Alexander Styhre

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Corporate Governance, The Firm and Investor Capitalism

Legal-Political and Economic Views

NEW PERSPECTIVES ON THE MODERN CORPORATION

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Legal-Political and Economic Views

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Preface

The finance market collapse of 2008 has inspired many scholars and pundits to spill much ink, and some have argued that the events of 2008 were the 'Berlin Wall moment' of free market capitalism (at times referred to as neoliberalism). In my view, that characterization is a misnomer, as the Berlin Wall coming down was the culmination of a long-term process where a politico-economic regime finally came to the end of the road as it could no longer uphold itself and satisfy even the most elementary human needs. In contrast, the financial market collapse of 2008 has led to few structural changes and the finance industry per se has been most successful in both pushing the costs for its restoration onto other actors (most notably national states, now operating under 'austerity schemes'; see, for example, Major, 2014; Schui, 2014; Blyth, 2013) and further entrenching their own interests, leading to an even more salient oligarchic structure of the finance industry. Rather than being a Berlin Wall moment, the 2008 events were more like the Harrisburg or Chernobyl nuclear plant accidents: they made us all aware of the risks and revealed some of the costs of the system but, after all, when the dust had settled, they changed very little. In the case of nuclear energy, the underlying nuclear physics theories, the regulatory work, or the market for nuclear energy did not change in any decisive way. In the case of the 2008 financial market collapse, the underlying neoclassical economic theory framework justifying the practices in the finance industry, the regulatory and legal framework (becoming increasingly more lenient and liberal), and the demand for credit and financial services did not change in any decisive way. In both cases, too many people had too much to gain from justifying and further reinforcing these advanced but ultimately fragile and thus potentially harmful energy and financial systems. In both cases, these were 'man-made disasters' and what Charles Perrow (1984) calls 'normal accidents'. Humans made and built these systems but apparently failed to keep them under full control; even more importantly, after the fact, when the harm had already been done, there were few possibilities for abandoning these systems despite their hazardous risks.

Perhaps future historians will address these two disasters – one environmental, polluting the life world of humans and other forms of life,

one socio-economic, leading to enormous social costs in terms of increased economic inequalities (but also, indisputably, provided many merits in terms of increased supply of credit) – as evidence of the learned helplessness of advanced, capitalist human societies, building techno-scientific and socio-economic systems to serve these societies but eventually no longer being able to run them as humans may wish as they become too complex to slow down and monitor, even when the risk of derailment becomes too high, or even acute. From my own perspective, the latter type of 'normal accidents', that of socio-economic systems such as the global finance industry, is part of my jurisdictional domain as a management researcher and business school scholar. The underlying politico-theoretical framework that justified and served to construct and fortress the present finance industry arguably deserves systematic scholarly attention. During the last few years, I have published three research monographs addressing the shift from managerial capitalism to investor capitalism. The first volume, *Management and Neoliberalism* (2014), addressed the political changes and free market activism beginning in the New Deal era during the 1930s. The second volume, *The Financialization of the Firm* (2015), examined the consequences for the individual corporation when it was no longer treated as a site where production capital was integrated and monitored under one single management and the board of directors, but was now better seen as 'a bundle of financial assets'. The third volume, *Leadership Varieties* (2016, co-authored with Thomas Johansson), discussed how the concept of leadership is strongly informed by the shift from managerial capitalism to investor capitalism, and how the fiduciary duties of former corporate elites have been gradually displaced by rational choice-informed incentives and compensation packages. In addition, the emergence of a market for corporate control has gradually undermined the very idea of the firm as an economic and social team production unit dependent on various forms of professional expertise for its functioning.

This fourth volume in this series of investigations focuses more explicitly on corporate governance and corporate law, and how neoclassical economic theory has by and large misunderstood, ignored, marginalized or trivialized not only management theory but also legal theory and corporate law when advocating its favoured contractarian theory of corporate governance. That is, this volume adds to the previous three volumes the analysis of how primarily legal theory and neoclassical economic theory in many cases are irreconcilable or complementary, and how much of the free market advocacy that has been integral to the politico-economic project to overturn managerial capitalism and to advocate free market capitalism – a project propelled by the political objective

