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ThinkBox

Democratic governance and the firm

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Abstract

An intended contribution to new thinking on an institution that seems to have lost memory of its origins and functions, conducted with the tools of organization, law and economics. The argument shows how far we can go in reconceptualizing the firm as a democratic institution using only efficiency and innovation arguments.

Keywords: Economic democracy; Governance mechanisms; Theory of the firm

Introduction

Governance is a central theme, if not ‘the’ grand theme in contemporary economic organization and management theory. Among all governance mechanisms and forms examined and assessed, though, the most important and celebrated device governing modern collective systems is almost never mentioned. A remarkable blind spot indeed. Is democratic governance useless in economic organization? What kind of entity the modern firm is, or has become, that seems to float outside the basic rules of our selfcalling democratic societies? This essay pulls together a series of studies and elaborations that, properly connected, can give a threefold response to the above question: first, where and why democracy is actually a superior economic governance mode; second, where and to what extent it is actually applied (more than it is acknowledged); and third, what some founding features can be of a renewed theory of the firm that, in the course of being scientifically more correct, is also more conducive to collective wellbeing and growth.

The approach is efficiency based, i.e. speaks the same language of economic organization analysis (hence hopefully also to organizational economists) and shows how far we can go in justifying democratic governance before introducing any motivational, ethical, or political consideration on the value of participation.

The itinerary bringing to the propositions summarized here has been long, and took moment also in dedicated initiatives that I promoted along all the 2000s, allowing discussions among scholars with different backgrounds but similar concerns.[1]

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[1] Among the earliest initiatives, there has been the Bocconi Centennial Conference on ‘Corporate governance and firm organization’, in 2002 roughly coincident with the Enron scandal and published in an edited volume (Grandori, 2004). Among the more recent events, there have been the Crora-Bocconi

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Democratic governance in modern economic entities is here argued to play a different role at an institutional and at an organizational level, that, therefore, will be kept distinct in the analysis. The 'institutional level' is meant to be that of what are the devices that 'institute' or 'constitute' an economic and juridical entity; it is the level that in larger entities such as states is in fact called 'constitutional'. What is the nature of the entity? How can it come into existence? What is the glue keeping it together? The 'organizational level', instead, refers to how decision rights and obligations are 'partitioned and coordinated' within the entity. Democratic governance plays a different role at the two levels because, it will be argued, in a constitutional sense and at a constitutional level, all legally recognized entities are democracies in modern societies, although the nature and number of the principals in the democracy may vary (Grandori, 2015). The internal organization of an entity, instead, obeys to laws of internal and external fit among organizational mechanisms, giving rise to different configurations, in which democratic mechanisms may be more or less represented in different situations (Grandori & Furnari, 2008).

The firm as democratic institution

Suppose in the beginning there is no firm. Where does the firm come from in the first place?

We can respond in two ways to this question, and in both ways (a rational reconstruction of) history helps. We can address the appearance of the firm as a species (a 'form' of economic organization) and as an individual subject (a firm getting established).

Firms are called 'companies' or 'societies' in law. Both terms come from the mother of all western law, i.e. Roman Law. They both indicated the formation of a 'partnership': 'cum panis' (from which 'company') literally means 'eating bread together', and the Roman 'societas' was an agreement stipulated among people for the common use of a resource (Hansmann, Kraakman, & Squire, 2006). Business historians have taught us that the first step beyond those simple 'societas of people' appeared in high Middle Age and fluorished in Renaissance was taken with the form called 'Commenda': an agreement capable of associating a variety of resources and dedicating them to a project in front of uncertain results. Very close to what a 'firm-like' organization is supposed to be: a 'continued associations among co-specialized, dedicated assets, coordinated by conscious direction' (Demsetz, 1991). Which economic activities or problems initiated in that period to which that kind of contract was a response? The relatively new phenomenon was the undertaking of economic projects, as 'silk route' expeditions, involving a level of scale, risk and uncertainty formerly experimented and reserved only to states' actions.

It has been observed that the features of those early agreements are interestingly close to those used to establish firms when for conducting risky uncertain projects, like modern start ups (Brouwer, 2005): investments of assets that differ in kind into a new entity, and residual reward and decision rights shared by the different types of investors (the entrepreneur investing mainly the project and knowledge assets, and actors like financial angels and venture capitalists investing mainly money).

