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Authority and Democracy in Corporate Governance?

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ABSTRACT. Although McMahon offers a potentially valuable extension of Joseph Raz's conceptualization of authority by distinguishing three different kinds of authority, this paper argues, first, that his account of the conditions and considerations that would justify managerial authority is problematic because it relies on a conception of reasons for action that excludes precisely the kind of rationality that plays an important role in the explanation and justification of authority in economic organization. This paper explains, second, why McMahon's thesis of the justificatory similarity of authority in governments and nongovernmental organizations can also be seen to hold for corporate governance of publicly owned firms more specifically. Finally, this paper raises some critical objections against McMahon's presumption of democratic governance in governments and NGO's alike. The thrust of these objections is that democratic corporate governance does not make sense in the publicly owned firms because: (1) it will not produce results that are fair or welfare maximizing, and (2) it will undermine the legitimacy of managerial authority in such firms.

KEY WORDS: corporate governance, McMahon, Raz, authority, managerial democracy, economic theory of the firm

Introduction

It remains a mystery to me why Christopher McMahon's *Authority and Democracy; A General Theory of Government and Management* (1994), as well as the subsequent article (1995) in *Philosophy and Public Affairs* addressing similar issues, have hardly had any impact on organizational scholarship and business ethics. In my view, this remarkable fact says more about the development of these two fields, and how they relate to other disciplines, such as political theory for example, than that it tells us anything significant about the important ideas that these two publications examine. Given that the occasion for which this paper is written involves a ten year retrospective examination of the book, I will not say anything about the article, even though I believe that all that I say here applies equally to all that is said there. And since there is really not much to say about the reception of the book and how it has impacted organizational theory and business ethics, I will concentrate, instead, on an assessment and critique of what I believe to be the main contribution of the book, hoping, meanwhile, that this will spark-off a long overdue debate on the book's significant contribution. I also aim to make clear why this book is a landmark achievement in business ethics and organizational scholarship in spite of it largely being ignored in these fields and in light of my disagreement with much of what is argued in the book.

A threefold contribution

There is a lot that is valuable and important in McMahon's well-argued and provocative book. Yet in my view the main contribution of the book consists of one conceptual proposal and two substantive theses pertaining to the application of this conceptual proposal to human organization in general. The conceptual proposal involves both a refinement of, and extension upon Joseph Raz's currently authoritative conceptualization of authority (1975, 1986, 1989, 1990). The refinement consists of making a

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distinction between three different kinds of authority within the broad confines of the Razian model. This refinement also comes down to an extension upon this framework, because not all of what is and can be said about these three kinds of authority can be traced back to it. McMahon uses the distinction between the three kinds of authority to argue two separate, yet related theses. Contrary to what appears to be commonly accepted, the first thesis holds that authority in both governments and nongovernmental organizations (NGOs) – including modern business corporations (henceforth: firms) – is justified by similar rather than different conditions and considerations. The second thesis holds that the conjunction of this justificatory similarity and the pursuit of the values of fairness and welfare maximization, create a normative presumption that authority in both governments and NGOs ought to be exercised democratically by those subject to it. Before I evaluate these theses, I must first elaborate on McMahon's discussion of authority.

Three kinds of authority

Joseph Raz (1975, 1986, 1989, 1990) has developed what is arguably at present the received conception of authority. He understands authority in terms of different kinds of practical reasons for action. First-order reasons for action are the common or garden variety of reasons we report to have in everyday life. They either count in favor or against undertaking certain actions. Second-order reasons for action, by contrast, are reasons that bear upon our first-order reasons for action, and that serve to preempt certain ordinary first-order reasons for action from being acted upon. Thus a promise of fidelity is an example of a second-order reason for action that aims to preempt the first-order reasons we may have to commit adultery from being acted upon. Things are roughly the same for authority. According to Raz, authoritative commands are best seen as second-order content-independent reasons for action that serve to preempt certain first-order reasons for action from being translated into action. When a professor says: ''Please finish your exam now,'' he gives us a reason to stop working on our exam that serves to preempt most of the ordinary reasons we may have to continue our work. And although a command would not preempt all the reasons that count in favor of continuing to work on the exam there might be, the sole fact that one has not finished the exam is arguably not a reason that would fall outside this command's domain of preemption.

Contrary to what one might think, there are often good reasons to let certain (first-order) reasons we have on the balance of reasons be replaced by (second-order) authoritative determinations. We let financial experts decide on adjustments of our investment portfolio, for example, because they will often do significantly better overall than we do in making investment decisions, and hence we should not be trying to selectively improve on their performance (Raz, 1986). And we accept the determinations of a referee in a football game, even if he makes a wrong decision, because arguing continuously about who did what and when would in all likelihood keep us from playing football to begin with.

