
IS SHAREHOLDER PROFIT MAXIMIZATION EFFICIENT? IMPROVING THE SOCIETAL EFFICIENCY OF CORPORATIONS: FROM SHAREHOLDER SUPREMACY THEORY TO STAKEHOLDERISM

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Abstract

This article fundamentally challenges the dominant corporate social responsibility (CSR) paradigm by arguing that structural governance reform (stakeholder boards) is necessary because voluntary CSR, disclosure requirements, and external regulation cannot adequately internalize externalities when boards are legally bound to prioritize shareholder interests. It fundamentally reframes CSR from a voluntary ethical choice or matter of “enlightened” management discretion to a structural governance problem. It challenges the dominant assumption that shareholder profit maximization maximizes societal efficiency. It demonstrates formally that when externalities can be externalized, shareholder profit (M) diverges from societal efficiency (E), sometimes dramatically. Current corporate law compounds this problem by legally obligating directors to pursue the misleading profit figure rather than genuine social value. The proposed solution offered is that stakeholder board representation offers a more direct and potentially more efficient mechanism for internalizing costs than relying on external regulation alone. Voluntary environment, social and governance reporting, stakeholder consultation, and investor pressure all fail because they leave intact the fundamental board structure that creates incentives to externalize. Stakeholder representation addresses the root cause.

Keywords: stakeholder board; shareholder profit maximization; societal efficiency; corporate social responsibility; stakeholderism.

[A] INTRODUCTION

This article addresses a fundamental question in corporate governance: does shareholder profit maximization maximize societal efficiency, and, if not, what governance reforms can better align corporate decision-making with social welfare? The conventional wisdom, articulated most famously by Milton Friedman (1970), holds that corporations best serve society by maximizing shareholder profits within legal constraints. This

“shareholder supremacy theory” rests on two critical assumptions: (i) markets are competitive, and (ii) all externalities are adequately regulated. When these conditions hold, profit maximization should drive efficient resource allocation and maximize social welfare. However, in practice, these conditions rarely exist. Markets often fail to internalize the full costs of corporate operations—pollution, health impacts, unemployment—creating a divergence between reported profits and genuine social value. As demonstrated below, when companies externalize costs, shareholder profit maximization not only fails to maximize societal efficiency but actively undermines it.

This article makes three core arguments. First, it demonstrates formally (section [C]) that when externalities can be externalized, the conventional equation linking profit maximization to social welfare breaks down. Secondly, it examines non-economic arguments against shareholder primacy (section [D]) and assesses alternatives including Oliver Hart and Luigi Zingales’s “shareholder welfare” maximization. Thirdly, it proposes (section [E]) and defends (section [F]) stakeholder board representation as a more direct and efficient mechanism for internalizing costs than relying on external regulation alone. The analysis proceeds as follows: Section [B] explains the economic case for shareholder supremacy theory. Section [C] demonstrates mathematically why this theory fails when costs are externalized. Section [D] reviews additional arguments against profit maximization. Section [E] proposes stakeholder boards as a governance solution. Thereafter, section [F] analyses whether such boards would enhance efficiency, drawing on evidence from German codetermination.

[B] THE ECONOMIC CASE FOR SHAREHOLDER SUPREMACY THEORY

The idea of profit maximization has moved to the central stage since the 1960s as Hansmann and Kraakman observed (2001: 444). They claimed that the dominance of a shareholder-centred ideology of corporate law among the business, government, and legal elites in key commercial jurisdictions was exerting pressures for governance practices around the world to converge to the shareholder-centred idea of profit maximization (Hansmann & Kraakman 2001: 439). Under the shareholder-centred model:

Ultimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests

protected by contractual and regulatory means rather than through participation in corporate governance; noncontrolling shareholders should receive strong protection from exploitation at the hands of controlling shareholders; and the market value of the publicly traded corporation's shares is the principal measure of its shareholders' interests (Hansmann & Kraakman 2001: 441).

The problem with this claim is that, in practice, there are no adequate contractual and regulatory means to protect other stakeholders in society.

Henry Hansmann and Reinier Kraakman (2001: 441) admit that: "This is not to say that there is agreement that corporations should be run in the interests of shareholders alone—much less that the law should sanction that result." They point out that "all thoughtful people believe that corporate enterprise should be organized and operated to serve the interests of society as a whole, and that the interests of shareholders deserve no greater weight in this social calculus than do the interests of any other members of society". In the same vein, Armour & Ors say that:

the appropriate goal of corporate law is to advance the aggregate welfare of all who are affected by a firm's activities, including the firm's shareholders, employees, suppliers, and customers, as well as third parties such as local communities and beneficiaries of the natural environment. This is what economists would characterize as the pursuit of overall social efficiency (Armour & Ors 2009: 28).

Thus, there is an agreement even amongst the shareholder-centric academics that corporations should be run for the benefit of society. However, they claim that "as a consequence of logic and experience, there is convergence on a consensus that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests", "[moreover] the most efficacious legal mechanisms for protecting the interests of nonshareholder constituencies—or at least all constituencies other than creditors—lie outside of corporate law" (Hansmann & Kraakman 2001: 442).

In his famous quote, Milton Friedman said that corporations' social responsibility is to increase profits: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits *so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud*" (Friedman 1962: 173; Friedman 1970: 33).

Thus, according to the shareholder supremacy theory, a company's responsibility is to maximize profit for the shareholders as this is the best way to maximize efficiency for society. This is because, according

to the free market theory, resources are allocated efficiently in a free market, and free markets exist when, amongst other things, there is no cost of exchange. However, there are always unavoidable costs. Under shareholder supremacy theory, shareholders, as residual claimants, have the incentive to keep the costs as low as possible. But these costs must be internalized if we are accurately to characterize the efficiency of the company's operation. When costs are all internalized, in a competitive market, the free market would weed out inefficient companies that do not have the ability to keep the costs down (ie companies that misallocate resources) and achieve societal efficiency. The relationship between shareholder supremacy theory (or shareholder profit maximization) and societal efficiency can be summed up in the following equation:

The basic framework

Societal efficiency can be expressed as:

$$\text{Societal Efficiency (E)} = [\text{Revenue} - \text{All Costs}] + \text{Producer Surplus} + \text{Consumer Surplus} + \text{Benefits (B)}$$

Where "All Costs" includes: materials, processes, pollution costs, medical costs, unemployment costs, regulatory compliance costs (RC), etc.

Crucially, shareholder profit (M) reflects only the costs borne by the company, not costs externalized to society:

$$\text{Shareholder Profit (M)} = \text{Revenue} - \text{Company's Costs}$$

When the company internalizes all costs, M and E align (adjusted for surpluses and benefits).

Thus, if another company that is not efficient in its operation, uses the same material and process but is wasteful in its production, then the cost would be higher and the profit would be lower and, in a competitive market, would be priced out of the market. The market selects the more efficient company over the less efficient, and that is good for allocative efficiency and social welfare.

But how does profit maximization increase social welfare? Michael Jensen explains that:

A company that takes inputs out of the economy and puts its output of goods and services back into the economy increases aggregate welfare if the prices at which it sells the goods more than cover the costs it incurs in purchasing the inputs (including, of course, the cost of the capital the firm is using) ... it is precisely because profit is the amount by which revenues exceed costs—by which the value of output exceeds the value of inputs—that profit maximization (*provided there*

are no externalities) leads to an efficient social outcome (Jensen 2001: 12, emphasis added).

He concludes:

Therefore, *as long as there are no negative externalities* in the input factor markets (an example would be a case where the supplier of an input was imposing negative externalities on others by polluting water or air), the opportunity cost to society of those inputs is no higher than the total cost to the firm of acquiring them ... Likewise, as long as there are no externalities in the output markets, the value to society of the goods and services produced by the firm is at least as great as the price the firm receives for the sale of those goods and services ... [A]s in the case of producer surplus on inputs, the benefit to society is higher to the extent that consumer surplus exists (that is, to the extent that some consumers are able to purchase the output at prices lower than the value to them). In sum, when a company acquires an additional unit of any input(s) to produce an additional unit of any output, it increases social welfare by at least the amount of its profit—the difference between the value of the output and the cost of the input(s) required in producing it. And thus the signals to the management are clear: Continue to expand purchases of inputs and sell the resulting outputs as long as an additional dollar of inputs generates sales of at least a dollar (Jensen 2001: 12-13, emphasis added).

