

Designing Stakeholder Boards in Developing Countries A Policy Brief

Bryane Michael (Linacre College, Oxford) and Serdar Dinler (CSR Association)

Why should the owners of a company allow others to take major corporate decisions? The stakeholder board concept asks stock holders to decrease their control over corporate decisions. Or so it seems. While the debate continues in the corporate governance literature, many companies are already experimenting with the stakeholder board. Stakeholder boards are Boards of Directors which include members who are not stockholders or company management. DPL Inc. -- a utility company based in Dayton, Ohio -- represents an example (which went wrong). According to the Corporate Library (a major Internet watchdog of corporate governance practices and abuses), "DPL...is currently mired in controversy -- and significantly dominated by Kohlberg, Kravis, Roberts & Co. Since the controversy began, several local leadership directors, instead of appropriately representing the community's interests...have mostly deserted the board, leaving the future of the firm almost solely in the hands of KKR interests. The resulting level of risk, to DPL's shareholders as well as the community it serves, has only increased as a result."¹

Yet, despite the controversy and uncertainty surrounding the use of stakeholder boards in developed countries, developing countries are being urged to adopt these types of boards. In China, for example, a number of state-owned enterprises have been encouraged to adopt stakeholder boards. Yet, a recent report notes that "these multi-stakeholder boards have not only been inactive, they lack a clear focus. The government needs to clarify whose interests these boards should represent." (p. 8).² A main reason for these poor results has been lack of guidance. Either recommendations are Panglossian (arguing that stakeholder boards must or must not be adopted en masse) or clouded in technical jargon. Pierick *et al.* (2004) is representative of a wide range of papers which presents complicated models with easily more than ten variables which affect corporate responsibility.

This policy brief reduces the complexity behind the issue of stakeholder boards and explores the trade-off between increased information flow to the company from external actors (such as suppliers, customers and regulators) and the weakened incentives to maximise shareholder profits (and thus decreased economic efficiency). This policy brief also tries to serve as a *vade mecum* -- using extensive footnotes to point the reader to future information. This brief is aimed at policymakers and business people and not particularly academics.

¹ Kohlberg, Kravis, Roberts & Co. (KKR) become famous for the 1988 leveraged buyout of RJR Nabisco -- still the largest leveraged buy-out in history at a cost of nearly \$25 billion. Other acquisitions have included Samsonite, Safeway, Texaco, Gillette, Playtex, Borden and Beatrice.

² Available at: http://www.acga-asia.org/loadfile.cfm?SITE_FILE_ID=26

Why Talk about Stakeholder Boards?

Increased diversification in the Board room partly reflects the increased fuzziness of organisational boundaries in the last 15 to 20 years.³ **Pro-Natura** is an international network of NGOs which seeks to work with business (unlike many NGOs which fear co-optation). Once a company has chosen to engage in environmental activity (for whatever reason), it must decide whether to work with Pro-Natura or to work on its own. Clearly the decision to outsource represents an extension of the company (where labour and capital work for the company even though they “belong” to Pro-Natura). Pro-Natura also takes business like decisions in order to meet the objectives of its partner. Pro-Natura is a business-like NGO and an NGO-like business. **Business in the Community** represents an example of companies banding together to form an NGO. The aim of the collaboration is to promote NGO-like objectives (through work on CSR). Yet, businesses ultimately take decisions through their membership rights. **Orinoco** (the Oxford Scrapstore) is an Oxford based registered charity whose paint and tool recycling programmes make a profit and support its operations. In each of these cases, the answer to the question “who are we” clearly impacts board membership.

While organisational fuzziness may (or may not) be a new phenomenon, non-profit interests have always been a part of business.⁴ The Turkish bank **VakifBank** represents an example of an institution (established in Ottoman times) whose goal has always been charitable. VakifBank receives bequeaths and administers the resulting trusts to build schools and hospitals. The Indian company **Tata** is widely known in India for its work in the local community ever since its inception. Tata is a large economic entity, yet its influence in Indian society stems in part of its involvement in social projects. In both cases, Board members of been cognizant of stakeholder interests.