In the Razian framework, legitimate or *de jure* authority is paradigmatic for all other forms of authority, including *de facto* authority. This is because *de facto* authorities can only function as authorities (rather than as mere bullies) by claiming to be *de jure* authorities. According to Raz, authority is *normally* justified if, and only if, it helps those who accept its determinations better to comply with reasons that apply to *them*, than if they were to try to asses and follow these reasons directly themselves (Raz, 1986, p. 53). Since the whole idea behind *de jure* authority is to serve those *under* authority, this account has been coined the ''service conception'' of authority (Raz, 1986). McMahon both refines and builds upon this service conception by distinguishing three different kinds of authority by the different sets of conditions and considerations that would justify them.

The first kind of authority distinguished by McMahon is the authority of experts or *E-authority*. It is already quite clear from the example above that we often have good reasons to follow the judgment of experts rather than to assess what we should do or believe on the balance of reasons ourselves. What is particularly interesting about McMahon's account of E-authority is that it can be both theoretical – involving reasons for belief – and practical – involving reasons for action (pp. 85–94). Hence there can be justified *moral* E-authorities, for example, because it is both possible and plausible that some of us will prove better guides to the moral choices we are confronted with than others.

The second kind of authority that McMahon distinguishes is *P-authority*, or the authority that comes into existence when one person promises to obey another person or organization. P-authority is arguably the most familiar kind of practical authority. In business and organizational life, we often promise to obey other people, either because we contract to do so directly and explicitly, or because we enter into an organizational structure consisting of different roles and responsibilities that come with different sets of rights and authorities. The essence of P-authority, then, is that it is justified by a promise to obey. Hence P-authority transcends the confines of the service conception, because it is not necessarily true that people promise to do only what they would have good reason to do. In fact, we often find ourselves making promises that turn out to be in conflict with what we believe we should do or refrain from doing later on.

The third kind of authority distinguished by McMahon is authority that facilitates mutually beneficial cooperation or *C-authority*. C-authority is justified if, and only if, its directives make those subject to it better comply with reasons that apply to them than if no directives would have been given. C-authority is therefore paradigmatic for the service conception. On the basis of a basic game theoretical analysis McMahon explains how – *in general* – authority can facilitate mutually beneficial cooperation. The gist of this account is that authorities can help to overcome assurance problems that burden many cooperative schemes. More specifically, authority can both support cooperation by making *salient* cooperative solutions to so-called coordination problems, and by assuring *compliance* in cooperative contexts troubled by problems of motivation as in the well-known prisoners dilemma (Green, 1988; van Oosterhout, 2002).

A Hobbesian view of authority in human organization

Precisely because these different kinds of authority depend on differential sets of conditions and considerations that would justify them, McMahon is able to say something about their respective strengths, and hence also about their applicability to different forms of human organization. McMahon understands the strength of authority in terms of its "robustness" and "reach" (pp. 102–123). Robustness is understood in terms of the scope of (different) situations in which an authority would give those under authority sufficient preemptive reasons for action. Reach is conceived by McMahon in terms of the fraction of agents for which an authority would give sufficient preemptive reasons for action given each situation.

McMahon argues that C-authority is typically much stronger than either E-authority or P-authority because most of what we humans value requires human cooperation, whilst human cooperation often is neither spontaneous nor optimal as a matter of fact (McMahon, 1994, pp. 102–123). Since the need for human cooperation is typically more encompassing and crucial than either the need for expertise or the value of making good on ones promises, C-authority will typically be more robust and have a larger reach than either E-authority or P-authority. Of course, the relative strength of C-authority is also the result of the relative weakness of both E-authority and P-authority. E-authority is relatively weak, on the one hand, because it is fragile in the face of an accessible external criterion – e.g. empirical evidence – by which the authority's performance can be judged, because this opens up the possibility of anyone *under* authority to successfully second-guess the authority in individual cases. Practical E-authority is no exception to this, and typically suffers from an additional weakness, as people often fail to agree about who are authorities or what is authoritative to begin with (McMahon, 1994, pp. 95–96). P-authority is relatively weak, on the other hand, because it is unlikely that a promise will preempt all reasons there may be on the balance of reasons of those who have promised obedience (McMahon, 1994, pp. 96–102). Thus even when we agree that a promise constitutes a reason for action,[1] the fact that one can promise just about everything limits the reason-giving-force of promising as such, and the preemptive status of promises in particular (Raz, 1986, pp. 80–94).