Merritt Fox points out that there is a “rough consensus”:

Among most (though not all) academic commentators that the proper goal for good corporate governance is that the firm should be operated to maximize its residuals—the difference between what the firm pays at contractually pre-determined prices for its inputs and what it receives for its outputs—over the life of the firm, discounted to present value (2014: 458-459).

He further argues that “doing so maximises the social wealth generated by the real operations of the corporation, *assuming that firms operate in competitive markets and that the potential externalities resulting from their activities, such as environmental damage, are properly regulated*” (Fox 2014: 458-459, emphasis added).

This resonates well with Friedman’s famous quote and Jensen’s explanation above.

Under these circumstances, the value of what the firm takes from society is, at the margin, properly measured by what it pays out at market-determined prices for contractually obtained resources, and the value of what it contributes to society, at the margin, is what it receives at market-determined prices for its output. The difference, the residual, is the firm’s value added and its contribution to society (Fox 2014: 458-459).

The residual, in other words, is the maximized shareholder value. Fox further points out that:

For investor-owned firms, shareholders are the recipients of these residuals. Thus, *according to the U.S. consensus*, such firms need to operate in a fashion that maximises share value. This need in turn suggests that the directors of the corporation should primarily represent the shareholders (Fox 2014: 458-459, emphasis added).

Thus, as Jensen emphasizes time and again, profit maximization leads to maximization of social welfare provided that there are no negative externalities.¹ Shareholder profit maximization provides shareholders with the incentive to use or monitor the use of company resources in an efficient way as they are the last claimants, so the argument goes. In economic theory, this is good for allocative efficiency. However, a rash of corporate collapses in the United States (US) since Enron (Hill 2005: 367) and global financial crisis also raised concerns about the merits of shareholder primacy and market discipline. Increasingly, there are many voices raised against profit maximization.

[C] WHY SHAREHOLDER SUPREMACY THEORY FAILS: A FORMAL ANALYSIS

As Fox observes, the contemporary views on profit maximization versus societal interest are a “hard-fought transnational debate” (Fox 2014: 458). Unfortunately, Friedman has often been misquoted, as most people seem to have focused on the first part of the quote ignoring the second part (see above in italics), which sets the condition that qualifies his view: in other words, Friedman did not suggest that companies can focus solely on profit maximization without complying with the law and by externalizing its cost. Law and rules are enacted to force companies to internalize costs. Companies can maximize profits only if all costs are internalized by complying with the rules of the game. Thus, there are two pre-conditions for shareholder supremacy theory to be optimal, as Fox, Friedman, Jensen, Christopher Stone, Geoffrey Hodgson, and many others have very accurately observed: (i) there has to be a free competition for the goods or services that the firm is providing; and (ii) all potential externalities of the activity of the firm are properly regulated (i.e. internalized).

¹ “If firms do not take externalities into account, society’s resources may end up being inefficiently allocated. Firms which are free to disregard social costs will be able to set lower prices. This will mean demand will be higher than it otherwise would be, which in turn will lead to the supplying of larger quantities. The ultimate result will be over-production from the perspective of society” (Cheffins 1997: 24).

In many real-world scenarios, the two preconditions do not always exist: (i) the market is either not competitive so dominating firms are able to externalize externalities, or the competition drives firms to externalize externalities in order to cut costs, as Hart and Zingales observe; competition can drive firms to choose dirty operation and cause damage (Hart & Zingales 2017a: 17-18; Stiglitz 2019); and (ii) externalities are not properly regulated (ie regulation is incomplete or not enforced) (Goo 2017). Therefore, in these circumstances, the shareholder profit maximization approach falsely magnifies the benefit firms make to society (Parkinson 1993: 311) and encourages firms to externalize externalities and cause harm to society at the same time as they benefit society; the contribution the company makes to society is not accurately reflected as my equation in scenarios 2 and 3 below show.²

As Fox, Friedman, Jensen, and others acknowledge, profit maximization maximizes social welfare only if all costs are internalized. This section demonstrates formally what happens when this condition fails. As mentioned earlier, when the company internalizes all costs, M and E align (adjusted for surpluses and benefits). But when costs are externalized, they diverge.

Three scenarios

Table 1 illustrates three scenarios assuming revenue of 600.

Scenario	Company costs	Externalized costs	Shareholder profit (M)	Societal efficiency (E)*
1 Full internalization	Materials (100) + process (100) + employment (100) + pollution (50) + medical (50) + RC	0	200 – RC	200 – RC
2 Partial externalization	Materials (100) + process (100) + employment (100) + RC	Pollution (50) + medical (50)	300 – RC	200 – RC
3 Race to bottom	Materials (50) + process (50) + employment (100) + RC	Pollution (150) + medical (150)	400 – RC	100 – RC

* Excluding producer surplus, consumer surplus, and other benefits (B) for simplicity, which remain constant across scenarios.

Table 1: Divergence between profit and societal efficiency

² For simplicity, only a few costs are mentioned in this equation. In reality, of course, the list of costs is much longer and would include cost of capital, etc. Profit here, as Jensen (2001) explains, refers to the difference between the revenue and the costs: ie when the value of output exceeds the value of input. Social efficiency would also include economic profit (or economic surplus), which is the sum total of producer surplus and consumer surplus. Producer surplus is the difference between the price consumers are willing to pay and the cost of production. Consumer surplus is the difference between the price consumers are willing to pay and the price at which the producer is willing to sell the product. Shareholders will enjoy the producer surplus, whereas consumers will enjoy the consumer surplus. Happiness/benefits refer to other intangible or unquantifiable benefits that may be enjoyed by all stakeholders, including shareholders.

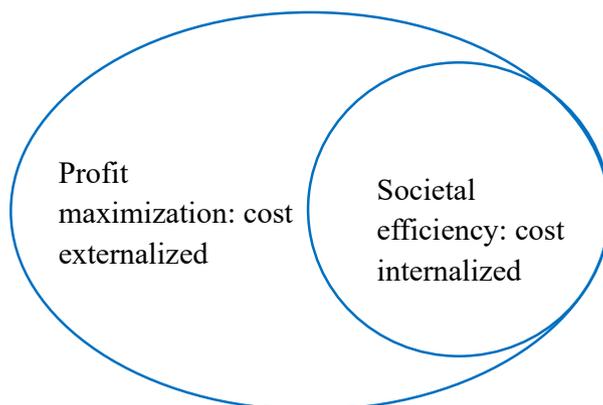


Figure 1: Analysis

Analysis

Scenario 1 (full internalization): Company A uses standard materials and processes, bearing all costs including pollution control (50) and worker health (50). Profit = $200 - RC$. This represents genuine value creation.

Scenario 2 (partial externalization): the company still uses standard materials/processes but externalizes pollution and medical costs. Shareholder profit appears higher ($300 - RC$), but societal efficiency remains unchanged ($200 - RC$) because society bears the 100 in externalized costs. The profit figure misleadingly overstates the company's social contribution by 50%.

Scenario 3 (race to bottom): Company B uses cheaper, inferior materials (50) and processes (50), cutting internal costs by 100 but increasing externalized pollution (150) and medical costs (150) by 200. Shareholder profit peaks at $400 - RC$, but societal efficiency falls to just $100 - RC$. Profit maximization has destroyed half the social value while appearing to double it.

The above analysis can be represented by a simple diagram (Figure 1).

The core problem

In competitive markets, Scenario 3 companies will outcompete Scenario 1 companies because they appear more profitable. Free market mechanisms select for apparent efficiency (high M) rather than actual efficiency (high E). As Hart and Zingales (2017a) observe, competition can drive firms toward dirty operations.

Current corporate law compounds this problem by requiring directors to maximize shareholder value (interpreted as M, not E), creating legal

obligations to externalize costs wherever possible within regulatory constraints. The result, as my equations demonstrate, is systematic misallocation of resources and destruction of social value masked by impressive profit figures.

This analysis reveals why Friedman's argument—despite its elegance—fails in practice. Companies cannot maximize profits “within the rules of the game” if the rules are incomplete, enforcement is weak, and the board's legal duty points toward externalization.