A new type of industrial cluster is starting to form around the world. Porter (1985) talked the interaction of local business in Italy which allowed the shoe industry to become highly profitable during the 1970s and 1980s.⁵ Bresnahan and Gambardell (2004) talk about the interaction between business, government, and financiers in Silicon Valley to make computer companies operating there highly innovative and profitable during the 1980s and 1990s. By the late 1990s and early 2000s, new groups are forming based around the interaction between business and NGOs. Digital Bridge and Anchorage in Bangalore (India) are an example of a for-profit business which works with an NGO to obtain training and access to ideas from the donor community.

Stakeholder versus Shareholder Boards

³ Such fuzziness has always existed as Jones (1995) argues in the conceptual relations between company and society. However, the fuzziness we refer to is concretely the organisational delimitation between NGOs, business and government.

⁴ Argandoña (1998) tries to establish an ethical foundation for stakeholder boards from the concept of promoting the “common good.” This section should make clear that resort to such concepts is unnecessary given the important gains deriving from “enlightened self-interest.”

⁵ We will not repeat this analysis other than to note that these areas had supply conditions which favored high quality products, competition which drove innovation, suppliers who were responsive to company needs and picky consumers of these products.

These examples cast new light on ideas from finance about the separation of ownership and control. Authors such as Hart (1995) and Freeman *et al.* (1990) discuss the tension between company management (who wants to see new ideas prosper) and financiers (who want a return on their money). Naturally, financiers worry about managers taking their money either directly or indirectly by shirking – and thus managers want a say in how their money was used.⁶ The major insight of much finance literature though is that dividing ownership and control may provide everyone with incentives needed to maximise their wealth.⁷ Giving some control to others besides the financiers may increase their incentives to make the company work well. The following attempts to summarise the main lessons from theory and practice.⁸

Lower “discount rates.” Hall and Soskice. (2001) note that German bank finance may be better than American equity finance because it is “patient capital.” Anglo-American equity finance often provides deep financial markets. However, stock investors looking at quarterly returns may dispose of assets which would be valuable in the long-term. Rhenish bank-centred finance may provide an alternative because investors are more patient. These investors are said to have low “discount rates” – they do not heavily discount (or disparage) the future. Other stakeholders (such as workers or even local communities) offer services to the firm which is not finance, but just as valuable. Unions offering wage concessions is a common example. **Indian Biscuit** (not the real company’s name) offers another example. India Biscuit is a small enterprise with only 40 workers located in a tiny village in Karnataka. In 2002, India Biscuit’s factory caught on fire. The local village rushed to put out the fire. In economics language, the villagers sacrificed their short-term interest for their enlightened long-term self-interest interest in having a responsible company in their community.

The logic behind lower discount rates underpins “**relational contracting.**” Many scholars are that East Asian (and especially Japanese firms) were so competitive in the second half of the 20th century because they took a stakeholder perspective.⁹ Toyota for example, would maintain close relationships with suppliers and communicate constantly. Mazda – when it had financial difficulties in the 1980s – was given extensive support by its suppliers and other stakeholders so it could survive.

Increased “informational capital.” The Board is a decision-making body, but it is also a deliberative body. Each member brings his or her own resources and informational networks to bear. Lorsch (1989) has argued that boards of directors often have insufficient information with which to perform their duties. Most commentators disparage “interlinking directorates” (or the same board members sitting on each other’s boards). While such a practice may be a type of collusion (and this remains to be proven),

⁶ The summary presented does not do justice to the ideas of these authors and is presented to provide the practitioner with a simply overview of these ideas.

⁷ Barton *et al.* ‘s (1989) regression analysis supposedly shows that increased amounts of “net organisational capital” (given by a stakeholder approach) increases profitability and results in lower debt ratios.

⁸ The following exposition focused mostly on positive features. Authors such as Key (1999) and Reed (1999) are critical of the entire notion of stakeholder involvement in corporate decisions.

⁹ Baker at al. (2002) offer a wonderful exposition of the issues around relational contracting.

interlocking directorates are an effective way of information gathering. The same logic extends to other stakeholders. By bringing in different skill sets, this increases the skill-set available for use. So far, these boards have been located either in utilities and state—managed enterprises, or business minded NGOs.

