Participation versus Consent: Should Corporations Be Run according to Democratic Principles?[1]

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ABSTRACT: The notion of "democracy" has become a much-debated concept in scholarship on business ethics, management, and organization studies. The strategy of this paper is to distinguish between a principle of organization that fosters participation (type I democracy) and a principle of legitimation that draws on consent (type II democracy). Based on this distinction, we highlight conceptual shortcomings of the literature on stakeholder democracy. We demonstrate that parts of the literature tend to confound ends with means. Many approaches employ type I democracy notions of participation and often take for granted that this also improves type II democratic legitimation. We hold this to be a mistake. We provide examples of the ambiguity of organizational procedures and show that under some circumstances a decrease in the degree of participation may actually increase legitimation because a governance structure that results in higher productivity can provide higher benefits for all parties involved, serve their interests and therefore meet their agreement. Less type I democracy may mean more type II democracy. We believe this to be an important insight for judging (and further improving) the legitimacy of both capitalistic firms and competitive markets.

KEY WORDS: democracy; stakeholder theory; legitimacy; constitutional economics; consent; participation

THE NOTION OF CORPORATE "DEMOCRACY" has become not only a much-debated, but also highly contested, concept in the literature. In business ethics, management, and organization studies, there is a long and established discussion on "organizational democracy" (Harrison and Freeman 2004; Kerr 2004), "stakeholder democracy" (Matten and Crane 2005b; Moriarty 2012; O'Dwyer 2005; Parker 2002; Turnbull 1994), "workplace democracy" (Pateman 1970; Dahl 1985; Greenberg 1986; Brenkert 1992; McCall 2001), and "industrial democracy"

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that finds its roots in the influential book *Industrial Democracy*, by the famous British socialists Sidney and Beatrice Webb (1897) (for a historical discussion, see Müller-Jentsch 2008).

In essence, many contemporary proponents of corporate democracy argue that conventional forms of corporate governance typically represent only the interests of the shareholders. Against the background of other critical voices on shareholder orientation (cf., e.g., Stout 2012), it is argued that democratization of the firm needs to include other stakeholders in corporate governance and, above all, in corporate decision-making processes (Driver and Thompson 2002; Thompson 2005; Matten and Crane 2005b; O'Dwyer 2005; Moriarty 2012; as well as Scherer, Palazzo, and Baumann 2006 or Schneider and Scherer 2010).

However, these are not universally held beliefs. Liberal critics of the corporate democracy agenda argue that democratization of the firm will undermine corporate governance and the corporate objective function (Jensen 2002), be incompatible with the functional differentiation of modern societies (Willke and Willke 2008), and ultimately undermine the underlying institutions of a free market society (Friedman 1970; Henderson 2004).

In contrast to many liberal critics, we believe that the issue of democracy is an important topic for business ethics theorizing as well as for its practice. In fact, we agree with Palazzo and Scherer (2006: 82) that modern society with its globalized markets requires corporations to engage in new forms of democratic processes to establish "a new legitimate political order that goes beyond the traditional forms of democratic nation state regulation." That said, however, we are also critical of most corporate democracy proponents, our chief objection being that stakeholder democracy is widely measured and discussed in terms of participation and subsequent organizational principles that view certain process criteria as inherently valuable.

The strategy of this paper is to introduce a conceptual distinction of two notions of democracy to the debate on corporate democracy. Following the work of the German philosopher and business ethicist Karl Homann (cf. Homann 1988), we refine the notion of democracy and distinguish between democracy as a specific principle of organization and democracy as a more general principle of legitimation. As a principle of organization, Homann (1988) argues, "democracy" refers to particular standards and procedures for organizing social interactions, such as the voting mechanism. As a principle of legitimation, "democracy" refers to the goal of consensual self-governance, that is, the characteristic of a social arrangement that allows the people affected by it to, in principle, give their deliberate consent to it. Particular organizational procedures may then serve to achieve this legitimation goal of safeguarding consensus. Put differently, "democracy" as a specific principle of organization that fosters participation in joint decision processes can be understood as one *means* (among many alternative means) of realizing the final *goal* of "democracy," that is, legitimation through factual or hypothetical consent.

