Quite obviously, this corporate constitution regulating the stakeholders' cooperation may be seen as corresponding to a family controlled corporation whose CSR governance structure of extended fiduciary duties provides for the protection of non-controlling workers. The typical case of the large corporation run by a board of directors (Blair-Stout's case) which is impartial between dispersed shareholders holding very weak ownership rights, and other non-owner stakeholders, is a small move toward the other ('symmetric power') direction. Companies governed through the co-determination model (such as large German corporations), where shareholders elect the managing board but other stakeholders are also represented in the supervisory board, are located somewhere in between the above two typical cases (Osterloch , Frey, Zeitoum 2010, Gelter 2009) .

5.4 *The Binmore-Rawls egalitarian solution*

The frame set out in the previous section allows players entering the social contract to reason about the choice of the corporate constitution (i.e. selection of a particular convention under which the repeated game has to be played) and the objective function (i.e. choice of a solution function selecting a unique point within the outcome space of the possible ways of cooperation). Assume that before the players engage in the relevant interaction (e.g. any largely incomplete contract equipped with different allocations of residual decision rights and responsibilities), they want ex ante to agree on the selection of one equilibrium point/outcome resulting from a possible convention of repeated plays. This may be seen as agreeing on a constitution stating to what they are entitled by playing their roles under a "corporation" implementing team production. This distributive norm is a skeletal constitution for the corporation that the agents would be ex ante prepared to enter.

There are many possible conventions, and the players want to avoid the risk of failing to coordinate on a combination of mutually optimal repeated strategies as good as possible for each of them. A cognitively convenient frame of reasoning (Denzau and North, Bacharach 2006) suited to ex ante agreeing on the same convention is that of looking for a 'fair' constitution, i.e. a constitution acceptable for all players independently of their personal perspectives. Hence, in order to accomplish the selection task, impartiality and impersonality are particularly fruitful modes of reasoning. Taken together with sympathy, these assumptions are the 'veil of ignorance' hypothesis. In other words, each agent makes his/her decision "as if" s/he were ignorant about his/her true identity, so that s/he takes in turn the positions of each possible participant in the game and identifies the constitution whose acceptance is invariant under any personal position's replacement. This is the same as delegating choice of the constitution to the "impartial director" presented at the beginning of the previous section, seen as an "arbiter" for the corporate constitutional choice.

The foregoing construction allows resorting to Binmore's vindication of Rawls' maximin principle (Binmore 2005, Rawls 1971) in order to define the solution of the corporate constitution selection problem. In this context, *impersonality* means that acceptance of the solution must not depend on personal and social positions. Thus, players - the poor but skilled worker (Eve) and the rich proprietor of means of production and capital (Adam) - should select a solution that cannot change under the symmetrical replacement of social roles and personal positions with respect to individual players. Technically fig.2 depicts any of these replacement by the symmetric translation of the initial payoff space X_{EA} with respect to the Cartesian axes representing the utility of player 1 and player 2, respectively. Thus, under the initial payoff space X_{EA}, player 1 will have all the possible payoffs of Eve and player 2 all the possible payoffs of Adam. But under the translated payoff space X_{AE}, roles are reserved and player 1 will then get Adam's possible payoffs and player 2 will get Eve's possible payoffs. Moreover, fig.2 illustrates that each player, when taking the other's perspective, exercises perfect *empathetic* identification. That is, when player 1, who under X_{EA} was Eve thinks to be Adam under X_{AE}, this player is able to reproduce exactly the same payoffs that player 2 experienced when the player was Adam.

(Insert fig. 2 about here)

Impartiality means that the players must agree on an outcome under the hypothesis that the reciprocal replacement of positions works in such a way that each stakeholder has an equal probability of finding himself in the position of each of the possible two roles. Equal-probability explains *how* it is possible that the solution does not change under the symmetrical translation of the payoff space with respect to the players' utility axes. Take an outcome x_{EA} that by replacing personal positions may realize in two non-coinciding ways (x_{EA} itself and x_{AE}). To make this outcome acceptable requires taking the expected value of an equal probability distribution over the two realization ways: $\frac{1}{2}x_{EA} + \frac{1}{2}x_{AE}$. This would identify a point in the space that is invariant under the players' positions replacement (i.e., an egalitarian solution residing on the bisector).