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to restore capital owner interests – is factually wrong or seriously flawed regarding the assumptions made and propositions stated. This may sound like a bold declaration, but in order to understand corporate governance the analyst must recognize legal theory, corporate law and the day-to-day practices in corporations. In other words, rather than being neatly derived from deductive reasoning on the basis of neoclassical economy theory propositions regarding, for example, market efficiency and individual decision choices, corporate governance is social and economic practice seated in legal traditions and political objectives that have evolved over time. Free market protagonists may wish the world looked differently (and I do not in any way deny them the right to think so), but they must recognize, like any other researcher and scholar, that their preferences are not the same thing as factual conditions. What is the case in the best of all possible worlds may, sadly, not be the world that we inhabit and try to operate within. Unfortunately, the world that managers, shareholders, regulators, politicians, customers and so on, inhabit and operate within and govern and regulate is far more messy and non-linear than neat models and parsimonious theories of economic activity may suggest, and consequently the tendency to cut theoretical corners easily obscures and leads astray to a higher extent than is recognized.

Alexander Styhre
Melbourne, December 2015

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Contents

Preface vi
Acknowledgements ix

Prologue: the Great Recession *Durcharbeitung* 1
Introduction: the nature of the firm and its governance 8

PART I INSTITUTING THE FIRM

1. Corporate law and the legal environment of the firm 29
2. Managerialism, the problem of principal–agent relations, and free market advocacy 60

PART II RETHINKING THE FIRM

3. The agency theory model of the firm and its implications 107
4. Investor capitalism and the nexus of contract view of the firm: assessing the consequences 165

Epilogue: neoclassical economic theory and ideology 219

Bibliography 236
Index 273

Prologue: the Great Recession
Durcharbeitung

> Capitalism does not invent hierarchies, any more than it invented the market, or production, or consumption; it merely uses them. In the long procession of history, capitalism is the later-comer. It arrives when everything is ready.
>
> Fernand Braudel (1977: 75)

The Annales school historian Emmanuel Le Roy Ladurie (1983) remarks that in the period of 1350 to 1750 there was only a modest population growth in Europe. The continent was held captured by a military-state apparatus, dominated by the aristocracy, and with the monarchy as a largely military institution, implicated in the European balance of power (Le Roy Ladurie, 1983: 15). To maintain the power balance, constant wars and skirmishes tortured the European population and prevented economic development and population growth for more than four centuries. 'From the fourteenth to the seventeenth century inclusive, the economy was servant not master', Le Roy Ladurie (1983: 23) writes. Only after the beginning of the industrialization process, itself derived from the advancement of the bourgeoisie at the expense of the aristocracy and its primary institution the monarchy, could the economy start to grow. In this case, the facts by and large speak for themselves: '[i]n 1328, the French population stood at 17 million; it was 19 million in 1700 – still about the same. But by 1879, it had reached 27 million and had risen to almost 40 million by the time of the Franco-Prussian war of 1870' (Le Roy Ladurie, 1983: 25). Roughly after 1750, midway between the glorious English revolution and the French and American revolutions, population growth could finally be reported. In Le Roy Ladurie's (1983) perspective, a series of reforms, institutional changes and new ideas contributed to the decline of the aristocratic-military state:

> The forces of renovation included the State, the modernized Church, the educational system – all more repressive and more efficient; a more plentiful money supply; a more sophisticated nobility and bourgeoisie; better-run estates; greater literacy everywhere; a more rational bureaucracy; more active trade; and urbanization at what eventually became an irresistible rate, forcing

> nations (whose productivity was not keeping pace) to produce more peasants in order to feed the new mass of townspeople. (Le Roy Ladurie, 1983: 25)

In the contemporary political affairs literature and debates, there are many worried concerns about regions in the Middle East and in the Maghreb being stuck in cycles of outbursts of violence and war and calmer periods, very much being 'medieval' in their nature. The lack of economic growth and work opportunities creates unrest and disappointment, and it is seemingly very complicated to change the downward spiral of escalating violence. Historians remind us that this was very much the situation on European soil for centuries, but today the wars have been canalized into other competitive activities such as commerce and sports.