Making Net Organisational Capital. Stakeholder boards are not designed to promote political participation the company (though they serve that function as well).¹⁰ Board members contribute to the profitability of the firm. Barton *et al.* (1989) evoke the idea of “net organisational capital.” The company in its daily work runs up a set of “chits” vis-a-vis its stakeholders. If it serves a customer well, it can expect future business. The expectation of future business almost acts as a type of “account receivable.” Similarly, a company which angers a supplier can expect future retaliation and should think of this action today as an “account payable.”

More money. In most of our executive training (especially in developing countries), business people ask how they profit from having the more socially responsible policies which a stakeholder board would pursue. Figure 2 shows some of these ways which made the business people sit up and take notice.

Figure 2: Making Premia vis-a-vis the Company's Stakeholders

Workers/Employees. The firm can earn a Corporate Social Responsibility (CSR) “wage discount.” The average wage differential between the private sector and the charity sector is roughly \$30,000 per year in the US. While firms engaging in CSR can not all benefit from such large reductions in wages, the gains can be significant. In one medium sized Turkish company we were working with, the wage bill was roughly \$30,000 (on average to make the calculations easy) over 70 employees. If the company could reduce its wage bill by 20%, the net savings would \$420,000.

Customers. CSR can improve profitability by lowering costs and raising demand. Entire market segments such as Fair-trade Coffee or the Body Shop's offerings are based on social responsibility.¹¹ Maintaining relationships with customers also decreases the likelihood that customers will stop buying from a particular seller. Sasser and Schlesinger (1997) present evidence that customer and employee satisfaction and loyalty predict better future financial success than past financial data. Such importance of perhaps explains why the travel company *First* lists the establishment of a stakeholder board as a key achievement in its service to customers.

Financiers. For large companies, investments by socially responsible investors can make CSR attractive. However, even for small companies, CSR can help reduce the cost of bank finance or increase accounts payable times. Banks set an interest rate based on their perceived riskiness of the borrower. If the borrower can convince the bank that risk is reduced because other stakeholders will step in if problems arise, then the risk premium charged might fall. **Turkish Holdings** (a company we have been working with) provides an example. We had discussed a tender for \$20 million dollar project. If Turkish Holdings won, it would finance the cost of the project with bank finance and then receive its money upon completion. Sitting with staff of the companies finance department and external finance officials, we discussed ways CSR programmes might make the company less risky. By the end of the conversation, most of the participants at the event did not find it unreasonable that the bank would drop the lending rate to 2% -- representing a savings (not including compounding) of \$400,000.

¹⁰ The Board room is actually a highly politicised place – for more see Freeman (1994).

¹¹ Miller and Lewis (1991) make a strong case for using stakeholder concepts in marketing.

Government. Working with government can certainly help promote the passage of regulations (or the application of regulations) which help the company. Anti-corruption is also a CSR issue. A strong CSR policy can be the best defense against bribe related costs. One head of a **Russian Services** (which was large in its area but small relative to the Russian economy) told us their bribe policy and their terrorism policy were the same – never negotiate. An economist might argue that the policy acts as a “credible commitment” by the company not to pay bribes – no need to even ask!

Problems. According to Besant-Jones and Tenenbaum (2001), “the California experience suggests that stakeholder boards will work only if they are limited in size, voting rules ensure that one or two classes cannot control the board's decisions, and a single regulator can step in when there is a deadlock.”¹² These companies were required by law to have stakeholder boards in order to participate in local energy projects. Yet, the problem was probably not simply stakeholder involvement, but *too much* stakeholder involvement. In other cases, too little stakeholder involvement results in the classic corporate governance problems.

A Simple Model of Stakeholder Board Design

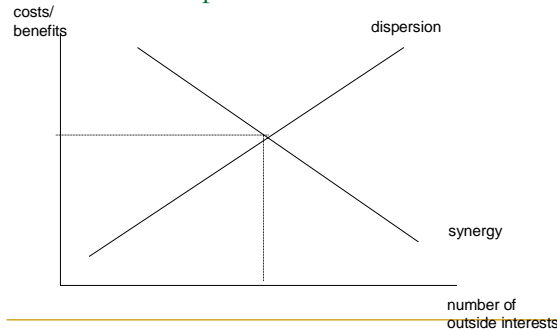
Much of the literature talks about stakeholder boards in either glowing or disparaging terms. A more nuanced view of the decision to establish a stakeholder board would not view stakeholder boards as an all-or-nothing proposition. Much the synergy from having a collection of stakeholders comes from the extra revenue per customer from better products and lower costs paid to the factors of production. *Each stakeholder makes a marginal contribution to that increase in profits.* Of course each stakeholder adds or subtracts value depending on the individual's own skill set and personal relationships. Yet, abstraction to explore general principles can be useful.