However, this construction is not meant to be an excessive idealization. Agents retain awareness that the solution must be an equilibrium of the original game. That is, the solution must be a convention or a collective rule of behavior that the parties know is self-enforceable and incentive-compatible once they think that they all are playing it. This is a requirement of realism of the agreed solution: agents cannot afford to agree ex ante on a solution if it is not incentive-compatible ex post (beyond 'the veil of ignorance'). The reason is simple. Admit that the impartial solution proves ex post not to be an equilibrium of the original game (does not belong to the original payoff space of the 'state of nature' game). Hence, the player who ex post would be most favored by returning to a solution belonging to the initial equilibrium set would simply deviate to an equilibrium strategy.

Consequently, the stability condition requires that the ex-ante solution (agreed behind the 'veil of ignorance') must correspond to an outcome that under the players' place-permutation would nevertheless belong to the ex post equilibrium set. In other words, the selected outcome must be an equilibrium (say) either if player 1 takes the position of Adam (and player 2 respectively the position of Eve) or in the opposite case when their identification is reversed (player 2 occupies Adam's position, whereas player B takes Eve's position), and all the more so when an equally probable combination of the two identifications is taken.

What has been just set is a more restrictive *feasibility* condition, replacing the initial one that stated as feasible all the outcomes represented in the equilibrium outcome set X_{AE}. Owing to the initial repeated game's assumptions, only equilibria of the original payoff space X_{EA} were feasible. Any further outcome – potentially subject to agreement – would be wishful thinking because no ex post equilibrium would exist that could implement it (see point U in fig. 2). Adding the conditions of impersonality and impartiality further restricts feasible outcomes to the symmetric intersection $X_{EA} \cap X_{AE}$ of the two payoff spaces generated by symmetrical translation of the original space, which is a proper subset of the initial outcome (equilibrium) set $X_{EA.}$ As shown in fig. 2. This is a symmetrical payoff space wherein any bargaining solution necessarily falls on the bisector, which is the geometrical locus of egalitarian solutions (where parties share the bargaining surplus equally). Note that this result takes for granted an egalitarian status quo preceding the agreement, but this assumption too is a consequence of the veil of ignorance.

In particular, players resort to the Nash bargaining solution (NBS), which is the most widely employed solution for bargaining games (Nash, 1950). It prescribes picking the point of the efficient (north-east) frontier of the payoff space (representing the outcomes set of possible agreements) where the product $\Pi(u_i - d_i)$ of the utilities u_i of players (I = 1, 2), net of utility d_i associated with their status quo, is maximal. Assuming that the players bargain according to the typical rationality assumptions of game theory (Harsanyi, 1977), and given that the feasible outcome set is the symmetric intersection sub-space $X_{EA} \cap X_{AE}$, the NBS is by assumption egalitarian and selects the point S of fig. 2.

The striking result deriving from this construction is that the minimal requirements of social justice (impersonality, impartiality and empathetic identification) become compatible with realism and ex post stability in an interaction where players are free to choose according to their preferences. In spite of Hayek (1973), freedom of choice and incentive compatibility does not require relinquishing the moral demands of social justice. On the contrary, it entails that the solution must be egalitarian and must coincide with the Rawls' *maximin* distribution, even within an originally asymmetrical set of possible outcomes. In fact, when the egalitarian solution is considered against the background of the initial equilibrium outcome space X_{AE}, it becomes evident that this solution coincides with the Pareto solution maximally preferable by the weak player E. Thus, given a real-life set of possible outcomes reflecting possible inequality between the participants, the solution falls on the equilibrium that most favors the worst-off. Thus Binmore vindicates the Rawlsian maximin rule (Binmore 2005). The Rawlsian view of cooperate governance consists in adopting such a solution as basis for choosing the corporate objective function and corporate governance structure (see also Sacconi 2010a,b, Sacconi 2011).

5.5 Two-steps social contract derivation of the multiple fiduciary structure

The social contract will be now employed to tell an hypothetical but simple story on how the multi-stakeholder corporation may have justifiably emerged, and its multiple fiduciary governance may have justifiably settled.