In the transformation of the European feudalism into modern states with growing economies (Bloch, 1962), the bourgeoisie and what was eventually called the middle class played a key role. The aristocracy has always enjoyed inherited privileges and has therefore opposed change and shown little interest in enterprising activities. For the aristocrat, the bourgeoisie striving to accumulate capital and to make a better living was not only unnecessary for the economically favoured class, tightly bound up in a network of reciprocal relations that ensured the highest possible economic welfare also for the coming generation, but this very idea was also the vulgar ambition of the parvenu. While the aristocracy was a leisure class, the bourgeoisie lived in accordance with what Gay (2001) refers to as the Gospel of Work, which prescribed hard and diligent work as a principal virtue. Virgil had written that '*Labor omnia vincit improbus*', that 'persistent labour conquers all' (cited in Gay, 2001: 192), and this became the leitmotif of the bourgeois way of life. 'The gospel of work was emphatically and almost exclusively a bourgeoisie ideal. By and large, aristocrats did not value it and the working poor did not need it', Gay (2001: 198) writes. Needless to say, out of historical necessity, the aristocracy did not commit to the bourgeois way of life. The multitude, the poor and the penniless, the rural classes and the 'little people' in the towns, endured living conditions that effectively prevented them from nourishing any ambition to create a better life for themselves. Only occasionally did the aristocracy and the working classes create venturesome and enterprising individuals who managed to escape the shackles of a class society that was far from dynamic and meritocratic. This new venturesome and diligent social class, the bourgeoisie, representing a 'distinctive combination of striving and straitening, desire and self-denial, hedonism and frustration' (Fourcade and Healy, 2013: 568), became a formidable challenge for the aristocracy to keep at bay. At the

end of the day and after many rivers have been crossed, it was the bourgeoisie that created Western capitalism, rooted in the idiosyncratic blend of a risk-taking attitude and the close monitoring of resources, enabling both economic ventures and the regulation of economic affairs, specific for the Western capitalist economy. To allude to Winston Churchill's famous bon mot, capitalism, the ultimate and lasting triumph of the liberal bourgeoisie over the conservative and self-destructive aristocratic-monarchic medieval state, is the 'least bad' of economic systems; it has beyond doubt demonstrated a remarkable capacity to accumulate economic wealth, but has been less trustworthy when it comes to the distribution of such benefits and in maintaining its stability over time.

The great financial market meltdown and the accompanying economic decline, widely referred to as the 'Great Recession' in the literature, was an event that caused much debate and discussion in both the media and academic circles (Eichengreen, 2015). The 2008 crash represented a 'Berlin Wall moment' of free market advocacy, Peck (2010: 9) argued, while for others, the events were little more than bumps in the road of the neoclassical prescription of the economic system. One of the most intriguing books being published in the period – the 2008 events produced an entire literary sub-genre, whereof, for example, Blinder's (2013) *When the Music Stopped* is one exemplary piece of scholarship and commentary – was Richard A. Posner's (2009) *A Failure of Capitalism*. Written by a judge and legal scholar with conservative and libertarian political convictions and preferences, Posner (2009) did not sugar-coat his pills regarding the causes and consequences of the finance market collapse. 'The depression[1] is the result of normal business activity in a laissez-faire economic regime – more precisely, it is an event consistent with the normal operation of economic markets', Posner (2009: 235) says.[2] Formerly being committed to free market capitalism advocacy, one can only speculate about the frustration Posner must have felt when writing these lines. Nevertheless, Posner (2009: 240) insists, '[t]he financial crisis is indeed a crisis of capitalism rather than a failure of government'. In addition, the crisis is 'systemic' (Posner, 2009: 236) and one of the principal consequences is that capitalism '[m]ay survive only in a compromised form' (Posner, 2009: 234). Posner also addresses which groups are responsible for the new situations, and the list becomes quite extensive before Posner is done with this job. First of all, the 'economic libertarians' were hit in 'the solar plexus' as the crisis was not a consequence, as they have regularly stated, 'of the government's overregulating the economy and by doing so fettering free enterprise', but derived from 'innate limitations of the free market' (Posner, 2009: 306).

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In brief, the free market advocacy was based on faulty premises and the wrong idea about the nature of unregulated and free markets. In addition, economists and especially finance professors should carry their share of the responsibility, Posner (2009: 257) says. Part of the problem is that these scholars are also actively working in the finance industry and therefore they try to combine two roles that are essentially incompatible and/or potentially violating professional scholarly norms: '[Professors of finance] are consultants, investors, and sometimes money managers; many of them, either before joining a university faculty or during leaves of absence from the university, have worked for the Federal Reserve, the International Monetary Fund, or other nonacademic institution' (Posner, 2009: 258–9).