By distinguishing these two related, yet fundamentally different, notions of democracy, we are able to highlight shortcomings of the stakeholder democracy rhetoric and identify avenues for advancing it. More specifically, we demonstrate that scholarship in the field of stakeholder democracy tends to mistake the means

of using participation as an organizational principle as the actual end of democracy. Means, however, are per se ambiguous. Depending on specific circumstances, they produce different results. To achieve the desired end, means must be adapted to the particular situation at hand. If "blueprint" democratic organizational principles are proposed without such an analysis, then attempts to democratize the firm might actually do a disservice to democracy in a wider sense: they can make people worse off and thus decrease the potential for consent. In short, alleged democratic activism might actually undermine democracy.

The argument proceeds in four steps, making the following contributions to the literature on stakeholder democracy.

In the first step, we clarify in more detail the distinction between democracy as a specific principle of organization (type I) and democracy as a general principle of legitimation (type II). A key contribution to scholarship on stakeholder democracy is showing that the widespread, though more narrow, notion of democracy as an organizational technique can be interpreted as describing a powerful means to achieve the end of the more encompassing notion of democracy as legitimation through consent. Whether these democratic organizational procedures (type I) truly foster democracy in a legitimation sense (type II), however, depends on their *functionality* in a given context. Seen from this perspective, type I democracy is not an end in itself.

In the second step, we look at the rhetoric of stakeholder democracy and show that it largely circles around the notion of democracy as an organization principle. In most stakeholder democracy accounts, the focus is on specifying organizational procedures, either with regard to concrete decision-making, such as in models of co-determination, stewardship councils, and voting mechanisms, or with regard to discursive processes of deliberation in multi-stakeholder dialogues. These accounts, however, fail to notice—and thus do not systematically take into account—the general ambiguity of such organizational procedures.

Consequently, our third step addresses this gap and develops an analysis of the functionality of proposals for democracy as an organization principle. We contribute to the literature on stakeholder democracy the differentiated argument that models of democracy as an organization principle (type I) are an ambiguous means of fostering consent (type II): In some circumstances, democratizing the firm in terms of participatory procedures can increase consent; in others, it can erode consensual legitimacy. As a result, there are situations in which less type I democracy may mean more type II democracy.

The final and fourth step summarizes and concludes our argument. Should corporations be run according to democratic principles? We show that the answer to this question is fundamentally different depending on whether one takes a type I or a type II democracy perspective. Arguing for the broader notion of democracy as a legitimation principle, we derive implications for the prospect of promoting democracy in business ethics theory and practice.

DEMOCRACY AS A PRINCIPLE OF ORGANIZATION VERSUS DEMOCRACY AS A PRINCIPLE OF LEGITIMATION

The history of thought on the notion of democracy could fill entire libraries and it is not our purpose here to provide a comprehensive overview of this vast body of work. Indeed, the notion of democracy is no longer confined to the specialized field of political philosophy, but is taken up by many other academic disciplines and is a facet of nearly every realm of life itself. As a result, it has evolved into a prominent part of societal *semantics*.

Following the German philosopher and business ethicist Karl Homann (cf. Homann 1988) and the ordonomic approach (Pies, Hielscher, and Beckmann 2009; Pies, Beckmann, and Hielscher 2010 and 2011; Beckmann, Hielscher, and Pies 2014), which emerged from Homann's work and specializes in analyzing interdependencies between social structure and semantics, this section offers a conceptual clarification by distinguishing between two mental models that are often used (and confused) in debates on democracy.

The Type I Mental Model: Democracy as a Principle of Organization

The first perspective on democracy we focus on looks at democracy as a particular principle or set of principles for organizing social interaction, collective decisions, or communication through participation. This perspective is closely related to everyday notions of democracy and usually refers to specific institutions such as free elections or general suffrage. According to this perspective, democracy is a desirable and intrinsically valuable process—a technology—for organizing the social sphere. We call this perspective "the type I organizational model of democracy."