At the beginning all stakeholders face a “state of nature” plagued by incomplete contracts and opportunistic behaviours. To put at an end to this mutually destructive interaction, they agree to form a multi-stakeholder productive association wherein all stakeholders have the same rights and duties, hence avoiding the situation where, by exclusive control, some may expropriate the fruits of other stakeholders’ investments. In the productive association, therefore, all the stakeholders are confident that if any one of them makes a specific investment, nobody can hold up him with the threat of exclusion from the relevant transaction. This minimizes the ‘contract costs’ that would derive from incomplete contracts.

Assuming that the multi-stakeholder association is a possible form of team production, each stakeholder will rationally negotiate his/her adhesion to the association’s plan of action, which requires adhesion by all of them. The association’s joint plan is then selected by the *First Social Contract* (*pactum unionis,* since by this contract stakeholders decide to coalesce).

This agreement stipulates the following: (i) *rejection* of (or redress for) joint plans generating negative externalities for broad-sense stakeholders who in fact join the association in order to ensure that they will not victimised, (ii) *production* of the *maximum surplus possible* (i.e. the maximal difference between the value of goods and services for consumers, who also belong to the association, and the costs incurred by all other stakeholders to produce them). (iii) ‘*fair’ distribution of the surplus* according to a rationally acceptable agreement reached among all the stakeholders in a bargaining process free from force or fraud and based on an equitable *status quo* insuring each stakeholder against hold-up.

The bargaining process is conducted by stakeholders under a veil of ignorance about their possible advantaged or disadvantaged positions in the productive association. The solution is calculated according to maximisation of the NBS within the symmetrical payoff space deriving from the association’s possible outcomes, when all feasible personal payoffs are equally affordable to all stakeholders given the possibility of reciprocal replacement of their relative positions and roles (see the previous section).

However, once the first social contract has been accomplished, stakeholders immediately realize that the equally inclusive association is plagued by governance costs. Collective choice costs, coordination costs, and also free-riding costs in peer-group-managed teams may hugely reduce its actual output. They thus agree to devise an optimal authority structure in order to minimise governance costs.

By a further step in the process, they settle a *Second Social Contract* (called *pactum subjections* because by this contract stakeholders agree to submit to an authority) on the association's *governance structure*. This agreement stipulates that authority is delegated to the single stakeholder who is *most efficient* in governance. This problem has different solutions: either the typical public company with dispersed shareholders, or family-controlled companies, or partnerships or consumer cooperatives may be the most efficient governance solution according to contingencies (see Hansmann 1996).

The stakeholders' class invested with authority is remunerated with the *residual* and is authorised to appoint those who run the firm operationally (managing directors). But it is understood among the association's members that the authority of the corporate governance structure will be legitimated only in so far as it is *instrumental to* the first social contract. In other words, authority will be accepted by the prospective non-controlling members of the association if and only if the association's new ownership and control structure proves to be *the best way to implement* the first social contact of the firm – which pre-exists the authority relation and gives reasons for accepting it (Raz, 1985, McMahon 1989). No constitution of the governance structure may be accepted if minimising governance costs is not a means to improve the fair remuneration of the association's members. Of course, the remuneration of those delegated the association's governing role will impinge on the surplus recovered from reducing governance costs. But no governance structure could be accepted by the second social contract if it were not beneficial in an impartial way to all the stakeholders. Hence also a principle of accountability to non-controlling stakeholders – asking that they participate in some internal committee having supervisory powers – must be added, so that they may verify that corporate management does not significantly deviate from the principles settled by the first social contract (The German system of co-determination, according to which representatives of non-controlling stakeholders – at least the workers – are recognised a supervisory power, seems a desirable complement to the Blair-Stout impartial hierarch model of the board of director, at least when ownership is not extensively dispersed through the stock market, or there are effective mechanisms for coordinating shareholder or for aligning mangers' interests to that of shareholders through incentive contracts.)