Hence, the birth of the firm, intended both as 'the invention of the enterprise' as a species and as the establishment of a single firm, is founded on the use of a partnership-like agreement (Landes et al., 2010); that in the Civil Law systems closer to the Roman inheritage, as Europe and Latin America, in fact called 'contract of societas' (Società/Socièté/Sociedad/Gesellshaft) (Grandori, 2010). The essential ingredient of such an agreement is the establishment of a third juridical person, different from the socii, into which assets can be invested and dedicated to a project (without exposing to risk all other investors' assets), while resource providers stipulate to share results without knowing them ex-ante in amount or even in kind.

That's the glue. No power, no hierarchy, not even necessarily any 'pooling of technical assets' (all assets can be immaterial) nor any 'employment relation' (there might be no employees) are necessary ingredients for establishing a firm and keeping it together; but an agreement in which a 'societas' is established, in which all the socii are principals. Given that assets become property of the societas (the firm), and what the socii have and share are residual rewards rights, a further complementary mechanism, is necessary for the contract to be acceptable: a sort of 'constitution governing the on-going cooperation' (Goldberg, 1976). In other terms, it is necessary to establish who has the right to decide, as things evolve. How can those rights be 'shared' among multiple actors?

What counts is who votes (Hansmann, 1988): the core mechanism for sharing decision rights among a set of principals is democracy – direct or representative, simple or weighted. That is the sense in which 'all companies are democracies' (Grandori, 2015) (and an efficiency rationale for modern organizational law, prescribing that any legally recognized association should be governed in a democratic mode). And that's why, I think, Hansmann (1988) once said that 'corporations are cooperatives of lenders'. True, in the sense that both establish societies to be governed by some democratic way of forming decisions. Probably false, however, in the sense that the difference between voting rights attached to heads or weighted by the amount of invested resources (attached to shares) is not trivial. A constitution may be democratic but voting procedures and the identity of principals can make a huge difference (Masten, 2013).

As to voting procedures, it may seem that one-head-one-vote systems (characterizing the constitution of cooperative firms for example) are more democratic than one share-one-vote systems (essential feature of corporations). Nevertheless, if by democratic governance we mean a fair system of representation of knowledge and interests (at an acceptable decision process cost) (Buchanan & Tulloch 1962), in an economic endeavors where parties invest resources, a representative system that is not linked to the relative value of the resource provided is likely to be unfair and unsustainable (Grandori, 1991; Lammers, 1993). The key question for designing a fair representation system, even more

Think-Tank Day on 'Democracy in and around economic organization' in September 2012; the Keynote panel at the EURAM Conference 2013 on 'Democratizing Management'; the Special Panel on 'The firm as a democratic institution' at the ISNIE Conference 2013.

than the voting procedure, is which type of resources providers are represented, namely the identity of the principals and the width of the society. Who should be principal and why? What are the efficient boundaries of a societas?.

I found the study of new firms most enlightening in this respect. In fact, what regularly happens in those settings, is that someone investing millions in money gets a minority of shares, while someone investing little sums of money but providing the project on which the firm is based owns a majority of shares. How can it be? The point is that knowledge assets become property of the firm (they are not subject to be withdrawn at will, as property right theorists typically claim) (Hart, 1995); and the human capital investor gets property rights in the firm in exchange, as any investor should. This argument implies that all investors of any kind of resource, in particular investors of human capital in small or large amounts, should be entitled property rights in the firm, in proportion to their investment (Grandori, 2013). Should such a principle, and incentive to invest, be applied the boundaries of the society of principals would be significantly enlarged with respect to current practices. Further expansions of the set of principals would ensue by the application of other organizational effectiveness and economic efficiency criteria such as: allocating decision rights (also of residual kind) to the actors who know best what the best actions are, and hold critical knowledge assets (Alchian & Demsetz, 1972; Aoki, 2010; Grandori, 2016); and allocating residual reward rights to all actors whose complementary resources, specific and general, contribute to generate the firm surplus (or quasi-rent) (Aoki, 1984).

In sum enterprises, even according to existing laws, are in fact democratic institutions, but like in Athen's democracy, the problem is that the boundaries of the societas, the set of principals, are usually too narrowly defined.

Democratic coordination mechanisms

It has become common to say that firms 'are' hierarchies. In spite of the rethorical success of the markets versus hierarchies opposition, strictu sensu the opposition is logically unsatisfactory and empirically counter-factual. While the statement that the large industrial enterprises of the last century tended to be organized in a hierarchical way is empirically supported by observation; we can also observe many entities that are firms do not employ hierarchy; as much as many entities that are not firms employ hierarchy extensively. Hierarchy in fact is not an institution, which is always multi-mechanism, as a market is. Hierarchy is just a coordination mechanism that can be employed in any entity, and actually also across entities (Grandori, 1997; Hennart, 2013). Democratic institutions also make a large use of hierarchy, from political parties to the state itself.