In its etymological origin, democracy refers to the power or rule of the people. The type I perspective on democracy asks how this concept is translated into organizational principles that will integrate people into their self-ruling, thus emphasizing the importance of *participation*. Different theories of democracy highlight different elements in this regard. More classical, liberal theories, for example, focus on the institutional framework for enabling participation in democratic decision-making, highlighting aspects such as representation, elections, political franchise, and the like. Theories of deliberative democracy, in contrast, concentrate on the process of deliberation prior to decision-making, highlighting the importance of participation in open and inclusive discourse (Dryzek 2000).

Despite their differences, what all versions of the type I perspective have in common is that they specify concrete organizational principles in defining what is "democratic," particularly in terms of participation. In other words, organizational principles for fostering participation in decision-making and participation in deliberation are seen as the essence of democracy, which has an important consequence. If participation in decision-making and in discourse defines democracy, then the degree to which these organizational principles have been implemented defines the degree to which full democracy has been realized.

If one follows this line of thought, the definition of specific "democratic" process criteria provides a framework for assessing the degree of democracy and how to advance it. Democracy then depends on the realization of criteria such as:

- Inclusiveness of participation: Is everybody included or at least represented in the process?
- Equality of participation: Can everybody participate in the same way?
- Scope of participation: Which issues are open for participation?
- Frequency of participation: How often is participation possible?

Seen from this type I perspective on democracy, the democratic process has an intrinsic value because it captures the essence of democracy. Democratization is then about further improving these democratic properties of participatory processes and extending these organizational principles to as many areas and situations as possible. Although, realistically, a departure from the theoretical ideal might be necessary, the type I organizational democracy perspective would thus define an ideal world as one in which every single decision is made via organized democratic participation of those affected by it.

The Type II Mental Model: Democracy as a Principle of Legitimation

In contrast to the type I organizational democracy mental model, the type II perspective put forward here does not start with the organizational form of the democratic process, but with democracy's function of legitimizing collective decisions. Here, the idea of self-governance does not so much involve formal characteristics of the democratic process itself, but, instead, the ability of those affected by collective decision-making to give, in principle, their *consent* to the process. The focus shifts from the formal "input" towards the "output legitimacy" of democracy (Scharpff 1999).

This idea—that democracy is about the consent of those governed—is not new. One of its most prominent advocates is James Buchanan in his work on constitutional economics. Buchanan develops several arguments for looking at democracy in terms of its potential to generate consensus. First, Buchanan (1987) makes the case for a "normative individualism," arguing that, ultimately, it is always individuals who are the source of value and legitimacy. As a consequence, the ideal of democracy as self-governance requires the consent of all individuals—that is, unanimous consensus. While this normative argument can be criticized as a judgment of value, Buchanan's second argument provides a positive case for the criterion of consensus. As Buchanan (1995) states, individuals have always certain discretionary freedoms. Consequently, if individuals see no grounds for consent, they could use their discretionary leeway to veto or boycott a solution. Consensus thus turns from a normative into a positive criterion for stability. If people are permanently disenfranchised, they will withdraw from cooperation or even overthrow the system. By this logic, both Popper (1966) and Mises (1962) emphasize that a key quality of democracy is that it allows the peaceful change of government.

Unanimous consensus, however, is an unrealistic hope in a real-life democracy. Individuals have diverse and competing interests as well as pluralistic worldviews. Consensus on collective action is even more unlikely given the "fact of reasonable pluralism" (Rawls 1993: 144), according to which modernity is characterized by an increasing heterogeneity of ethical viewpoints.