Accordingly, there is a two–step, agreement, and the directors' fiduciary duties ensue from each step. They owe special fiduciary duties to 'residual claimants' *via* a *narrow* fiduciary proviso replicating the typical duty of due care and non-conflict of interest. But this narrow proviso is obligating only under the constraint of respecting a *broader* fiduciary proviso owed to non-controlling stakeholders, which is more fundamental and overriding**.** In other words, once the three provisos of the first social contract have been met, if two or more courses of action indifferent in terms of broader proviso compliance are still feasible, the directors are obliged to choose the course of action more favorable to the residual claimant (owner or shareholders)**.** But no priority of the shareholder value maximization principle over the stakeholders' common interests stated by the board's fiduciary proviso can be admitted.

To reconstruct this argument according to the Marcoux criterion of "vulnerability" (Macroux 2003), those suffering externalities are clearly vulnerable third parties. Once, however, externalities had been neutralized with a commitment to prevention or redress for them, strict stakeholders would come to the fore. Vulnerability due to incomplete contracts, specific investments and the risk of being subjected to *hold-up*, is actual for many of them. Moreover, the multiplicity of vulnerable stakeholders is not peculiar to the corporate case alone. Many fiduciary relations may involve multiple "stakeholders" also in the same class of beneficiaries: i.e. a doctor's many patients, a lawyer's many clients etc. Partiality cannot be admitted in their treatment: rather, impartial and equal respect is required among them. Equal respect of the fiduciary duties owed to all beneficiaries requires a fair solution of the distributive justice problem among them (at least on the distribution of the professional's time and attention among their cases). In the enterprise case, the solution is given by the NBS of the symmetric bargaining game among stakeholders in the strict sense.

A clear priority order of stakeholders' claims thus follows, and (*contra* Marcoux) all vulnerable stakeholders thus are privileged in some respect. Broad-sense stakeholders are clearly the most vulnerable, and are thus assigned priority, but only in the weak sense of restricting the company's range of action to those joint plans that do not engender strong externalities detrimental to them. Second in priority are strict-sense stakeholders, who are granted a wide range of privileges as guiding principle in the discretion area of directors who must protect their specific investments and then arbitrate cooperation according to the symmetric NBS.

Last, in the subset of possible corporate decisions indifferent to the NBS, residual claimants are assigned privileges in order to allow (constrained) shareholder value maximization. Indeed, since the NBS is a uniquely determined solution, substantial discretion in choosing *shareholder value maximization* strategies that do not also entail improvement of the other stakeholders' positions is quite unrealistic.

6. CONCLUSIONS

The chapter has countered all the criticisms raised against the multi-stakeholder governance model and the constitutive interpretation of CSR. In particular, Jensen's criticism that a multi-stakeholder approach to strategic management and corporate governance would make the objective function of the firm either indefinite, too complex or unmanageable has been shown to be untenable. In fact, the objective function of the firm is univocally defined not as the maximisation of shareholder value, but as the maximisation of the Nash bargaining product of the stakeholders' utilities within a symmetrical payoff space, after having set the negative externality on other non-cooperating stakeholders at a minimum. This objective function is perfectly calculable as the Pareto efficient allocation of payoffs that maximizes the egalitarian distribution (viz. the symmetrical Nash bargaining product), which (in the case of an asymmetrical outcome space) equates with maximizing the worst-off strict-sense stakeholder's positions. Though abstract, this is by no means more detached from reality than the traditional 'maximization exercise' about profit. This objective function is the one to which stakeholders would have agreed in the case of a hypothetical contract whereby they could have decided to start up the firm as a cooperative venture to their mutual advantage under the veil of ignorance. The objective function is genuinely normative and can be translated into a set of practical prescriptions concerning a hierarchy of company's goals according to which managers are accountable (see Sacconi 2006a):

First: minimize the negative externalities engendered by the firm's operations and affecting stakeholders in the broad sense (perhaps by paying suitable compensation);

Second: pursue the maximization of the joint surplus and its simultaneous fair distribution, as established by the impartial cooperative agreement among the stakeholders in the strict sense (i.e. maximizing the egalitarian distribution, or the worst-off stakeholder position);

Third: if more than one option is compatible with the above defined agreement, then choose the one that maximizes the *residual* allocated to the owner (for example, the shareholder).