Since in practice C-authority will typically be much stronger than either E-authority or P-authority, and precisely because C-authority is justified by facilitating mutually beneficial human cooperation, it will typically prevail over the two other forms of authority in organizations. That is, C-authority will often be legitimate where both

E-authority and P-authority fail to be. Thus even whilst the legitimacy of authority in NGOs appears *prima facie* to depend on a promise to obey to the managers in charge of these NGOs – with the authority of these managers in turn depending on a promise to obey either the board of that NGO or some (authoritative) goal that the NGO is to serve – P-authority in NGOs will typically be weaker than when the same authority is understood in terms of C-authority facilitating mutually beneficial cooperation between those under authority. Something similar holds true for the relationship between E-authority and C-authority in organizations, as reliance on expertise can be seen as just one of many ways to advance human cooperation.[2]

That C-authority will prevail over E-authority and P-authority is not just the case in political life, however, where Hobbesian arguments, i.e. arguments appealing to conditions and considerations that would justify C-authority, have traditionally been important in the justification of authority of the state (Green, 1988).[3] According to McMahon, it is also true for authority in NGOs, and hence for authority within human organization *in general*. McMahon believes that this change in the way of thinking about the justification of authority in NGO parallels the shift from the 'droit divine' model to the social contract justification of political authority of the state that took place in 17th-century England (McMahon, 1994, pp. 289–292). And indeed, the thesis that the legitimacy of authority in all human organizations ultimately depends on similar rather than different conditions and considerations represents a radical break with how we tend to conceive authority in governments and NGOs in everyday life.

The presumption of democratic governance

Both McMahon's distinction between three different kinds of authority and his thesis that authority in all forms of human organizational reality ultimately depends on a similar justificatory logic, shed an important light on what constitutes legitimate authority in governance. Yet, even legitimate authority in governance can be exercised in different ways. On the one hand, it could be exercised autocratically by – what would then be – a benevolent dictator. On the other hand, it could be exercised democratically by those under authority. The latter is also how McMahon understands democracy. In his view democracy is "reflexive authority," that is, "the collective exercise of authority by those subject to it" (McMahon, 1994, p. xii).

McMahon argues that the pursuit of the values fairness and welfare maximization create a presumption that authority in organizations ought to be exercised democratically. This is because the democratic principle of 'one man, one vote' establishes "that each will get what he deems best about equally often," which is what best promotes the value of fairness, whilst simultaneously ensuring that what is authoritatively decided "is deemed best by more people than not," which is what the value of welfare maximization requires (McMahon, 1994, p. 258). Yet, McMahon argues that the case for democratic governance is much stronger for governments than it is for NGOs. This is because the case for democratic governance of NGOs critically hinges on the constraints that higher – typically governmental – authorities may impose on the goals of NGOs and the means whereby these goals may be pursued (McMahon, 1994, p. 265). Yet in spite of the case for democratic governance of NGOs being weaker than it is for governments, "constitutions for non-governmental organizations that fail to provide the employees as a whole with some sort of role in formulation of ultimate managerial policy are problematic," says McMahon (1994, p. 285).

Authority and democracy in *corporate* governance?

My evaluation of this threefold contribution arises mainly from an attempt to apply the conceptual proposal and the two theses based on it to the realm of economic organization and the issue of corporate governance in particular. Below, I first raise some reservations about the conception of reasons for action that seems to underlie McMahon's analysis of the considerations and conditions that would justify C-authority, and hence also about the applicability of this conception to the economic realm. I will then consider his thesis that authority in governments and

NGOs is based on a similar rather than a different justificatory logic by applying it to the publicly owned corporation (henceforth: firm). Although I will find that the thesis of justificatory similarity can be seen to hold in the context of corporate governance of publicly owned firms, I also find that the same reasons that support this thesis force me to reject the presumption of democratic corporate governance.

Reasons for action in the economic realm

In explaining how C-authority is justified, McMahon formulates two principles of rationality. The principle of *individual* rationality, first, establishes that a person has sufficient reason ''to contribute to a cooperative venture ... if the incremental value ... that will be created by one's contribution exceeds the costs to one of contributing'' (McMahon, 1994, p. 103). The principle of *collective* rationality, second, holds that ''One has reason to contribute to a cooperative venture ... if its total value to one when one's contribution is added to those of the others who have contributed or will contribute exceeds the cost to one of contributing'' (p. 104). The question whether one should contribute therefore appears to come down to a relatively straightforward cost-benefit analysis.