As a consequence, democracy can hardly be measured against the benchmark of achieving unanimous consensus on every single decision. But how, then, is it possible to operationalize the idea of democracy as the consent of the governed? Elaborating on the classic contribution by Buchanan and Tullock (1962), Buchanan (2000) as well as Brennan and Buchanan (1985) we develop an answer to this question in three steps. First, the starting point is to relate consensus not to the specific outcome of an isolated single decision, but to the rules that channel outcomes over the sequence of many decisions. An individual may thus consent to a rule if the rule results in a net benefit over a sequence of events even though there might be single events that leave the individual worse off. Unanimous consensus still seems unlikely, however, as there are many rules that would result in a net benefit for some but a net loss for others. In a second step, Buchanan answers this criticism by conceptualizing the establishment of societal rules as a multi-level process. The key idea is that not all social rules are located on the same level; rather, there are different levels of a rule hierarchy. Figure 1 illustrates this idea. At the lowest level are rules governing rather specific basic games. These rules are agreed upon in meta-games governed by more abstract rules that cover a broader scope of the social sphere. Establishment of these second-level rules occurs in another (meta-meta) game that is at a higher level in the hierarchy. This process of moving another level upward continues until one reaches the highest level, where the rules have something of a constitutional character. This conceptual framework is valuable for showing that even in a heterogeneous society, there is a focal point for unanimous consensus if one moves to the appropriate level in the rule hierarchy. Brennan and Buchanan explain this mechanism as follows:

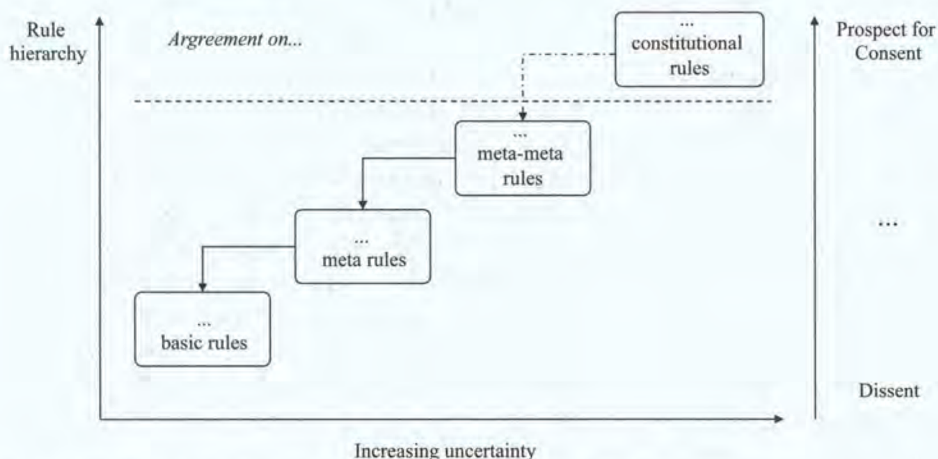

Figure 1: The Societal Rule Hierarchy (adapted from Beckmann 2010: 120)

> As both the generality and the permanence of rules are increased, the individual who faces choice alternatives becomes more uncertain about the effects of the alternatives on his own position. . . . The uncertainty introduced in any choice among rules or institutions serves the salutary function of making potential agreement more rather than less likely. . . . To the extent that a person faced with constitutional choice remains uncertain as to what his position will be under separate choice options, he will tend to agree on arrangements that might be called "fair" in the sense that patterns of outcomes generated under such arrangements will be broadly acceptable. (Brennan and Buchanan 1985: 29, 30)

Third, Buchanan (2000: 224) specifies that any democratic discussion on rule-reform needs to start from the *status quo* with its factual "assignments of individual rights" to each member of the community. More specifically, for Buchanan (2000: 213) democratic consensus on each level of the rule hierarchy is conceptually only possible if the status quo bears some features of Hobbesian anarchy, i.e., if it "represents a social dilemma in the strict game-theoretic terminology." In a social dilemma, the behavior of rational actors "generates results that are desired by neither party, results that can, with behavioral coordination, be changed to the benefit of all parties" (Buchanan 2000: 211). As a consequence, democratic consensus is strictly tied to the common interest in the shared win-win gains of overcoming a dilemmatic status quo.

For Buchanan, this status quo orientation has far-reaching implications: First, taking the status quo as starting point is closely linked to attaching high importance to the *relevant alternatives* at hand, and not to some sort of wished-for utopia (Buchanan 2000: 210). In fact, Buchanan is very clear that the status quo always has to be measured against the relevant alternatives, and the relevant alternatives are not alternative single outcomes but alternative *rule-arrangements*, that is, one or more rules that govern a bundle of single outcomes.