Besides the unique and calculable definition of the socially responsible corporation's objective function, the social contract theory also provides a practically implementable solution, so that the CSR model of CG may not be defined as 'wishful thinking'. In fact, section 4.2. provided a well-defined board of directors' behavioural model that allows the solution to be reached through the "veil of ignorance" mode of behaviour and reasoning. Moreover, implementation is 'realistic' insofar as the impartial director focuses only on agreements implementable by stakeholders whose behaviour ex post rests on their individual incentives. Once the social contract has been identified/ and admitted that stakeholders develop the mutual belief that all of them will abide by the agreement selected, none of them has an incentive to deviate because the constitution selected corresponds to a convention of iterated play which is a Nash equilibrium point of the repeated game. There is no incentive to deviate from the agreed objective function and corporate conduct insofar as there is mutual expectation that all stakeholders will abide by it. The agreed solution is ex post stable and compatible with individual motivations and incentives.

There is of course a limitation implicit in the assumption that players have developed such a system of mutually consistent beliefs in the ex post perspective. Elsewhere I have argued that there is no logical necessity that this system of beliefs will ensue (Sacconi 2010a, Sacconi 2011). It is for this reason that I have developed a behavioural theory of reciprocal beliefs and conformist preferences also evidencing that ex post, after the agreement under the veil of ignorance, stakeholders will comply with the CSR model, since once they have agreed on the normative model of CSR they develop the reciprocal expectation of conformity and then also the desire to reciprocate conformity. This supports the prediction that stakeholders will comply with the normative model of CSR not just because of the ex-ante selection of a Nash equilibrium, but because they develop what can be called a 'sense of justice' which extends beyond purely self-interested rational behaviour (Grimalda and Sacconi 2005, Faillo and Sacconi 2010, Sacconi 2011, Sacconi, Faillo and Ottone 2011).

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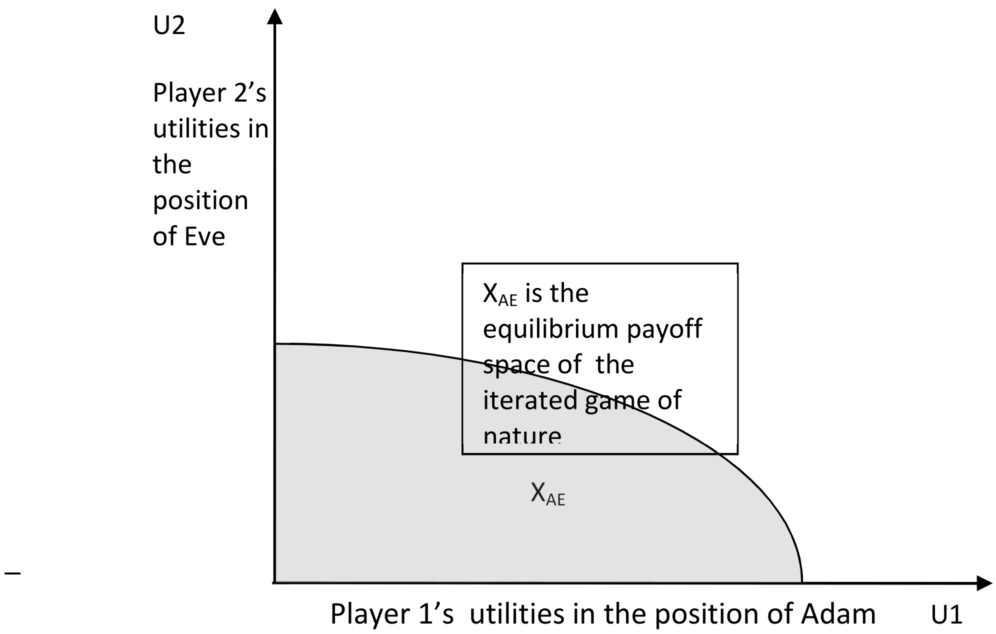

Fig. 1 **The repeated game equilibrium set X_{AE},**

Fig.2 **The Binmore-Rawls Egalitarian Social Contract**