The marginal productivity of each stakeholder representative on the board is shown in Figure 2. Adding one extra stakeholder increases enormously the synergy with the interests of financial interests and adds new perspectives. Dispersion is relatively low because the one stakeholder represents a minority. At the other end of the spectrum represents a full-stakeholder board with a number of varied interests. The optimal lies in the middle and depends on the relative distraction versus synergy extra members bring.¹³

¹² According to Navigant Consulting, “flaws in the market rules can favor the stakeholders in the market over consumers or others less well represented by stakeholder Boards.... As a result, some jurisdictions which started with stakeholder Boards have moved towards independent Boards. In California, one of the first reactions to the crisis by FERC was to unseat the stakeholder Board.” Available at: http://www.nbmcdccmnb.ca/docs/IssuePaper-Systems_Operator.doc

¹³ Depending on the relative dispersion or synergy, a “corner solution” may exist such that it is optimal for none or all Board members to be stakeholders rather than shareholders.

Figure 2: The Optimal Number of Stakeholder Representatives



All stakeholder board representatives are not the same – individual differences matter. Like all business decisions -- including human resource decisions used on employees – the a Board member should increase profits. Unlike democracies where representativeness should be strived for, a **method of triage** of board members should be put in place.¹⁴ The problem with many previous attempts at making stakeholder boards is that designers tried to use democratic principles of representation and used an all-or-nothing view of stakeholder boards.¹⁵

Shareholders are leery of stakeholder boards because they believe that these stakeholders are unable to take sophisticated business decisions. The easiest solution is to give them a business education! Companies like Citigroup give management training in the local communities in which they work. Such expertise could be used in the Board room as well. The UK Institute of Directors offers many types of Board-level training programmes. Both options are not very expensive.

Shareholders are also leery because they fear that inefficient stakeholder representatives will slow down decisions and militate for non-economic decision making. However, Board members should have performance criteria like any other company employee. Stakeholder board members are just as accountable to these criteria. These members can also be sacked or shuffled if they prove too disruptive.

Recommendations for the Design of Stakeholder Boards

Stakeholder boards in developing countries should not simply follow the practice of developed economies. Stakeholder boards may be even more important for developing countries. First, capital markets are much less developed. In classic economic theory, efficient capital markets will place resources where they are most useful. Without these

¹⁴ Berman *et al.* (1999) rightly find that stakeholder representation increase profitability. However, the diversity of that representation does not, “community, diversity, and the natural environment--failed to exhibit statistically significant impacts on firm financial performance. This is particularly true for the measures relating to community relations and diversity” (501).

¹⁵ Such thinking still pervades thinking about stakeholder boards. Brenner and Cochran (1991) elaborate a very complicated method of assigning stakeholders “weights.”

markets, the “invisible hand” of the market must be replaced by the “visible hand” of the stakeholders themselves. Second, these countries have increased government participation and increased socialistic leanings in the design of the business system. Many advisors suggest removing these structures and allowing “free markets” to work. Instead, these structures must be used – important organisational capital lies within them. Institutions such as TOBB in Turkey help coordinate business policy and many developing countries have similar structures.

A national co-ordinating body may help define the role of stakeholder boards in a particular country. Kar CSR (Hindi for Do CSR!) represents a forum for defining the role of stakeholder boards. Started by local NGO (Anchorage), this Karnataka-wide programme aims to train government, business, and NGOs. It hopes to co-ordinate CSR activity through the establishment of a Committee of Stakeholders. These stakeholders represent state and local government officials, media representatives, industry members, trade associations, and NGOs among others. They do not sit in companies. Instead, they sit together to advise on how members from their stakeholder group can sit together in companies. They also work together to define CSR priorities. A Secretariat supports their day-to-day work.

How to Design a Stakeholder Board in Brief

To design a stakeholder board, the company should define the importance of shareholder interests in its profits, decide on a number of stakeholder members, conduct triage based on particular individuals strengths and weaknesses, and be prepared to change board composition as particular stakeholders become more or less important.

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