Second, comparing the status quo with the relevant alternatives can be carried out in two different directions: (i) If the status quo can be characterized as a social dilemma, then an alternative institutional arrangement is possible that provides a net benefit for all involved parties and thus meets their common rule-interests. (ii) If the status quo *cannot* be interpreted as a social dilemma, a rule reform does not lead to a net improvement for all parties and, thus, institutional change will meet the resistance of at least one actor involved.

Third, carefully reflecting on the relevant alternatives also allows switching from the concept of *factual* consensus to the concept of *hypothetical* consensus (Buchanan 2000: 213). It is well possible that people have never given their factual consent to each and every rule-arrangement that exists (and persists) in society, or that public opinion has never been subject to empirical investigation (by, e.g., surveys or polls). Yet, it is still conceivable that hypothetical consent is present because people could *in principle* either agree to the status quo or to an institutional reform of the status quo. When comparing the status quo with the relevant alternatives, factual consent can be examined at any point if required.

Yet, finally, the *focus* on the status quo must not be confused with a *preference* for the status quo. Quite the contrary, the search for potentially improvable situations

can be seen as an active contribution to societal learning if this quest helps identify a mutually agreeable win-win potential that would remain undetected otherwise.[2]

The work of James Buchanan thus offers an interesting input for a type II perspective on democracy that does not focus primarily on the organizational aspects of involving people in decision-making processes of common concern, but on the legitimacy dimension of whether people can, in principle, consent to the *rules* that govern such processes. If one follows this perspective, as Homann (1988) does, two conclusions can be drawn.

First, no concrete rule, organizational principle, or process criterion—be it an electoral mechanism, inclusion, etc.—provides legitimacy per se because of its intrinsic democratic qualities. Rather, the type II perspective on democracy highlights that rules gain democratic legitimacy if they are in the interest of the governed and if they are perceived by the governed as such.

Second, the potential for democratic consent depends on the contextual functionality of a concrete rule. Consent is not about a single outcome or about an abstract rule per se: the same rule can lead to different results in different contexts. Contextual functionality thus refers to the embeddedness of any situation in a larger institutional setting. The rule's functionality must be tested and demonstrated in each setting.

The Relationship Between Democracy as an Organizational Principle and Democracy as a Legitimation Principle

Comparing type I and type II perspectives on democracy reveals that a key difference between the two is that they can be located on different levels. The type II legitimacy perspective focuses on the end of democracy—legitimation and consent—and sees progress toward democracy made when people can in principle consent, not necessarily to every single outcome, but to the rules that channel these outcomes. The type I organizational perspective looks at specific organizational means of fostering joint discussion and joint decision-making. It assumes progress toward democracy when more people become involved at higher levels of participation.

Seen in comparison, the organizational model of democracy is a narrower concept that can be subsumed under the more encompassing legitimacy model of democracy—but not vice versa. Participation and involvement can be a means to achieve the end of consent. Yet consent does not provide a means for participation and involvement. To be sure, some people value (their) participation as an end itself; as something that is intrinsically bound up with values such as freedom or self-respect. Yet, if this is the case, then, again, participation is still instrumental for achieving consent because those who value participation in itself would otherwise withdraw their consent from the rule arrangement at hand.

From the more encompassing perspective of providing legitimation, type I democracy is thus a potential means for achieving the ends of type II democracy. This insight has far-reaching consequences. Means are, in principle, ambiguous. Depending on the context, they can be functional but also potentially dysfunctional. By this logic, if mistaken as an end in itself, type I democracy can both overlap but also conflict with the aim of type II democracy. Figure 2 illustrates this relationship. Boxes A