But things are different than they seem. In order to establish the costs and benefits of contributing to a particular cooperative scheme, McMahon argues that we should calculate the benefits of cooperation as the difference between the value of the cooperative outcome and the value of non-cooperative outcome, whilst ignoring the potential benefits of free-riding (p. 105). According to McMahon, the reason for the latter is that ''the principle of collective rationality preempts the principle of individual rationality'' because only ''if the requirement that it articulates excludes and replaces the judgment deriving from individual rationality will the cooperative benefits associated with compliance be achieved'' (p. 117). This requirement, however, is problematic for two reasons.

It is problematic, first, because when developing an account of justified C-authority, that is, a justification for letting certain reasons for action that articulate collective rationality preempt reasons for action articulating individual rationality, one cannot revert to simply stipulating that collective rationality preempts individual rationality, as this is precisely what needs to be established. What one must argue, instead, is why it would *not* be rational to free ride if one could get away with it without undermining the cooperative outcome and without getting caught. McMahon does not do so and thereby fails to give a satisfactory account of the conditions and considerations that would justify C-authority.

It is problematic, second, because in excluding the kind of ''opportunistic'' rationality (Williamson, 1985) that agents display when they defect on each others irreversible commitment, McMahon exposes himself to subscribe to a particular conception of reasons for action, one that has a strong ''externalist'' and perhaps even moral flavor (Williams, 1981). McMahon explicitly denies that his understanding of reasons is a moral one (p. 106), yet he fails to explain why collective rationality must preempt individual rationality as seen from the individual in a non-moral way. In the context of giving an account of legitimate authority in corporate governance this will prove highly problematic, because in excluding this opportunistic rationality from the onset, McMahon also excludes the very kind economic rationality that is necessary to explain and justify the existence of authority and firms within markets.

In my view, McMahon faces something of a dilemma here. Either he sticks to his 'generalist' (or even moral) account of rationality in which reasons have equal action guiding force for all in like situations (McMahon, 1994, p. 105), or he admits the kind of individualist and opportunistic rationality we see – or rather assume – in the economic realm (see Mueller, 2004), and that is necessary both to explain and to justify the legitimacy of managerial authority in corporate governance.[4] If he chooses the former option, he will severely limit the scope of organizational reality to which his understanding of C-authority can be applied, thereby effectively excluding most extant forms of economic organization. Yet if he admits the kind of opportunistic rationality that characterizes homo economicus, he still owes us an explanation of why collective rationality should preempt individual rationality in prisoner's dilemma-like predicaments, and hence an account of what would justify C-authority in such cases. Either way, his account of authority in human organization loses its intended force.

Authority in corporate governance

Whether there actually is authority in the firm to begin with is an issue that has divided economists and organizational scholars ever since Coase's (1937) visionary essay on the nature of the firm. On the one hand, there are those who believe that the existence of authority relations is precisely what demarcates firms from markets (e.g. Barnard, 1968; Cyert and March, 1963; March and Simon, 1958; Williamson, 1985, 1991). On the other hand, there are those that deny that there is any authority within firms, and that all that a firm consists of are "ordinary market contracting" relations between corporate constituencies (Alchian and Demsetz, 1972, pp. 777–778). The latter view is commonly referred to as the nexus of contracts approach (e.g. Boatright, 2002; Chueng, 1983; Easterbrook and Fishel, 1989, 1991; Jensen and Meckling, 1976), and is at present a powerful paradigm in organizational theory. I will not get into the issue here whether there is indeed authority in the firm, as that will not be necessary to evaluate McMahon's claim of the justificatory similarity of authority in governments and firms.[5] Instead, I will review the arguments there are in the literature concluding that there is authority within firms, and assess whether these arguments support McMahon's thesis of justificatory similarity between firms and states.

There are quite a few theories and arguments offering explanations of why there is authority in firms, and why there are firms within markets. Since most of these arguments spring from an economic – or rational choice – methodology (Blaug, 1992; Mäki, 2001), they typically simultaneously provide a justification of authority when it is interpreted as being functional to the ultimate goal of welfare maximization. Often, however, it is not very clear whether the argument leading to authority as the conclusion is a positive or normative one, as such arguments often leave unexplained how and by what mechanism authority is produced as a matter of fact (cf. Dow, 1987). Below, I will briefly discuss the arguments that would justify authority within firms in order to assess whether McMahon's justificatory similarity thesis holds for corporate governance.