Armour tries to justify shareholder profit maximization theory by saying that creditors, workers, and consumers will only deal with companies if it is in their interest to do so, and shareholders have pecuniary interest to maximize their interest to entice them to transact with the company.³ However, he adds that, “Whether, in fact, the pursuit of shareholder value is generally an effective means of advancing overall social welfare is an *empirical question on which reasonable minds can differ*” (Armour & Ors 2009: 29, emphasis added).

It is true that, in theory, creditors, workers, and customers will consent to deal with a corporation only if they expect themselves to be better off as a result. However, in reality, as explained by Stone, many creditors, workers and consumers who deal with a corporation either do not have a choice or do not have the pertinent information that can help them ascertain whether they are better off as a result of the deal. Many consumers do not know they will be \$2 worse off for every dollar that shareholders gain. For example, they do not necessarily know that the materials or methods of production used could be harmful to them or the environment in the long run. Workers and customers may not know if in the long run they will be worse off indirectly as the state may have to spend money to clean up the environment or provide medical care and therefore have less money for worker and customer welfare in other ways, or have to raise more money in taxation, and so on. Armour & Ors

³ Armour & Ors (2009: 28-29): “it is sometimes said that the appropriate role of corporate law is simply to assure that the corporation serves the best interests of its shareholders or, more specifically, to maximize financial returns to shareholders or, more specifically still, to maximize the current market price of corporate shares ... such claims can be understood as saying, more modestly, that focusing principally on the maximization of shareholder returns is, in general, the best means by which corporate law can serve the broader goal of advancing overall social welfare. In general, creditors, workers, and customers will consent to deal with a corporation only if they expect themselves to be better off as a result. Consequently, the corporation—and, in particular, its shareholders, as the firm's residual claimants and risk-bearers—have a direct pecuniary interest in making sure that corporate transactions are beneficial, not just to the shareholders, but to all parties who deal with the firm. We believe that this second view is—and surely ought to be—the appropriate interpretation of statements by legal scholars and economists asserting that shareholder value is the proper object of corporate law.”

(2009) acknowledge that whether profit maximization in fact advances overall social welfare remains debatable. I argue that profit maximization cannot in fact advance overall social welfare when companies are able to externalize part of the cost and harm stakeholders' interests, as the extracts above from Friedman and Fox seem to imply and my equation above demonstrates.

[D] OTHER ARGUMENTS AGAINST PROFIT MAXIMIZATION

There are several other non-economic arguments against profit maximization.

First, it has been argued that the objective of a business is not to maximize shareholder return, but “to use its resources as efficiently as possible in supplying goods and services to its customers and to *compensate equitably those who supply these resources*” (Anthony 1960: 128, emphasis added). In other words, the objective is to earn a “satisfactory return on capital employed”—a “satisfactory” return being “equitable compensation paid for the use of capital”.

In real-world scenarios, businesspeople do not engage in profit maximization in many complicated problems such as pricing, choice of product line, marketing strategy, the direction of research efforts, what size plant to build, capital budgeting and so on (Anthony 1960: 128-132). This is primarily because “it is too difficult, and it would be immoral” (ibid 132). Shareholder profit maximization requires businesspeople to disregard other stakeholder interests as much as possible without ethical considerations, but that is not the case in the real world (ibid 132-133).⁴

⁴ “The ethical problem is that profit maximisation requires that the business manager think only of the best interest of the shareholders, whereas any responsible manager knows that he must actually consider the interest of all parties who have a stake in the business, of which the shareholders are only one. Profit maximisation requires the businessman to use every trick he can think of to keep wages and fringe benefits down, to extract the last possible dollar from the consumer, to sell as low quality merchandise as he can legally hoodwink the customer into buying, to use income solely for the benefits of the stockholder, to disclaim any responsibilities to the community, to finagle the lowest possible price from his vendors regardless of its effect on them, and so on. ... [The profit maximizers] deny the existence of a businessman’s conscience, and they exclude ethical considerations as being irrelevant to the subject. A businessman is a human being, and it is completely unrealistic to assume that he should act in an ethical vacuum. As a human being, he is deeply concerned with how his actions jibe with his own conscience, the respect of his family, and the opinions of his associates. Moral standards change, and whereas 50 or 100 years ago the profit maximising manager would perhaps have been tolerated in some circles of some communities, today society clearly expects the businessman to act responsibly. He cannot do this and at the same time seek to maximise the share of income going to just one of the several parties that have a stake in the business” (Anthony 1960: 133).

Perhaps it is precisely because many business people did not in fact act as profit maximizers that we encountered far fewer problems in the 1950s. What they in fact sought was “satisfactory return”, which is not the same as profit maximization. However, from the 1970s, investors began to put pressure on managers to maximize profits. “Labor unions, boards of directors, investors, bankers, and the government all exert pressure to ensure that the group each represents receives an equitable share of the revenue” (Anthony 1960: 133), but this is not always possible, especially when managers are under pressure to maximize profits. “Satisfactory return” does not mean that managers are not acting in the interest of the company to be efficient. “They will vigorously seek out opportunities to improve profits when they can do so ethically, and competition will force them to seek ways to improve efficiency even if no increase in profits results” (ibid 133). Anthony concludes that shareholder profit maximization is a misrepresentation of what happens in reality and is not one that any society should take pride in (ibid 133).⁵

Second, research shows that being socially responsible can be good for increasing firm value,⁶ and in such a case, stakeholder approach collapses into a shareholder maximization model. According to George Serafeim: “Very little evidence exists to suggest that sustainability can be an impediment to corporate profitability. In contrast, evidence is emerging that under certain conditions ‘sustainability pays’” (2014: 12). However, it is important not to make a broad generalization that doing good for

⁵ “The consequences of the profit maximisers” misinterpretation are not only that their concepts are not useful to businessmen, but also that they happen to be conveying a false impression of what our economy really is like. Consider this statement, which is part of Samuelson’s summary of the essence of our economic system: ‘A rich man’s dog may receive the milk that a poor child needs to avoid rickets. Why? Because supply and demand are working badly? No. Because they are doing what they are designed to do—putting goods in the hands of those who can pay the most, who have the money votes.’ This is a shocking statement. If it were true, no one should be proud of the American system; such a system would certainly not be welcomed in other countries. If it were true, we should prefer communism. The plain fact is that this statement is not true. Our system does not condone, or encourage, fattening dogs by starving children. Our system is one of which we may be proud. It can be described accurately if the assumption of profit maximisation is discarded for the idea of satisfactory return. Such a change will lead to more accurate reporting and to the development of more useful rules and concepts, concepts which focus on the businessman’s responsibility to all the parties at interest, concepts which we can be proud of, and which will lead to improvements in our system of which we can be even more proud” (Anthony 1960: 133).

⁶ “Corporate decisions that advance the interests of other stakeholders beyond what is required by the corporation’s existing contracts may, of course, enhance share value at the same time. For example, a firm’s discounted-to-present-value aggregate future residuals, and hence its share value, might increase if, despite a cost in terms of current earnings, the firm develops a reputation among current and potential workers as a good employer or among consumers as a ‘green’ company that works to reduce global warming” (Fox 2014: 460).

stakeholders will consistently benefit shareholders as well, as it often reduces share value, and thus, one has to make a choice.⁷

Third, Adolf Berle and Gardiner Means—whose observation of the phenomenon of separation of ownership and control in modern corporations that led to Jensen and Meckling’s agency theory which misconceived shareholders as the principals of the management—did not advocate shareholder profit maximization as the ultimate goal of corporations. They advise that:

It is conceivable—indeed it seems almost essential if the corporate system is to survive—that the “control” of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity (Berle & Means 1932: 312-313).

Einer Elhauge recognizes that profit maximization is too narrow a goal for managers when shareholders have social concerns (Elhauge 2005, cited in Hart & Zingales 2017a: 6). Lynn Stout (2012, cited in *ibid* 6), like Elhauge, also affirmed that, given that shareholders are prosocial, managers should pursue a broader agenda than profit maximization. Stout argued that the view that the fiduciary duty of managers and directors was to maximize shareholder wealth was not consistent with US corporate law. Another clear statement supporting stakeholder interests comes from Sir Adrian Cadbury, whose Cadbury Report lent impetus to the debate on corporate governance in the United Kingdom (UK):

Corporate governance is concerned with holding the *balance between economic and social goals and between individual and communal goals*. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the *interests of individuals, corporations and society* (Cadbury 2000: ‘Foreword’, emphasis added).