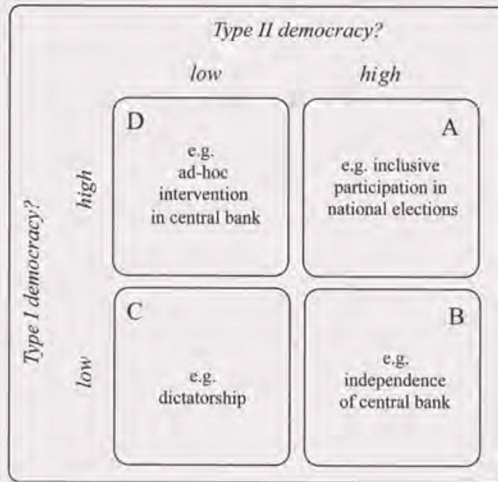

Figure 2: Type I versus Type II Democracy

and C in Figure 2 summarize those cases where the participatory organizational principles of democracy in a type I sense are in line with the type II democracy aim of legitimation through consent because implementing these principles is also functional. Box A captures those cases where implementation of formal participatory organizational principles also increases the potential for consensus, for example, in the case of free, open, and inclusive parliamentary elections. Box C describes the opposite case where the absence of type I organizational principles also decreases the potential for consensus because participation would be in the interest of the excluded. Dictatorship is a simple example of this situation.

The more interesting cases, those in which the aims of type I and type II are in conflict with each other, are shown in Boxes B and D. In Box B, low levels of type I democracy increase the potential for consensus (type II). Vice versa, in Box D, the implementation of type I organizational principles is dysfunctional, leads to undesirable results that make the democratic constituency actually worse off, and therefore reduces the potential for consent. Take the long-running debate about central bank independence (Cukierman 2010). Central bank decisions clearly affect the entire population of a country. In fact, the central bank is supposed to act on behalf of its principal, the population. How can the notion of democracy be applied to this context? From a type I perspective, the answer is simple. If the decisions of the central bank affect the entire population, then it is necessary to implement as many democratic organizational principles as possible into the workings of the bank, such as elections, democratic voting procedures, or plebiscitary elements. An independent central bank violates these organizational principles and is therefore outright undemocratic if judged from a type I perspective (Box B). In terms of type II democracy, however, the picture is very different. Central bank independence is a rule that emerged from the experience that a democratically controlled central bank runs into severe time inconsistency problems that make a credible commitment to inflation control and other monetary principles impossible (Kydland and Prescott 1977; Barro and Gordon 1983). As a result, direct democratic control of the central

bank's single decisions could backfire, create unproductive inflation, and actually make the democratic constituency worse off (Box D). Thus, it might very well be in the population's best interest to create independent and even autonomous institutions—central banks, judicial courts, research institutes, etc.—that are not directly controlled by processes of political involvement. In these instances, reducing type I democracy improves type II democracy. In contrast, dismantling the independence of such institutions for the sake of "democratic control" fosters democracy in a type I sense (existence of nominally democratic procedures), but doing so could very well undermine democracy itself in the more encompassing type II sense. It would weaken social cooperation, make the overall constituency worse off, and therefore erode the potential for consent and thus legitimation of the system.

THE TYPE I DEMOCRACY MENTAL MODEL AND THE NOTION OF STAKEHOLDER DEMOCRACY

The previous section established the distinction between type I democracy defined as an organizational principle and type II democracy defined as a legitimation principle. In this section we use this distinction to examine the rhetoric of the stakeholder democracy debate.

Conventional Corporate Governance from a Type I Perspective on Democracy

The type I mental model defines democracy as normatively desirable principles of organizing matters of collective concern through participation. The quality of participation then hinges upon criteria such as inclusiveness, equality, scope, and frequency of participation. Seen from this type I democracy perspective, corporations and their corporate governance necessarily must appear to be highly undemocratic institutions.

First, in terms of *inclusiveness*, conventional corporate governance gives only managers the authority to make routine day-to-day-decisions, whereas stockholders are the only group included in decision-making about corporate governance, the appointment of board members, and so on. Other stakeholders, such as employees, clients, or NGOs, have no or very little say (e.g., in German *codetermination*) in these decision-making processes. Democratic inclusiveness is thus extremely low from a type I perspective.

Second, corporations appear to be 'undemocratic' when it comes to *equality* of participation. Not only are most stakeholders excluded from formal decision-making processes, even those who are allowed to participate are treated very unequally. For example, democracy in the political arena is based on the "one man, one vote" principle; however, shareholder voting rights depend on the number of shares held. Consequently, size of investment is determinative of degree of participation in a corporation, a situation that a type I democracy concept finds hard to qualify as democratic.