In fulfilling such multiple and diverse roles, finance professors, being the leading advocates of free market capitalism and the deregulation of finance markets, mix up their responsibilities in culpable ways: '[i]f they [professors of finance] criticize the industry and suggest tighter regulations, they may become black sheep and lose lucrative consultantships' (Posner, 2009: 259). In addition, the Federal Reserve's two chairmen during the period, Alan Greenspan and Ben Bernanke, two conservatives, operated for too long on the basis of misconceived ideas regarding the nature of the finance market and thus failed to stem the tide once the levees broke. Finally, the Bush Administration accomplished little more than to deliver a 'cascade of blunders' (Posner, 2009: 308).

These are quite harsh words, especially as they are written by one of the allies of free market advocators. Posner's (2009) disappointment and anger is present on every single page of his book, and we may therefore pay attention to the claim made that capitalism may only survive in a 'compromised' and revised form. At the height of the last system-wide capitalist crisis, the Great Depression, the Harvard Law School professor Merrick Dodd (1932) addressed the question regarding to whom salaried managers are accountable and advocated what would eventually become known as corporate social responsibilities. When reading Dodd's text, more than eight decades after its publication, the issues addressed by Posner (2009) seem oddly familiar:

> Concentration of control of industry in a relatively few hands has encouraged the belief in the practicability of methods of economic planning by which such security can be achieved in much greater degree than at present. This belief is no longer confined to radical opponents of the capitalistic system; it has come to be shared by many conservatives who believe that capitalism is worth saving but that it cannot permanently survive under modern conditions unless it treats the economic security of the worker as one of its obligations and is intelligently directed so as to attain that object. (Dodd, 1932: 1151–2)

Plus ça change. Still today, conservatives believe capitalism is 'worth saving', but there are few distinct ideas about how that can be accomplished on a basis of the predominant regime of investor capitalism. Perhaps we are witnessing, as Fligstein (2005) suggests, the decline of the shareholder welfare and finance industry dominance era, but there are many who doubt competitive capitalism is at the crossroads.

Despite the 2008 finance market debacle, competitive capitalism remains a magnificent engine in terms of its ability to maximize economic value creation. This engine is much worse in terms of *sharing* and *distributing* this value (as indicated by the conspicuous growth of economic inequality in most OECD countries and elsewhere; see, for example, Perugini et al., 2016) and it is certainly not capable of 'self-regulating' as free market advocators have persistently claimed since at least the interwar period. Despite these 'systemic' features, competitive capitalism remains the least bad economic system, but it is a system that needs to be kept under tight control and to be understood as what serves societies and human beings. Fernand Braudel, one of the leading economic historians of the twentieth century, emphasizes that capitalism cannot exist without its surrounding and supportive society: 'capitalism is unthinkable without society's active complicity. It is of necessity a reality of the social order, a reality of the political order, and even a reality of civilization. For in a certain manner, society as a whole must more or less consciously accept capitalism's values' (Braudel, 1977: 63–4). While Braudel's (1977: 61) claim that one of capitalism's 'greatest strengths' is its ability to adapt and to change (capitalism is 'conjunctural', Braudel says), capitalism nevertheless 'only triumphs when it becomes identified with the state, when it is the state' (Braudel, 1977: 64).

The hard-liners of free market advocacy, claiming that 'economic freedom' is privileged above and beyond any political idea about freedom (that is, they reject Braudel's thesis about the role of society and the state – the formalized and bureaucratized organization of society – out of hand), and who want to subsume any human activity under market evaluations and pricing, may not be in the best position to justify competitive capitalism for the wider population. For these staunch defenders of free market capitalism, there is no escape from the purifying and all-encompassing cleansing of market pricing. Any human decision, no matter how small, is uncompromisingly evaluated and thereafter priced by the market. Rather than God seeing all, knowing all, it is now the market, the supreme calculator and information processor, that executes such a function. Similarly, just as God lets us all be held responsible for our choices and behaviour in the Christian liturgy, so too

does the market reward and punish choices and behaviour, free market protagonists argue. The works of, for example, Alan Blinder (2013) and Richard Posner (2009), independent of their previous role in creating the existing system of competitive capitalism, are indicative of a willingness to, perhaps for the first time since the mid-1970s, one more time discuss the economic system of competitive capitalism and to try to figure out how this remarkably efficient economic engine can be embedded in a society that both creates and reproduces this economic system while also being the primary beneficiary of its functioning.