Fourth, Hart and Zingales argue that firm should maximize shareholder welfare, not just shareholder value, and underline the flaw in the idea of shareholder profit maximization. They claim that “the time has come for companies, economists, and society to abandon [Friedman’s argument]” (2017b: 5).

⁷ “The self-evidently overly broad generalization that, at least in the long run, doing good for other stakeholders consistently benefits shareholders as well. The happy incantation of this generalization by some authorities evades the fact that often an act that benefits other stakeholders reduces share value” (Fox 2014: 460).

The literature is divided on Friedman's thesis. One group believes that Friedman-type arguments hold only in a Arrow–Debreu complete market economy where each firm is a perfect competitor (Hart & Zingales 2017a), which of course does not always exist in real-world scenarios. The second group claims that in a world of incomplete contracts, stakeholders are all vulnerable to opportunistic behaviour and, thus, to encourage them to make relationship-specific investments, it may be important for managers to deviate from short-run profit or value maximization, and that under some conditions it may be efficient for the company to be set up as a worker, producer, or consumer co-operative or as a non-profit (ibid 5-6). The third area of literature—and it is vast—is primarily concerned with the empirical implications of a company's pursuit of a broader objective than merely shareholder value, raising the question of whether putting some weight on social issues actually increases profit in the long run (ibid 6). There is also a small theoretical literature on corporate objectives when shareholders care about public goods and externalities, although most of it is concerned with corporate gift-giving rather than the mitigation of externalities (ibid).

Hart and Zingales add to the debate by looking at how a consumer who owns shares in a company will choose between a clean and dirty decision. They make the following observations and conclude that companies should endeavour to maximize shareholder welfare and not market value.

- (1) consumer–shareholder will vote for a clean decision over dirty decision if and only if the profit from a clean decision (e.g. \$10) is larger than the profit from a dirty decision (e.g. \$12) minus the damage (e.g. \$4), and if the significance he or she attaches to damage is large enough;
- (2) If the profit for a clean decision (e.g. \$10) is larger than the profit for a dirty decision (e.g. \$9), he or she will vote for the clean decision over dirty decision;
- (3) If the profit for a clean decision (e.g. \$10) is smaller than the profit for dirty decision (e.g. \$12) minus the damage (e.g. \$1), he or she will vote for the dirty decision over clean decision;
- (4) If the profit for a dirty decision (e.g. \$12) is larger than the profit for a clean decision (e.g. \$10) but the latter (\$10) is larger than the former (e.g. \$12) minus damage (e.g. \$4), the consumer's preference will be the same as in situation 1 above;
- (5) If the profit for a clean decision (e.g. \$10) is the same as the profit for a dirty decision (e.g. \$12) minus damage (e.g. \$2), the consumer's preference will be the same as in situation 3 (Hart & Zingales 2017a: 7-10).

Hart and Zingales investigate how consumers–shareholders (not non-shareholders–stakeholders) would choose between clean and dirty decisions, and reveal that prosocial shareholders will vote for clean decision in situation 1. This shows that Friedman’s belief was mistaken in situation 1: prosocial shareholders will vote for a clean decision even if the associated profit is less than the dirty decision because the profit and externalities cannot be separated. However, one interesting point from Hart and Zingales’s analysis is that even prosocial shareholders cannot be relied on to make socially responsible decisions in situations 3 and 5. And managers who are required to act for the shareholders’ interests will likewise do so. In such situations, it would be necessary for stakeholders to sit on the board to protect their interests.

Hart and Zingales also affirm that in the case of perfect competition, dirty choices by other companies will likely reduce marginal costs and force prices down, reducing the firm’s profit. If company A is in duopolistic competition with company B, which has chosen a dirty technology, shareholders of company A confront a dilemma. If they choose clean technology, they will lose market share to company B if the latter’s marginal cost is lower. The consequence is a considerable amount of environmental damage by company B. If they choose the dirty technology (which they would prefer not to), they may produce possibly smaller damage themselves and still make money (Hart & Zingales 2017a: 18-19).

In view of this analysis, what is the fiduciary duty of managers or directors? Hart and Zingales say that the academic literature is confused (Hart & Zingales 2017a: 19). They argue that the duty is to maximize shareholder *welfare*, not just shareholder value (ibid).⁸ Unfortunately, as they point out, managers of pension funds are required by law to maximize value rather than welfare, unless there is a vote at shareholder meeting to tell them otherwise (ibid 21-22). They also observe that a consequentialist shareholder would vote to transform the company into a clean one as “she feels guilty about the pollution produced if she does not act to curb it”, unless the pollution is “moderately inefficient” (ibid 26). However, if a shareholder is categorically imperative, they will make all inefficient takeovers impossible and eliminate any problem of free riding, collective action, and even adverse selection or moral hazard (ibid 26-27).

⁸ One problem is for the managers or directors to find out what shareholders want (their welfare). Hart & Zingales think that this can, however, be resolved by using digital polls that are cheap and fast (2017a: 20). Another option is to have specialized socially responsible mutual funds (not the normal mutual fund which trade regularly for profit only). On the strategy for social investing, they advocate that “invest and engage” would be more successful than “diverting” from dirty companies (ibid).

More recently, Colin Mayer and colleagues (2020), writing on the 50th anniversary of Friedman's article in *New York Times Magazine*, argue that, after 50 years, it is time for a new paradigm. They say corporations should be clear about their purpose as an expression of the responsibility they and their directors have in society, not as a matter of choice but as a matter of duty, and suggest that all corporations with over \$1 billion of revenues should be formed as public-benefit corporations as Senator Elizabeth Warren proposed (Mayer & Ors 2020).

Fifth, we cannot rely on market or profit maximization to look after stakeholders, not only because of shareholders' self-interest and market failure but also because markets cannot address the social justice consideration in a society. It is well known that corporations possess enormous powers (decision-making power in terms of what to produce, in what quantities, and at what price, etc; power over consumers in the market; making delegated decisions instrumental to production, eg on technology, organization of the workforce, plant location, and executive prerogatives) and can exercise their powers to the detriment of stakeholders (Parkinson 1993: 3-21; Stiglitz 2019: chapter 3). Individual and collective interests and values ought not to be sacrificed in a company's pursuit of profit—for example, employees' rights in case of dismissal and to a minimum wage—and because of the defect inherent in the market, a company can externalize costs to society (Parkinson 1993: 41-42). As Stone also emphasizes:

Even at its ideal best, the market is not a remedy for all the problems a society may have with its commercial actors, but plays a general allocative role, encouraging capital, labour, and other factors of production to flow to those industries and firms that can put them to the most beneficial social use ... few [economists] if any are satisfied that the market of itself can allocate resources adequately to fill social needs (Stone 1975: 88).

This is because those who have faith in the market or profit maximization as an assurance to achieve socially desirable goals are implicitly making certain assumptions each of which is often questionable (Stone 1975: 89): (i) that the consumers know *the fact* that they are being "injured". It often takes a long while for consumers and the public to know that certain products cause harm, for example, cigarettes or coal dust in a coal mine and the like, or what the products contain and their likely effect in the long term. (ii) That consumers know *where* to apply pressure, that is, who is the real culprit. Consumers identify products by brand name, not usually by the producing company. Thus, when dissatisfied with one product, they might inadvertently switch to another brand produced by the same company. (iii) That consumers are in a *position* to

apply pressure. The complaining party may not have any legal (contract or tort) relation with the company to be able to apply pressure. Or the company is a monopoly or oligopoly. And (iv) that consumer pressure will be *translated* into warranted changes in the institution's behaviour. When dissatisfied consumers turn to another brand, the management may not know why the company has lost sales, or even if they know, they may not be willing or able to remedy the problem in the most desirable way. "All large organizations seek to seal off or 'buffer' their technical core from disruptive environmental influences (like the market—or the law) [Thompson 1967: 20-23]. So far as possible their tendency is to fight rather than to switch" (Stone 1975: 89). Thus, you cannot leave it to the management to decide whether to remedy and how to do it. A stakeholder board will help or force them to change.