Assuming that companies or societas are democratic societies at the institutional level, a different question is to what extent democratic coordination mechanisms, based on joint decision making, are applied at the organizational level; with respect to central hierarchical decision making, and to still other possible coordination mechanisms (as rules and routines for example).

For an organization to work, all those mechanisms need to present to a certain extent. This is old wisdom in organization design theory (Galbraith, 1974; Thompson, 1967) and social theory (Fiske, 1992). Recently, a series of configurational studies, based on quantitative data from questionnaires, provided support to that traditional idea, enriched by a specific enquiry into the application of democratic mechanisms as a separate class of organizational practices (Grandori & Furnari, 2008, 2013). In those studies, four classes of organizational practices have been considered: 'Market-like' (e.g. pay for performance, internal labor market flexibility); 'Bureaucratic' (e.g. degree of vertical and horizontal partitioning of structure, formal decision, control and HRM rules and procedures); 'Communitarian' (e.g. knowledge sharing, team work); and 'Democratic' (e.g. diffusion of property rights and representation rights in ruling bodies; task self-determination rights). The operationalization of democratic mechanisms in those studies, included both an organizational component of empowerment, job enrichment and participation, and a measure of what we have called the boundary of the societas, i.e. how diffused the allocation of property rights is. Each class was composed by 4 practices and the presence of each practice measured as a 0–1 dummy; hence the intensity of market-like, bureaucratic, communitarian and democratic mechanisms could vary from 0 to 4. The sample consisted in 80 valid questionnaires received from a contacted population of the largest 500 Italian firms in 2006. Through Qualitative Comparative Analysis techniques, we enquired into which combinations of those practices or mechanisms made a difference in observing (or not observing) above average performance in terms of innovation and efficiency indicators. We provide here some specific elaborations on this data base, presented in various conferences and circulated in Research Reports but published only in Italian in this format (Grandori, 2015), that are specifically useful to highlight the role of democratic practices (Table 1).

Table 1
Average scores of democratic and other mechanisms, in high and low performing major Italian firms.

	Market-like	Bureaucratic	Communitarian	Democratic
High efficiency	2.2	2.4	2.2	2.1
High innovation	2.8	2.1	2.7	2.1
Low efficiency	1.4	2.5	2.1	1.0
Low innovation	1.4	2.5	2.0	1.3

The interesting result emerging is that, while bureaucratic and communitarian mechanisms are widely applied both in high and low performing firms, what makes a difference are democratic (as well as 'market-like') kinds of mechanisms: there is a deficit in their application in low performing firms with respect to high performing firms. Even more interesting, is the result that the presence of democratic governance mechanisms has positive effects not only on innovation but also on efficiency. In fact, that democratic organizational and HR practices are fit to knowledge intensive activities and innovation is more intuitive and analyzed (Lepak, Scott, & Snell, 2002; Miles et al., 1997; Osterloh & Frey, 2006; Rajan & Zingales, 2000). The incidence of such practices may be prevalent with respect to that of other mechanisms, to an extent that the whole organizational configuration or 'form' may be qualified as a democracy. Thus conceived, democracy provides a fourth organizational alternative, next to the traditional forms of market, bureaucracy and clan (Ouchi, 1980) fit to conditions where those other forms are known to fail: the governance of differentiated interests and knowledge, coupled with high task complexity and uncertainty (Grandori, 2016). By contrast, under what conditions, what kind of democratic mechanisms, at what level of intensity, can contribute to organizational efficiency where tasks are simpler and not knowledge intensive is a much less addressed topic, at least in recent times; and should rank high in the agenda for future research.

Concluding remarks

The study of 'organizational alternatives' should rank high in the research agenda, particularly because the recent times have been troubled times of economic crisis (AMP Symposium, 2016). The above argument and studies contributed to an emerging critical rethinking on the nature of firm and its governance, aiming at correcting the trends in the opposite direction that have occurred in practice, and that may well have significantly contributed to the crisis: verticalization of power, increasingly unequal and unproductive distribution of surplus, loss of sight of the functions of firms as a different person with respect to financial investors, increasing disregard toward the contribution of labor and transfer of firm risk to collaborators, narrowing down of the boundaries of citizenship in the firm 'societas'. Therefore times are more than ripe for revitalizing the study of how the democratic governance of economic institutions can sustain not only innovation, but also efficiency and growth.

Conflicts of interest

The authors declare no conflicts of interest.

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