Part of that story, it is claimed here, consists of how the corporation has been enacted over time and how it has been supported by and reformed by legislation, law enforcement, regulation, and the advancement of economic theories that shape and influence the object of analysis. The common term for all these different practices and engagement is *corporate governance*, here denoting the broad concern regarding how companies – incorporated business charters – are to be understood within society and the economy in which they are operating. In addition, to fully recognize the shifts and changes in the discourse on corporate governance, beginning in the latter half of the nineteenth century, a historical perspective is taken in this volume, starting around the Great Depression and the Wall Street crash of 1929, and moving on into the new millennium. Only from this bird's-eye view can corporate governance practices and their influence in the economy be fully recognized and understood.

NOTES

1. Posner (2009) refuses to use the concept of 'recession', in his view a euphemism that seeks to blindfold the public in an attempt to trivialize the causes and consequences of the crisis. Hence the use of the more eye-catching term 'depression'.
2. The term 'normal operation' used by Posner (2009) deserves some attention. Greenwood and Scharfstein (2013) argue convincingly on the basis of solid empirical evidence that it was the combination of new asset management practices and the expansion of credit, primarily in the form of mortgages, which fuelled the swift growth of the finance industry after the mid-1990s (see Chapter 4 for an extended argument). While the output from 'traditional banking' as a percentage of GDP was 'roughly the same in 2007 as it was in 1997' (Greenwood and Scharfstein (2013: 19), a substantial share of this growth occurred in 'transactional services', which in turn were 'largely reflected in fees associated with deposits, residual loan origination, and the catchall category of "other products supporting financial services"' (Greenwood and Scharfstein, 2013: 19). In short, 'non-traditional banking' took off in the period after the mid-1990s. The increased securitization of financial assets also 'went hand-in-hand with the growth of "shadow banking"' (Greenwood and Scharfstein, 2013: 21) and what Engel and McCoy (2007) call 'predatory lending' (substandard lending aimed at distributing risks through securitization), wherein key functions of traditional banking are provided outside of the traditional financial entities that

do not benefit from central bank liquidity or public sector credit guarantees (Greenwood and Scharfstein, 2013: 21). Shadow banking is a thinly veiled approach to circumvent regulatory control and therefore also increases the instability of the financial system. '[T]he shadow banking system that facilitated this expansion [of mortgage credit] made the financial system more fragile', Greenwood and Scharfstein (2013: 26) conclude. Cole and White (2012) also examine the causes of the finance industry collapse of 2008 and their data suggest a run-of-the-mill, indigenously produced, man-made crisis that was more or less following previous patterns for such events:

> [M]ost banks in the current crisis are failing in ways that are quite recognizable to anyone who has studied the hundreds of bank failures that occurred during the 1984–1992 period; hence the phrase 'déjà vu all over again' ... Banks that invest heavily in commercial real estate loans, including construction and development loans, non-residential mortgages, and multifamily mortgages, are taking levels of risk that are not simply captured by existing capital requirements, just as they were back in the 1980s. (Cole and White, 2012: 27)

As Greenwood and Scharfstein (2013: 26) remark, this recurrent pattern very much runs counter to the traditional 'functional' view of finance (apparently not able to adjust itself to emerging empirical evidence), wherein 'a primary function of the financial sector is to dampen the effects of risk by reallocating its efficiently to parties that can bear risks the most easily' (Greenwood and Scharfstein, 2013: 26). That is, the 2008 financial crisis was not a bit unusual or indicative of an emerging irregular pattern, but was in an everyday sense of the term perfectly 'normal'. Still, the question remains as to why yet another finance industry crisis occurred when theoretical prescriptions render the finance industry the capacity of self-correction and stabilization. Fahlenbrach and Stulz (2011) and Hagendorff and Vallascas (2011) both stress the incentive structure underlying executive compensation in financial institutions, in turn derived from a shareholder primacy ideology now widely entrenched in large domains of the world of business. '[C]EOs with better incentives to maximize shareholder wealth took risks that other CEOs did not. Ex ante, these risks looked profitable for shareholders. Ex post, these risks had unexpected poor outcomes', Fahlenbrach and Stulz (2011: 25) conclude. '[L]inking executive compensation policy to align the interest of shareholders and management in banking is likely to lead to excessive risk-taking', Hagendorff and Vallascas (2011: 1094) add. Banks and other financial institutions that theoretically, practically and legally enjoy the jurisdictional discretion to spread and minimize risks in the economic system through financial operations were instead incentivized to become sites where such systemic risks were fabricated on an industrial basis (for a recent review of the literature on corporate governance and risk management in banks, see Ellul, 2015). From the mid-1990s and onwards, this became the new conventional wisdom – what Posner (2009) refers to as 'normality' – of the finance industry.