Sixth, looking after stakeholder interests or not maximizing profit is not bad for efficiency. Law and economic scholars often cite efficiency as the justification for supporting shareholder profit maximization. Japanese companies, often seen as the "odd man out", and, more recently, Chinese state-owned enterprises provide interesting examples of how looking after stakeholder interests is not bad for societal efficiency. Since 2002, Japan's emergence, albeit slow after its decade-long economic malaise (Katz 2003; Ito & Ors 2005), has prompted intriguing questions as to whether recovery was achieved by revamping its laws and economic institution along more American lines, as Daniel Kelemen and Eric Sibbett (2002: 269) argue, or if the recovery provides evidence of "the robustness of its broader, stakeholder-oriented system of governance", as David Collison and Yoshinao Kozuma contend (2002, cited in Nottage & Ors 2008: 21). "Does Japan's experience ... reflect the triumph of US-style shareholder-oriented governance, or the endurance of Japan's stakeholder-based model of capitalism?" (Nottage & Wolff 2005: 133; Nottage & Ors 2008: 21)

It is well known that Japanese companies are not primarily interested in profits and dividends, and yet:

large Japanese companies, though they may be privileged, are also intrinsically efficient. They could hardly make goods of such high quality and deliver them on time if they were not. No one, Westerner or Japanese, need be in any doubt that the Japanese system works (Clark 1979: 225).

Very little had changed after the lost decades.⁹

⁹ One reason for the *status quo* was "political, using that word in the widest sense. The company and Japanese industry as a whole confer their benefits on enough people for there to be considerable support for the status quo" (Clark 1979: 225)."

Although there has been a marked shift in Japan since 2002 from “employee sovereignty” towards “shareholder sovereignty” and development of a market for corporate control (Dore 2005a: 443; Jacoby 2005), and other phenomenon such as real threats of takeovers and much greater managerial concern with share price and faster growth of directors’ compensation compared to that of other workers (Dore 2007), there has been little revision of bureaucratic internal promotion systems for top managers (Jacoby 2005; Dore 2007). Thus, Haley maintains that the corporate sector in Japan continues to display a broader stakeholder approach to corporate governance which fits with Japan’s ongoing communitarian approach to law and society (Dore 2005b), and Dore concurs with Haley that Japan still retains key infrastructure for stakeholder-based firms (Dore 2007). Jacoby also argues that Japanese companies are still very much organization-oriented, focusing on long-term employees and broader stakeholders in their corporate governance, with a high-powered centralized human relations department (Jacoby 2005: 11-12). Even the rational self-interest theorists, such as Mark Ramseyer, who argue that the Japanese are not communitarian but are driven by straightforward market forces, not idiosyncratic and persistent institutional arrangements, agree that little has changed (Ramseyer & Nakazato 1999; Miwa & Ramseyer 2006).

On the other hand, there was the contrasting view that Japan was departing from stakeholder capitalism and moving towards an embrace of shareholder primacy (Nottage & Ors 2008: 26).¹⁰ In fact, formal Japanese corporate law is closer to the Anglo-American model than the German model, as it presupposes the shareholder-oriented model and that employees are not given any say in the board.¹¹ However, lifelong employment explicitly marks the difference between the Japanese and

¹⁰ For example, Emmott, the editor of *The Economist* in 2005, claimed in rather colourful terms that cross-shareholdings, lifetime employment are no longer the rule, and executives now behave more like American (chief executive officers (CEOs) with pay linked to performance (Emmott 2005, quoted in Nottage & Ors 2008: 27): “Cross-shareholdings have largely been unwound. Lifetime employment, even in big firms, is now the exception not the rule thanks to changes in labour laws that have allowed workers to be employed on short-term contracts. Such employees make up 40 per cent or more of the total at manufacturers such as Toyota. Many – though not all – corporate boards have been streamlined, with more independent directors and fewer placemen [sic] ... Executive remain primarily bureaucratic but there are now many more exceptions, sounding and behaving more like American CEOs and with senior management pay geared to performance. And foreign executives are no longer unacceptable.”

¹¹ Araki 2005: 26; cited in Nottage & Ors 2008:56): “[Japanese corporate law] presupposes that a corporation is [the] shareholder’s property and the role of management is to maximize the interests of shareholders. Unlike [the] German co-determination law which opens the supervisory board to employee representatives, Japanese law does not give employees or their representatives any status as a constituent of the corporation ... Thus, ostensibly Japanese law resembles more the Anglo-Saxon market oriented model.”

US systems, which brings the Japanese firms closer to Germany's stakeholder-oriented model in substance.¹²

During the peak of the Japanese economy, lifelong employment and the broader model of stakeholder capitalism were trumpeted as the secret of the Japanese success, providing a worthy alternative to the liberal market economy, whilst, during the recent downturn, they were regarded as a drag on labour mobility and economic efficiency (Boyer & Yamada 2000: 3; Ahmadjian & Robinson 2001: 624; Nottage & Ors 2008: 57).

There has been debate as to whether lifelong employment has ceased to exist in Japan. However, the empirical evidence seems to indicate that lifelong employment persists but is under strain (Nottage & Ors 2008: 74). Despite Bill Emmott's assertion (2005), and despite a number of changes since 2002,¹³ the Japanese stakeholder-oriented model remains largely intact albeit with considerable realignment of stakeholders (Nottage & Ors 2008: 28, 38).¹⁴

Thus, the Japanese experience does not show that looking after stakeholders can be bad for societal efficiency. The lost decade were more likely a result of the Plaza Accord, international finance and Japanese monetary policy at the time, not corporate governance structure or stakeholderism in Japan (Ito 2015).

¹² Konzelmann (2005: 593-594; cited in Nottage & Ors 2008: 57): "Traditionally, Japanese firms have been 'organisation oriented' while American firms have been more 'market oriented'. This is reflected in the dominant features of corporate governance and work organization, where despite movement towards the American model, the Japanese system of stakeholder-oriented corporate governance and its view of labour as a productive resource continues to stand in sharp contrast to the American shareholder-based system and view that labour is a factor of production with a cost to be determined". Lifelong employment, along with seniority-based wages and enterprise unions are the "three sacred treasures" that represent "stakeholder governance" (Jacoby 2005b), even though it is neither mandated under Japanese corporate law nor part of any explicit contractual promise but a mere "unwritten guarantee" (Dore 2000: 107), "social norm" (Jackson 2007: 282), or a "moral imperative" (Ahmadjian & Robinson 2001: 624).

¹³ For a detailed analysis of the changes, see Nottage & Ors (2008: 30-37).

¹⁴ "Japan is experiencing significant but not overwhelming change in its system of corporate governance", claim Nottage & Ors (2008: 38). "Shareholders have become more central compared with creditors and employees (with more change underway than acknowledged by Haley). However, shifts are more ambivalent in some areas of industrial organization (especially in relation with key suppliers). Influences on firms from regulators or the broader community (such as NGOs) are also changing but remain more peripheral" (ibid 29). It has been suggested that: "[S]uch changes are best understood as evidence of an intensification of an existing mode of regulation—flexicurity—rather than a harbinger of more dramatic institutional shift. The system is undergoing stress, clearly, but its key features remain in place ... Lifelong employment ... is not 'withering away'; rather, it is reinventing itself in response to the intensification of the flexicurity mode of regulation. As the empirical evidence illustrates, the 'tree' of lifelong employment may have many of its branches swaying in the wind (some may have even snapped off), but this tree remains rooted in the same political compromise between labour and management settled over five decades ago" (ibid 79).

Finally, the theory of organization (the O-theory) suggests that looking after stakeholders can be equally efficient. According to the theory of the firm (the F-theory), firms are “to maximize profit—the difference between value of product and cost of production” (Simon 1952-1953: 40-48). In the F-theory, the entrepreneur is explicitly treated as a rational individual, and the other participants—employees, customers, suppliers—are passive “conditions” to which the entrepreneur adjusts in finding the solution that is optimal to them (ibid). In contrast, the O-theory treats participants in a more symmetrical fashion, as participants are offered an inducement for their participation in the organization, through which they make a contribution to the organization (ibid). The participant’s contributions are regarded as “factors” and the inducements as “products” (ibid). Thus, the organization transforms its members’ contribution into inducements which it, in turn, distributes to these members (ibid). Both theories are ultimately concerned with the optimal distribution of satisfactions—the F-theory is about optimal distribution for the entrepreneurs and the O-theory for all participants. The latter shows that once an optimal state is reached in the demand-and-supply curve, any combination of surplus to each participant is optimal, except that each participant will experience a different degree of satisfaction. As Simon explains:

Suppose that we have a solution in which each participant is receiving more than the minimum satisfaction required to retain him in the system—each has a satisfaction greater than zero. We suppose further that the satisfaction of all participants cannot be simultaneously increased—e.g., if the quantity of production is held constant, wages cannot be increased without increasing prices or reducing net profits. Then we could still maintain the system if we reduced wages to a point where the satisfaction of the employee was just above zero, and increased the satisfaction of the entrepreneur, or increased the customer’s satisfaction by reducing prices ... We may select, for example, that particular one or the other optimal solution for which the satisfactions of the entrepreneur and the customer are each equal to zero, and the satisfaction of the employee therefore attains the maximum value that is consistent with viability. The employee, in this case, captures the entire “surplus” of satisfactions. Alternatively, we may select the solution in which the entrepreneur captures this “surplus”, and the satisfactions of customer and employee are held at zero (Simon 1952-1953: 40-48).