Coase's original contribution (1937) constitutes an interesting starting point for our analysis. Coase was one of the first to notice that there is a cost to using the price mechanism. These so-called "transaction costs" include: the costs of discovering efficient prices; the cost of bargaining; and the costs of drawing up contracts to support economic exchange. According to Coase, these transaction costs can often to a significant degree be circumvented by carrying out transactions through the authority of a coordinator-entrepreneur rather than through the market. He held that one should continue to complete transactions through the firm until the marginal cost of doing so equals the marginal cost of carrying out the transaction through the market (Coase, 1937). In this view, spontaneous coordination of the market and authoritative coordination within the firm become substitutes and the choice between them a matter of comparative efficiency. Focusing on decision-making *within* organizations, Kenneth Arrow (1991) has argued in a somewhat similar vein that economizing features of communication in collective decision-making require elite control of organizations, and provide a justification of the authority of executive officers within firms.

Both arguments therefore support the conclusion that there will be justified authority within the firm, but only in a rather limited sense. Authority in the firm will be justified for as long as it will be more efficient for economic parties to be guided by authoritative directives in conducting their transactions than if each of those actors would carryout these transactions on their own. In my view, the kind of authority that can be justified by these considerations therefore most resembles (practical) E-authority, or the authority of expertise. E-authority is legitimate within firms for as long as managers make better decisions in coordinating transactions within the firm than those under authority would do spontaneously by themselves. As a result, it is typically weaker than the accounts of C-authority in the firm discussed below, because managers may very well be proven wrong in individual cases, whilst experiencing difficulties establishing their authority to begin with.[6]

Arguments that would establish the justification of C-authority in the firm clearly go beyond the requirements that would justify the (coordinating) expertise of managers within firms. These arguments involve the safeguarding and distributive functions of authority in economic organization. Oliver Williamson's transaction costs approach to economic organization is paradigmatic for the safeguarding role of

authority in firms. According to Williamson, transactions, which differ in their vulnerability to problems of defection and expropriation, are discriminatively aligned with governance structures, which differ in their costs and protective qualities, in a (mainly) transaction cost economizing way (Williamson, 1991). Hence one-shot transactions that take place under conditions of uncertainty and that require investment in specific assets, are particularly vulnerable to *ex post* hold-up problems, and are hence best carried out under the unified control of common ownership rather than through arms length market contracting (Williamson, 1985).

But it is not just *ex post* hazards of defection that arise from parties making specific investments in their contribution to the firm. There also arises an *ex post* distribution problem because the contribution of any corporate constituency to the corporate venture will typically require some form of dedicated investment. The dedication of factors and assets will generate so-called ''quasi rents'' once the firm is a going concern (Zingales, 1998), because it will lead to a difference between their value being put to use *within* the firm, and the highest value that they can recover *outside* the firm. The distribution problem crops up because it is not feasible to negotiate complete contracts that will exhaustively stipulate how such quasi rents should be distributed over corporate constituencies in all possible contingencies *ex ante* (Grosman and Hart, 1986; Hart and Moore, 1990; MacNeil, 1974; Rajan and Zingales, 1998). At least some of the quasi rents will need to be distributed *ex post*, and it is here that the distributive function of authority in corporate governance becomes important. Inspired by Alchian and Demsetz (1972), Blair and Stout (1999) have elaborated on this distributive function of authority in corporate governance. On the basis of an analysis of the American publicly owned firm, they argue that directors of such firms can be seen to have the authority to distribute quasi rents in order to enable them to secure ongoing mutually beneficial cooperation between the constituencies that make up the firm (see also Bainbridge, 2003). These directors can only fulfill their function of ''mediating hierarch,'' however, when they have sufficient authority to decide on the distribution of quasi rents over the corporate constituencies that make up the firm (Blair and Stout, 1999). The authority at stake here is C-authority, because managers only have this distributive authority to secure superior cooperative outcomes.

In contrast to their everyday conception of the firm as a chain of promissory obligations that begins with its owners and ends with the firms lowest ranking employees, the literature on corporate governance and the theory of the firm does not provide us with much that could be used to justify P-authority in the firm. This is first, because in the eyes of many economists, promises are but ''cheap talk'' that has no effect on reward structures and outcomes (cf. Farell and Rabin, 1996). It is second, because precisely the problematic nature of promises has spurred the development of a strong current in economic organization theory attempting to explain – or design – those institutions and organizational features that turn promises into 'credible commitments' (Williamson, 1983). The most significant branch within this theoretical current is ''agency theory'' (Fama, 1980; Fama and Jensen, 1983; Jensen and Meckling, 1976), which is at present the dominant theoretical framework in corporate governance theory and research (Schleifer and Vishny, 1997). In agency theory, the firm is conceived of a chain of agency relations – rather than promissory obligations – that require remedies to avoid inefficient outcomes. Although there is some confusion between the legal conception of agency, which takes promissory obligations as given and unproblematic, and its economic counterpart, which takes precisely the opposite view (Orts, 1997), it is quite clear that the literature on corporate governance and the theory of the firm challenges rather than supports there being justified P-authority in the firm. This is in line with McMahon's view that P-authority is typically weak and therefore problematic in economic organizations.