Introduction: the nature of the firm and its governance

ASSUMPTION AND PROPOSITIONS

This volume is based on one assumption and two propositions. This assumption and the two propositions are the recurrent themes which this volume purports to address and whose significance will be demonstrated. For the sake of clarity, they should therefore be defined at this early point:

- *Assumption*: The recent thoroughly demonstrated and researched growth of economic inequality and economic stagnation in Western capitalism cannot be explained by individual activities or policy changes, idiosyncratic events, or by sheer *force majeure* beyond the influence of informed policy-making, but needs to be examined as institutional changes in what can best be described as the infrastructure of the corporate system of Western capitalism. More specifically, these infrastructural changes in the corporate system are most accurately described as questions pertaining to corporate governance. Corporate governance here includes '[a]ll the devices, institutions, and mechanisms by which corporations are governed' (Macey, 2008: 2). Ultimately, corporate governance denotes decision-making regarding the value creation and value extraction in the corporate system, and, more specifically, within a focal firm, under the influence of market-based competition, legislation, and existing regulatory frameworks.
- *Propositions*: (1) Managers do not, by and large (even though noteworthy exceptions are reported), shirk or act incompetently in *predictable ways* when seeking to navigate in competitive environments to create economic value accruing to their stakeholders and when submitting to extant legal frameworks and institutionalized regulatory control. (2) If they did (which is counterintuitive and unsupported by empirical evidence regarding the degree of economic value creation in the corporate system of Western capitalism), it would still not induce agency costs in relationship to other

comparable costs (a) to the extent proposed by agency theorists and contractarians, and/or (b) to the extent that it would justify legal and regulatory reform to further channel economic resources to a limited number of organizational stakeholders, most noteworthy the shareholders.

ECONOMICS IN BOOKS AND IN REAL LIFE

Max Weber (1949) remarked in his seminal book on the methodology of sociological inquiry that a new science is in the first place a form of social organization of joint intellectual pursuits, and only in the secondary instant can a new science address practical concerns in the surrounding world: '[i]t is not the "actual" interconnections of "things" but the *conceptual* inter-connections of problems which define the scope of the various sciences. A new "science" emerges where new problems are pursued by new methods and truths are thereby discovered which open up significant new points of view' (Max Weber, 1949: 68, emphasis in original). The same idea was later expressed by Georges Canguilhem (1989: 30): '[t]he history of science concerns an axiological activity, the search for truth. This axiological activity appears only at the level of questions, methods and concepts and nowhere else'. A science is therefore a shared explanatory framework which from time to time, but not always, manages to predict outcomes or to explain certain previously puzzling phenomena. But such benefits are only secondary to the very formation of the discipline's internal organization. Teece and Winter (1984: 117) address the difference between managerial work and its dependence on explanatory frameworks capable of guiding decisions and the neoclassic economic theory framework and its inability to provide such heuristics and rules of thumb: '[m]ost management problems are ill-structured. They are messy, involving complex interdependencies, multiple goals, and considerable ambiguity, and their nature is much dependent on the conceptual lens through which they are viewed'. In contrast, neoclassic economic theory, formalist and mathematized, in turn, is 'shaped by a concern with problems that are very different from the management problems just described' (Teece and Winter, 1984: 117). As a consequence, Teece and Winter (1984) reason, neoclassical economic theory has many benefits but it is by and large not very practically useful for managers in need of more straightforward decision-making tools and heuristics to act professionally within their domain of practice.

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