Why should the entrepreneur capture all the satisfaction? The F-theory is optimal but does not increase the welfare of other participants. It rather selects out of all viable solutions the one that maximizes the satisfaction of the entrepreneur and assumes that they alone will seek to capture the “surplus” of satisfactions and the other participants will be persuaded to remain in the system by marginal inducements that just equal the

marginal opportunity costs of their respective contributions (Simon 1952-1953: 40-48). This bargaining allows customer and employee to retain part of the “surplus” (consumers’ surplus and labour’s surplus), but when the elasticity of the demand for product or the supply of labour becomes infinite (as in perfect competition in the market for the product and the labour market), these respective surpluses disappear, in which case, the F-theory requires that the inducement offered to customer and employee be just equal to the opportunity costs of their contributions (ibid). That is the reason why other stakeholders do not receive a fair share for their contributions under the current Anglo-American capitalism, which prefers the F-theory. Simon asks, “are we to restrict ourselves to the solution that is optimal to the entrepreneur (as in F-theory), or to consider the wider classes of optimal, or even viable, solutions (as in O-theory)?” (ibid). I believe the answer to the former is “no” and the latter is “yes”. Whilst not saying which theory to choose, Simon observes that: “Institutional economists, and theorists of organization who have perhaps been in closer contact than traditional economic theorists with the empirical phenomena, have been by no means satisfied that the F-theory coincides with the observed facts of organisational behaviour” (ibid). Stakeholder boards would not only help the demand-and-supply curve to yield a better/more optimal/efficient equilibrium by internalizing all costs of production (evidenced in my equations above) but also help all participants negotiate for a more optimal solution for them in line with the O-theory and create greater wealth for society.¹⁵ Stakeholder board is a platform where stakeholders interests are distributed in line with O-theory. Thus, in theory, it is plausible that stakeholder boards would be as efficient as—if not more than—shareholder boards.

[E] STAKEHOLDER BOARD TO INTERNALIZE EXTERNALITIES

Thus, the analysis above demonstrates that relying on consumer, worker, and environmental laws and regulations to regulate a company is insufficient to force companies to internalize their costs of operation. I have argued elsewhere that one possibility is to appoint stakeholder directors to represent stakeholder interests (shareholders, workers, consumers, community/society and the environment respectively) on the board of directors (Goo & Klinger 2014; Goo 2017). This would allow stakeholder interests to be considered in the company’s decision-making process and internalize all its costs of operation directly.

¹⁵ See Simon (1952-1953) chapter 5, C2 and C3 on how stakeholders might increase efficiency.

The idea of stakeholder directors on the board was proposed by Ralph Nader, Green and Seligman in the 1970s (Nader & Ors 1976: 125) but not adopted in the US. It is familiar to civil law countries, such as China, Japan and Germany as they have worker representation on the supervisory board with different degree of voting rights. Stakeholder boards would just be an extension of this.

[F] WOULD STAKEHOLDER BOARDS BE MORE EFFICIENT?

Hitherto, we have been relying on law and regulation as mechanisms to internalize these costs. In the last decade, we have also been requiring companies to make environment, social and governance (ESG) reporting to internalize costs. However, as with many such reports or disclosures, they tend to degenerate into a box-ticking exercise. We need some internal governance mechanism of checks and balances. Having stakeholder directors on the board as an internal check and balance is one way to encourage internalization of the costs (Goo & Klingler 2014; Goo 2017).

But the stakeholder board remains a concept on paper—there is no empirical evidence to show whether it would be efficient. The nearest one can get is the German codetermination board which is a more limited form of stakeholder board. Free market economists see little value in state intervention into a functioning market and are therefore sceptical about the efficiency effects of German codetermination boards (FitzRoy & Kraft 2005: 235). Property rights theorists also dislike intervention by government into the decision rights of firms (FitzRoy & Kraft 2005: 235). Armen Alchian and Harold Demsetz (1972) argue that a private firm is allocationally efficient when all control and property rights reside in one agent, the firm owner (ie the shareholders): the owner pays a competitive wage, monitors worker shirking and, as the residual claimant, has incentives for efficiency (Fauver & Fuerst 2006: 679). This underlies the theory of shareholder profit maximization as mentioned above. Codetermination disturbs this as property rights are now split between two agents each pursuing a different agenda (ibid). However, whilst in the Alchian and Demsetz's neoclassical analysis employees have no firm-specific skills, it is now generally agreed that employees do develop firm-specific skills which are nontransferable, so employees do make human capital investments, and as long-term employment contracts either do not exist or lack specificity, and returns on their human capital investments (ie wages) commensurate with their investment may never materialize, employees may be reluctant to make human capital investment that is

vital for the success of a firm (*ibid*), and if invested would have incentive to see the company successful. Eirik Furubotn and Steven Wiggins (1984: 176-192) suggest that codetermination can promote human capital investment and increase firm value (Fauver & Fuerst 2006: 679).

Michael Jensen and William Meckling asked in the late 1970s:

if codetermination is beneficial to both stockholders and labour, why do we need laws which force firms to engage in it? Surely, they would do so voluntarily. The fact that stockholders must be forced by laws to accept codetermination is the best evidence we have that they are adversely affected by it (1979: 469-506).

However, as Steven Ramirez points out:

While markets certainly are powerful tools for allocating resources, they do not seem to imbue corporate governance standards with any degree of precision sufficient to positively influence law and regulation. This is the essential lesson from the race to the bottom debate. (2007: 356)

According to Oliver Williamson's transaction-cost theory (Williamson 1975), competitive forces drive the firm to its lowest-cost organizational form, so it follows that, as codetermination laws are imposed, natural and efficient governance is not achieved (Fauver & Fuerst 2006: 679). However, it is also pointed out that these criticisms do not take into account the coordination problems (*ibid*). As in the standard prisoner's dilemma, the first-best outcome cannot be obtained without coordination (*ibid*). By the same token, if a single firm implements codetermination on its own without the compulsion of law, even if it creates firm value, the compensation differential between management and worker is likely to fall, and worker job security is likely to rise, resulting in the firm losing its best management talent and attracting the least productive workers (*ibid*). Thus, adverse selection induces a negative externality if codetermination is unilaterally introduced, and coordination through legislation is therefore necessary to realize the benefit of codetermination (*ibid*).