But McMahon's thesis of justificatory similarity receives even stronger support from another branch of theorizing on corporate governance and the theory of the firm. In the so-called property rights school of thought in economic organization theory (Grossman and Hart, 1986; Hart and Moore, 1990), property rights within the firm are not taken as a given source of promissory obligations, but are rather endogenously explained in terms of the relative costs and benefits of contracting and ownership respectively. Hansmann (1996) has given an accessible and elaborate account of property rights

assignment in economic organization. Since in his view property rights in the firm need not be connected to the supply of capital to the firm, they can be assigned to any ''patron'' an economic enterprise interacts and exchanges with on a regular basis (Hansmann, 1996, p. 15). He argues that ownership of an ''enterprise'' is most efficiently assigned to that corporate constituency that ''minimizes the sum of all of the costs of a firm's transactions'' (1996, p. 22). Given that we find a great variety of extant ownership structures in economic organizations in most advanced economies, there is sufficient reason to believe that ownership of economic organizations is not an exogenously given constant, but rather a variable that is explained in terms of its economizing virtues in the cooperative venture of firms. When ownership is explained in terms of its function of facilitating mutually beneficial cooperation within the firm, it loses its given and unproblematic status as a source of P-authority in economic organization, while simultaneously providing a more solid foundation in terms of the conditions and considerations that would justify C-authority in the firm. McMahon's thesis of the justificatory similarity of governments and NGOs therefore also holds for economic organization in general and corporate governance more specifically.

Democratic corporate governance?

Given what we now know about the considerations and conditions that would justify authority in economic organization, the final issue now at stake is the question whether there is indeed a presumption that authority in corporate governance ought to be exercised democratically. Remember that McMahon holds that the pursuit of fairness and welfare maximization require that (legitimate) authority in NGO be exercised democratically, because the democratic principle of ''one man, one vote'' establishes ''that each will get what he deems best about equally often,'' whilst simultaneously ensuring that what is authoritatively decided ''is deemed best by more people than not'' (McMahon, 1994, p. 258). Contrary to what is argued by McMahon, however, I believe there to be two rather fundamental reasons why democratic corporate governance does not make much sense.

The first reason is that in the context of corporate governance, the democratic principle of ''one man, one vote'' will not produce the kind of results that make democratic employee governance desirable from the perspective of fairness and welfare maximization. The main problem is that this principle does not do justice to the different stakes that natural persons typically have in the corporate venture. Natural persons will have an interest in the firm only indirectly through their differential corporate constituency status of shareholder, employee, integrated supplier or customer. And since these different interests in the firm will also make these natural persons have a different 'stake' in it, it does not seem very fair to give them all an equal say in things. Moreover, it will often be the case that different natural persons have very different interests – and hence very different stakes in the firm – even *within* the same corporate constituency group. Thus owners may, and typically do have very unequal shareholdings (La Porta et al., 1999), while older employees will usually not have the same interests as younger ones (Hansmann, 1996, pp. 89–119). But it is not just that democratic corporate governance will not produce the kind of fairness results that McMahon envisages. Neither will it be welfare maximizing, because the equal say that natural persons would then have in spite of their differential stakes in the firm will often clash with what maximizes their welfare. The fact that employee governance is relatively rare, and in practice mostly restricted to professional services, constitutes *prima facie* evidence that it will often not be efficient enough to weigh up to the considerations that make it a desirable feature of corporate governance (Boatright, 2004; Dow, 2004). McMahon (1994, pp. 10–15) rejects a ''stakeholder'' perspective on corporate governance,[7] however, and maintains that the democratic principle of ''one man, one vote'' only makes sense when applied exclusively to employees. This brings me to the second reason why I reject the presumption of democratic corporate governance.