But what does the empirical evidence tell us? As noted by FitzRoy and Kraft, surprisingly, board level codetermination has received little attention from economists, and there is not much econometric evidence on codetermination (FitzRoy & Kraft 2005: 234). Until recently, studies of the German system tended to examine the effect of the 1976 legislation (Codetermination Act 1976) or focus on non-economic measures of performance such as a firm's capacity to make decisions and implement change or the ability of employees to influence corporate policy (Fauver & Fuerst 2006: 675, citing Gerum & Wagner 1998). Felix FitzRoy and Kornelius Kraft suggest that: "Most theoretical models agree that

there is likely to be an optimal degree of codetermination in terms of efficiency, and ‘too much’ participation or employee representation will be counterproductive” (2005: 238). Some studies on codetermination in Germany have focused on financial performance or firm value (Gurdon & Rai 1990; Gorton & Schmid 2000; Fauver & Fuerst 2006; Kraft & Ugarkovic 2006; Vitols 2008), productivity and profits (Gurdon & Rai 1990; Renaud 2007), or abnormal returns (Petry 2015), but the results are not consistent due to different methodological frameworks and the panel data used (Conchon 2011; Lopatta & Ors 2018: 2). Other studies have criticized earlier research for using only cross-sectional data (eg FitzRoy & Kraft 2005: 234, commenting on FitzRoy & Kraft 1993 and Gorton & Schmid 2000), a mix of firms with different characteristics (eg sample size), sample sizes that are too small, or unsuitable statistical analysis procedures, none of which allow for controlling for possible unobserved or omitted firm-specific effects (FitzRoy & Kraft 1993; Gorton & Schmid 2004; Conchon 2011; Lopatta & Ors 2018: 5, citing Bermig & Frick 2010). As noted by John Addison and Clauss Schnabel (2011: 354-374), however, there is a wealth of empirical literature on the effects of codetermination at enterprise level. The literature focuses on the analysis of changes in productivity, shareholder value and profitability, and the impact on the firm’s innovation and employment level. Older studies on the impact of codetermination on productivity (eg Svejnar 1982; Gurdon & Rai 1990; FitzRoy & Kraft 1993; FitzRoy & Kraft 2005; Renaud 2007; Wagner 2009; Boneberg 2010) and profitability (eg Gurdon & Rai 1990; FitzRoy & Kraft 1993; Wagner 2009; Boneberg 2010) tended to be more negative, whereas the recent studies are more positive. Its impact on stock prices is more uniformly negative (Benelli & Ors 1987; Baums & Frick 1996; Schmid & Seger 1998; Vitols 2006; Frick & Bermig 2009). So the results are not conclusive (Sadowski & Ors 2000; Kraft 2006: 710), and it is difficult to know who is right because of the different methods and data used (Boneberg 2010: 8), though some believe that the more recent investigations are more reliable because of their improved methodology (Vitols 2005: 26).

On the other hand, there is also no evidence that profit maximization is more efficient than serving stakeholders’ interests. Board level employee representation (BLER) has existed in Europe for quite some time.¹⁶ There

¹⁶ Fourteen countries have representation at board level in both private and publicly owned companies: Austria, Croatia, Czech Republic, Denmark, Finland, France, Germany, Hungary, Luxembourg, Netherlands, Norway, Slovakia, Slovenia and Sweden; five countries have representation at board level in only publicly owned companies: Greece, Ireland, Poland (also privatized companies), Portugal and Spain; 12 countries have no compulsory board level representation (other than voluntary): Belgium, Bulgaria, Cyprus, Estonia, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Malta, Romania and UK. There is also the SE in all European Union (EU) countries.

is a depth of knowledge and experience on how such a system works (ECGI 2017: 3). In a recent conference on BLER, Franklin Allen argues (ibid) that corporations should serve stakeholders, noting that there are, however, cross-cultural differences as far as the answer to this question is concerned, having considered a number of papers that argue against stakeholder governance on grounds of being biased against innovation (Hellwig 2000: 95-134) and of posing problems with correct incentives to managers (Tirole 2001: 1-35; 2006), as well as papers that claim that BLER supports corporate governance on grounds of facilitating the implementation of stakeholders' concerns (Blair 1995) and of providing the benefit of internal mutual monitoring (Allen & Gale 2000).

There is a debate as to whether the German system is efficient,¹⁷ and an argument that more flexibility should be given to firms to experiment with different governance or BLER regimes (ECGI 2017: 4). At the same time, there is a growing number of German companies reincorporating as *Societas Europaea*¹⁸ to avoid and mitigate BLER and to opt for a one-tier board system (ibid).

Allen argues that, if the firm is confronted with cost uncertainty, stakeholder governance can benefit shareholders, whereas, if it is confronted with demand uncertainty, stakeholder governance can hurt shareholder profit (Allen & Ors nd: 3-4). Maug (ECGI 2017: 7; Maug 2017, citing Fauver & Fuerst 2006: 674) and Franklin Allen and Douglas Gale (2002) argue that in incomplete, imperfect markets, a stakeholder corporate governance system stressing cooperation between management and employees (ie codetermination) may allocate resources more efficiently than a shareholder system, although the empirical studies examining the impact of codetermination on stock returns, market-to-book ratios, and performance ratios do not furnish conclusive evidence regarding the impact of BLER on corporate performance (ECGI 2017: 7).¹⁹ This is because of the shortcomings associated with the data, the fact that none of those measures fully capture the impact of BLER on firm value and, more generally, the presence of multiple dimensions of corporate governance that interact in ways that are difficult to capture (ibid). Maug notes that companies never opt to use BLER voluntarily, but do not seem to try to avoid it either and concludes that the empirical literature is

¹⁷ And only German employees are represented on the board. The European Court of Justice has recently ruled in *Konrad Erzberger v TUI AG* (2017) that such a rule is not incompatible with EU law on non-discrimination on grounds of nationality and free movement of persons.

¹⁸ A public limited liability company formed under EU law that operates across member states with a single legal identity.

¹⁹ See also ECGI (2017) chapter 5, fns 277, 281, 282, 324.

inconclusive and that firm behaviour seems to suggest that there are no first-order gains from having employee representation or avoiding employee representation (ibid). There are, however, other empirical studies that suggest that codetermination can enhance productivity and even firm performance.

Although there is no conclusive empirical evidence of the efficiency of German boards, the results being mixed because of their limitations, the balance of evidence suggests that German boards are efficient from the perspective of productivity and firm performance, but not in terms of short-term shareholder value or share price. More robust studies could be carried out to illuminate this. However, the fact that the German economy is the third largest in the world, after the US and China, speaks louder than words for its overall societal efficiency, especially as it is a small country compared to the US and China in terms of its geographical size and population. How can Germany be producing high-quality, world-class vehicles and other industrial outputs if its companies are not efficient?

Can stakeholder boards restore efficiency? A formal analysis

If stakeholder representation forces companies to internalize costs at board level, can it restore the link between profit maximization and societal efficiency? The answer depends on whether the cost of stakeholder governance (SBC) is less than the harm prevented (see Table 2).

Key findings

- ◇ Stakeholder boards are more efficient than shareholder boards if $SBC < AH$: Where SBC is the cost of stakeholder board governance (director costs, longer meetings, coordination) and AH is additional harm from externalities. For large-volume producers, AH scales with production while SBC remains relatively fixed, making stakeholder boards increasingly efficient at scale.
- ◇ Even partial internalization improves efficiency: if stakeholder boards only partially prevent externalization, they still improve societal efficiency provided $SBC < (\text{externalities prevented})$.
- ◇ The cost threshold is likely favourable: director costs are not additional (same number of directors, different representation). The main costs are coordination and potentially longer deliberations. These are dwarfed by externalized harms in sectors like chemicals, mining, and manufacturing.

Governance structure	Company bears	Society bears	Profit (M)	Societal efficiency (E)*	Condition
Shareholder board (Scenario 2)	Materials (100) + process (100) + employment (100) + RC	Pollution (50) + Medical (50) + Additional Harm (AH)	300 – RC	200 – AH – RC	Baseline
Stakeholder board (Scenario 4)	Materials (100) + Process (100) + employment (100) + Pollution (50) + Medical (50) + RC + SBC	0	200 – SBC – RC	200 – SBC – RC	SBC < AH for improvement
Shareholder board (Scenario 3)	Materials (50) + process (50) + employment (100) + RC	Pollution (150) + medical (150) + AH (200)	400 – RC	100 – RC	Worst case
Stakeholder Board (Scenario 4 versus 3)	Materials (100) + Process (100) + employment (100) + pollution (50) + medical (50) + RC + SBC	0	200 – SBC – RC	200 – SBC – RC	SBC < 200 for improvement over Scenario 3

*Excluding producer surplus, consumer surplus, and benefits (B), assumed constant.

Table 2: Comparing governance structures

Type of values and companies	For whose interests?	Who decides?	Goal of firm?	Efficient?
Enlightened shareholder approach (UK)	For shareholders' interest	Managers	Profits maximization	Least efficient
China	Shareholders' & workers	Managers & workers	Profits maximization and others	Moderately efficient
Enlightened value maximization (Jensen 2001) (eg benefit corporations)	For firm value (all stakeholders)	Managers	Long-term value of firm Dollar=dollar	Moderately efficient
Stakeholder Board (Goo 2017)	For firm value (all stakeholders)	stakeholders	Maximize value for constituencies, and maximize firm value (using Jensen's test)	Most efficient

Table 3: Boards with varying degrees of stakeholder participation

As Table 3 shows, the current approach adopted in the UK which leaves it to the managers to make decisions, and requires them to act for the interests of shareholders, would still bring us back to Scenario 2. Jensen (2001) has pointed out the problem of the stakeholder theory and argues that companies should be run to maximize long-term firm value, which presumably includes value to all stakeholders, not short-term profit. This is an improvement from the current position, but he still leaves it to the managers to make the decision, which again would bring us back to scenario 2 to a certain extent. My proposed stakeholder board which leaves the decision to be taken by stakeholder directors would solve this problem, (ie takes us back to scenario 1).

Jensen has, since 2001, recognized the importance of stakeholder interests:

[does stakeholder theory] have no legitimate corporate uses? And can corporate managers succeed by simply holding up value maximization as the goal and ignoring their stakeholders? The answer to both is an emphatic no. In order to maximize value, corporate managers must not only satisfy, but enlist the support of, all corporate stakeholders—customers, employees, managers, suppliers, local communities (Jensen 2001: 16, emphasis added).

He continues:

Indeed, it is a basic principle of enlightened value maximization that we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators, and communities (ibid).

[G] IMPLICATIONS FOR CORPORATE SOCIAL RESPONSIBILITY THEORY AND PRACTICE

The analysis above fundamentally reframes debates about CSR. Rather than a voluntary ethical choice or a matter of “enlightened” management, CSR emerges as a structural governance problem requiring institutional reform.

Why voluntary CSR fails

Three mechanisms currently rely on voluntary CSR.

- (i) ESG disclosure and reporting: companies report environmental and social impacts, hoping transparency will drive behaviour change. But disclosure without governance reform merely documents externalization without preventing it. Directors remain legally bound to maximize shareholder value.
- (ii) “Enlightened shareholder value”: the UK Companies Act 2006, section 172, requires directors to “have regard to” stakeholder interests while pursuing shareholder benefit. This approach fails because (a) “have regard to” creates no enforceable duty, and (b) it still subordinates stakeholder interests to shareholder profit.
- (iii) Investor pressure: ESG investors and responsible pension funds supposedly discipline management. But as Hart and Zingales demonstrate, even prosocial shareholders may rationally choose “dirty” operations in scenarios 3 and 5 when profit differentials are large enough (2017a; 2017b).

Why external regulation is insufficient

Environmental law, employment law, and consumer protection provide a regulatory floor, but three factors limit their effectiveness.

- (i) Regulatory incompleteness: laws inevitably lag behind corporate innovation in externalization. By the time products such as asbestos, tobacco, or microplastics are regulated, the damage has already been done.
- (ii) Enforcement gaps: regulatory agencies face resource constraints, capture risks, and jurisdictional limits (especially for multinational corporations).
- (iii) Incentive misalignment: even with perfect regulation, boards structured to maximize shareholder profit will seek legal ways to minimize costs, lobbying against stronger regulation rather than internalizing costs voluntarily.

Stakeholder boards as structural CSR

Stakeholder board representation addresses these failures in the following ways.

- (i) Internalizing costs at the decision point: rather than detecting and punishing externalization after the fact, stakeholder directors prevent it during strategic planning.
- (ii) Creating countervailing power: worker, consumer, and community representatives can block decisions that externalize costs, even if legally permissible and profit-maximizing.
- (iii) Reducing information asymmetries: stakeholder directors bring local knowledge about impacts that external regulators cannot easily obtain.
- (iv) Aligning incentives: unlike shareholders (who capture gains but externalize losses), stakeholder directors internalize both the benefits and costs of corporate decisions.

A new CSR paradigm

This analysis suggests CSR discourse should shift from “Should companies be responsible?” to “What structures ensure responsibility?”; from “Does sustainability pay?” to “How do we make companies bear full costs?”; from “voluntary commitments” to “mandatory governance reform” and from “stakeholder consultation” to “stakeholder representation”.

The business case for CSR remains relevant, but only within a governance structure that prevents externalization. Without stakeholder boards (or equivalent mechanisms), even well-intentioned CSR programmes will be subordinated to profit maximization when trade-offs arise.

International and development implications

As noted in the conclusion, US and UK resistance to stakeholder governance may reflect their ability to externalize costs to developing countries through global supply chains. This has profound implications as detailed below.

- (i) Supply chain responsibility: if home-country boards must include stakeholder representatives, they cannot ignore externalities in overseas operations.
- (ii) Development policy: developing countries hosting multinational subsidiaries may wish to mandate stakeholder boards domestically, even if home countries resist.

- (iii) Trade and investment law: bilateral investment treaties and trade agreements should preserve policy space for host states to require stakeholder representation.
- (iv) Climate justice: the analysis explains why voluntary climate commitments fail and why Conference of the Parties (COP) negotiations should address corporate governance structures, not just emissions targets.

[H] CONCLUSION

This article has challenged the dominant assumption that shareholder profit maximization maximizes societal efficiency. While this equation holds in theory when markets are competitive and all externalities are internalized, these conditions rarely exist in practice. When companies can externalize costs—as they routinely do—profit maximization not only fails to maximize social welfare but actively undermines it.

The central achievement of the article is that it has (hopefully) demonstrated formally that when externalities can be externalized, shareholder profit (M) diverges from societal efficiency (E), sometimes dramatically. A company that appears to generate 400 in profit may actually destroy social value, creating only 100 in genuine welfare once externalized costs are included. Current corporate law compounds this problem by legally obligating directors to pursue the misleading profit figure rather than genuine social value. The proposed solution offered is that stakeholder board representation offers a more direct and potentially more efficient mechanism for internalizing costs than relying on external regulation alone. By bringing worker, consumer, community, and environmental representatives into board-level decision-making, this reform would conceivably:

- (i) force cost internalization at the strategic planning stage, not after the fact through litigation or penalties;
- (ii) create countervailing power against externalization even when legally permissible;
- (iii) reduce information asymmetries between companies and affected stakeholders; and
- (iv) align board-level incentives with genuine social value creation.

Drawing on evidence from German codetermination, I have shown that stakeholder boards can enhance societal efficiency provided the governance costs (SBC) are less than the externalized harms prevented (AH). For large-scale producers in sectors with significant externalities—

chemicals, mining, manufacturing, agriculture—this threshold is easily met because governance costs remain relatively fixed while externalized harms scale with production volume.

This analysis fundamentally reframes CSR. Rather than a voluntary ethical choice or matter of “enlightened” management discretion, CSR emerges as a structural governance problem. Voluntary ESG reporting, stakeholder consultation, and investor pressure all fail because they leave intact the fundamental board structure that creates incentives to externalize. Mandatory stakeholder representation addresses the root cause.

Given operational complexities and the experimental nature of this reform, I propose a phased approach in the strategy for implementation, thus:

- (i) mandatory for large multinationals: corporations above \$1 billion revenue with history of externalities or human rights concerns should be required to adopt stakeholder boards;
- (ii) voluntary for others: smaller companies or those in low-externality sectors could adopt voluntarily, creating competitive advantage in ESG-conscious markets;
- (iii) sectoral variation: energy, extractive industries, chemicals, and manufacturing face the strongest case for mandatory stakeholder boards; professional services less so; and
- (iv) international coordination: home countries of multinationals should mandate stakeholder boards to prevent externalization through global supply chains.

The persistence of shareholder primacy in the US and UK despite its inefficiency may reflect ability to export externalities to poorer nations. That is to say that there are international political economy dimensions to this issue: domestic stakeholders in these countries benefit from profit maximization while foreign workers and communities bear the costs. This suggests international pressure and developing country reforms may be necessary to drive change.

It has to be admitted that critical questions remain about optimal stakeholder board composition, voting arrangements, and mechanisms for resolving deadlock. Pilot programmes and comparative research on German, Chinese, and Japanese models can inform institutional design. The key insight, however, is clear: when markets fail to internalize costs, voluntary CSR and external regulation are insufficient. Structural

governance reform is necessary to align corporate decision-making with social welfare.

Fifty years after Friedman's famous article, as Mayer and colleagues (2020) observe, the time has come for a new paradigm. That paradigm must recognize what the equations in this article demonstrate: shareholder profit maximization is efficient for society only when companies bear the full costs of their operations. Since neither markets nor regulation can ensure this, governance structures must change. Stakeholder boards offer a promising path forward.

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