McMahon restricts democratic (corporate) governance to employees alone because he does not think that being *affected* by the consequences of authoritative determinations is quite the same thing as being *directed* by them (McMahon, 1994, pp. 10–15). In McMahon's view, only employees are guided by authoritative directives and hence only employees can be *under* authority. And since McMahon under-

stands democracy as the reflexive exercise of authority, that is, as authority exercised by those subject to it (1994, p. 12), only employees can exercise this authority democratically. I have explained, however, that the strongest kind of authority there is within publicly owned firms is authority that facilitates mutually beneficial cooperation between *different* corporate constituency groups, and that in this view managers function as "mediating hierarchs" in safeguarding dedicated contributions of corporate constituency groups, on the one hand, and in *ex post* distributing the resulting quasi-rents over these groups, on the other. It is important to note that in this view it would be highly problematic when authority is exercised democratically by employees alone – as proposed by McMahon – because assigning the (democratic) exercise of authority exclusively to employees may significantly undermine the legitimacy of authority in the firm.

This is, first, because employees – as a corporate constituency group – are in a poor position to fulfill the coordinative, safeguarding, adjudicative or distributive functions of authority that jointly provide for the conditions and considerations that would justify authority in the firm. Informational economies (Arrow, 1991) and problems of collective decision-making (Hansmann, 1996) will make it largely infeasible for employees to fulfill any significant coordinating or decision-making function within the firm, while the fact that employees are but one of the firm's constituency groups whose dedicated contributions will need to be safeguarded – and who are hence also party in the distribution of quasi rents – speaks against employees having mediating or distributive role in the firm, even they could overcome their information processing and decision-making problems.

Assigning the democratic exercise of authority in the firm exclusively to employees will undermine the legitimacy of that authority, second, because the exercise of authority by employees *alone* will not do justice to the fact that natural persons within other corporate constituency groups are not merely *affected* by authoritative determinations, as claimed by McMahon (pp. 10–15), but also find a significant part of the reasons for action that they may have as a result of their specific constituency interest in the firm *preempted* by authoritative determinations. Contrary to McMahon, I believe that it is the condition of having ones reason for action preempted by authoritative determinations, rather than the question whether one is guided or merely affected by them, that is the relevant criterion for deciding whether one is under authority or not. And because McMahon's criterion for assessing whether one is under authority or not is misguided in my view, he also unnecessarily restricts the democratic exercise of authority in the firm to its employees alone, thereby simultaneously undermining the legitimacy of that authority.[8] That shareholders, and not just employees, are to a significant extent *under* managerial authority in publicly owned firms is not merely an issue of conceptual disagreement between McMahon and me. The issue finds a real life illustration in the so-called "business judgment rule," a case law concept in Delaware corporate law according to which Delaware judges have consistently been unwilling – but for a few exceptions – to review everyday managerial decisions, even if those decisions harm the legitimate interests of shareholders.[9] Democratic employee governance in publicly owned firms is therefore largely in conflict with their being legitimate authority in the firm, that is, authority that is justified by facilitating mutually beneficial cooperation between different corporate constituency groups. And when the value of democratic corporate governance becomes chiefly incompatible in this way with there being legitimate authority in the firm, it is clear that the value of democratic corporate governance must give way.

Conclusion

I have argued, first, that McMahon offers a potentially valuable extension on the Razian model of authority by distinguishing three different kinds of authority by the different sets of conditions and considerations that would justify them. I have also argued, however, that his account of the conditions and considerations that would justify C-authority is problematic, because it appears to rely on a conception of reasons for action that excludes precisely the kind of one-eyed rationality that plays an important role in the explanation and justification of authority in the firm.

I have argued, second, that McMahon's thesis of the justificatory similarity of authority in firms and NGO

also holds for corporate governance, because P-authority hardly plays any role in the justification of authority in corporate governance of publicly listed firms, whilst the conditions and considerations that would justify the much stronger C-authority in the firm explain why P-authority need not play a role at all in corporate governance. This thesis hence establishes a Hobbesian picture of authority in human organization that applies as much to economic organization as it applies to governments and other NGOs.

I have argued, finally, that the presumption of democratic governance neither holds, nor makes much sense in the corporate governance of publicly owned firms. It does not make much sense because corporate democracy will not produce the kind of results that are desirable from the pursuit of fairness and welfare maximization. The realization of fairness is undermined because the principle of "one man, one vote" will do injustice to the different stakes natural persons typically have in the cooperative venture of the firm, whilst the pursuit of welfare maximization is frustrated because democratic decision-making by employees alone will often be guided by interests other than what will maximize welfare. Moreover, the presumption of democratic governance does not hold in the context of corporate governance because corporate democracy will largely undermine there being legitimate authority in the firm.

In spite of my disagreement with an important part of what is argued by McMahon, I believe his book to be a landmark achievement nevertheless. It sheds important light on a conceptual issue in economic organization theory. While the presence of authority is seen by many as what demarcates organizations within markets, it has really never been made very explicit what precisely authority is been taken to mean. It also remains important because it demonstrates how concepts and theories from political theory can be fruitfully applied to the realm of economic organization. This was already the case the other way around (cf. Moe, 1984), but McMahon's work demonstrates that it is not a one-way relationship. It thereby more closely connects the fields of political and economic organization at the conceptual level, and has made me realize that the bulk of my own research (e.g. van Oosterhout, 2002, 2005, 2006; van Oosterhout et al. 2006) is actually in the intersection of these two fields. Finally, McMahon's work demonstrates that normative theory in economic and political organization is far from dead, and that we can – and should – take a much broader perspective than what is currently in vogue in organizational theory and business ethics. That makes it all the more surprising that McMahon's two publications have actually largely been ignored in those fields. I can only hope that our exchange of ideas here will bring an end to that.

Notes

[1] Both promises and authoritative directives can be seen as so-called "content-independent reasons for action." See Hart (1982).

[2] This raises the question whether E-authority and C-authority are really different kinds of authority, or whether E-authority is just a particular kind of C-authority. I come to the latter conclusion elsewhere (van Oosterhout, 2006). Although I will not address this issue in this paper, I do create some confusion when I characterize "Coasian" managerial authority as E-authority below. I will come back to this later.

[3] Green (1988) elaborates on the authority of the state in remedying both problems of coordination and problems of motivation and compliance in prisoner's dilemma-like situations. He finds, however, that the justification of authority is problematic in both contexts. I have addressed similar problems in my dissertation (see Van Oosterhout, 2002, chapter 2), and have come to more or less the same conclusion.

[4] Pettit (1995) argues that even though the assumption of the rationality of homo economicus in mainstream economic theorizing is evidently inveracious, it can be retained in economic theorizing when homo economicus is seen as *virtually* rather than *actually* governing human action. In Pettit's view, homo economicus will only take "the driver's seat" in actual human agents under certain conditions, such as when the interests of the agent in question are served less well than those of similar agents in similar situations. In such cases, the agent is stimulated to change his disposition of rationality and will move closer to the rationality captured in the ideal type of homo economicus. Note, however, that Pettit's proposal concerns positive – or explanatory – rational choice theory rather than normative – or justificatory – rational choice theory. Christiano (2004) observes that the assumption of homo economicus in economic theorizing ultimately leads to an incompatibility between the normative and positive ambitions of rational choice theory, in that *actual* movements to situations of higher aggregate welfare identified on the basis of the rational-

ity of homo economicus may very well be hindered by the constraints set by exactly the same rationality. I think McMahon's position on the preemption of individual rationality by collective rationality nicely illustrates the kind of problem Christiano is concerned with, but it is beyond the scope of this paper to elaborate on this any further. My point is merely to demonstrate that assuming reasons for action to be general, and having equal guiding force for all in like situations, offers no substantive solution to the clash between individual and collective rationality as manifested in prisoner's dilemma-like situations.

[5] I do address that question in van Oosterhout (2006), however.

[6] As I observed above in note 2, one can conceive E-authority as a subspecies of *coordinating* C-authority rather than as a separate kind of authority. In spite of its coordinative function, I characterize this Coasian kind of authority as E-authority here because (1) I do not believe that the kind of managerial authority involved here merely concerns solving problems of pure coordination, as it will typically involve some form of expertise, and (2) because the conditions and considerations that would justify this kind of authority resemble those that would justify E-authority more than those that would justify C-authority, even if only because the latter additionally involves safeguarding and distributive features (see below). Elsewhere I abandon McMahon's classification of the three different kinds of authority precisely for these reasons and introduce the distinction between strong and weak authority as an alternative classificatory scheme (van Oosterhout, 2006).

[7] By which I do not mean what is commonly understood in business ethics and organizational theory as "stakeholder theory" (see Donaldson and Preston, 1995; Freeman, 1984). I merely want to point out that different natural persons tied up in the corporate venture may have very different stakes in the firm. That observation does not require any further conceptualization of the notion of stakeholder, nor do I want to import the specific connotation here that the concept of stakeholder has received in stakeholder theory.

[8] Note that in this view, democratic employee governance does not even satisfy the conditions of "reflexive authority," understood by McMahon as "the generation of authoritative directives by those who will be subject to them" (1994, p. 12). This is because shareholders would be *under* authority in democratic employee governance without having any role in its exercise.

[9] As evidenced in: *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) and *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

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