Third, in terms of *scope* of participation, the corporate sphere is again likely to be regarded as 'undemocratic' in a type I sense. To start with, as mentioned by Cutler (2001: 133), "liberal mythology makes the content of the private sphere disappear by defining it out of existence as a political domain. In so doing, liberalism effectively insulates private activity from social and political controls." Or, in other

words, corporations and the market are outside the scope of established democratic procedures. Even those few type I democratic elements, such as voting at the annual shareholder meeting, are limited to a very few decisions, such as the appointment of board members.

Finally, in terms of *frequency*, corporations again seem to fail achieving a significant degree of type I democracy. Only at the annual shareholder meeting are type I democratic organizational principles implemented. In contrast, the political democratic process is characterized not only by regular elections but also by frequent democratic voting within political parties, parliamentary committees, and during the legislative process.

In short, if one understands democracy from a type I perspective and defines its essence (a) in terms of concrete organizational principles for participation as well as (b) in terms of the quality of these principles' implementation, corporations will be viewed as highly 'undemocratic.' Proposals for increasing stakeholder democracy are then likely to single out some of these organizational principles and to make the case for governance reforms aimed at integrating these type I democratic organizational principles into the corporate context (see, e.g., Dahl 1985: 111 et passim; Pateman 1970; Brenkert 1992; McCall 2001; Moriarty 2012).

The next section shows how this type I thinking influences much of the stakeholder democracy rhetoric.

The Type I Mental Model of Democracy in the Stakeholder Democracy Rhetoric

There is no single perspective on stakeholder democracy; the literature on this topic takes diverse, often conflicting, perspectives. Nevertheless, this section shows that much of the stakeholder democracy debate implicitly builds on a type I mental model of democracy that highlights specific "democratic" organizational principles.

For example, in their introductory article for a special issue on stakeholder democracy, Harrison and Freeman (2004) see *participation* as the cornerstone of stakeholder democracy and state (p. 49, emphasis added): "Democracy means that members of an organization or society *participate* in processes of organizing and governance." Participation is then defined as an organizational principle that allows people to *actively influence decision-making processes*. Defining participation as actively influencing decision-making thus sets up a clear yardstick against which to assess degrees of democracy. As Harrison and Freeman elaborate:

> [A]ny action, structure, or process that increases the power of a broader group of people to influence the decisions and activities of an organization can be considered a move toward democracy. In contrast, any action, structure, or process that works to concentrate decision power and management influence into the hands of one or a smaller group of people is a move away from democracy. (Harrison and Freeman 2004: 49)

In a similar vein, Matten and Crane, also in an editorial for a special issue, define stakeholder democracy in terms of the organizational principle "that stakeholders participate in processes of organizing, decision-making, and governance in corporations" (Matten and Crane 2005b: 6). In likewise fashion, O'Dwyer emphasizes the

idea of "democratization through participation" (O'Dwyer 2005: 30). For O'Dwyer, participation and thus democracy consists of direct involvement in corporate decisions and therefore focuses on "processes enabling stakeholders to have a 'say' in organizational decisions impacting on their lives." (O'Dwyer 2005: 29). Following the same pattern, Driver and Thompson define the essence of "firm democracy" as promoting "the interests of those traditionally excluded from any say in the organization of the firm" and look at how these "interests could be incorporated into the firm's decision-making structure" (Driver and Thompson 2002: 121). Accordingly, Thompson (2005: 146) discusses organizational participation in terms of an "explicit role for other stakeholders directly in corporate decision-making" and views this as a move toward "corporate democracy" that could be directly promoted through changes in corporate governance structures "to include overt stakeholder involvement" (Thompson 2005: 138). Scherer, Palazzo, and Baumann also make the case for participation in their demand for "the democratization of corporate activities through continuous discourse participation and enlarged mechanisms of transparency, monitoring, and reporting" (Scherer, Palazzo, and Baumann 2006: 520). Finally, Schneider and Scherer underline that "the notion of stakeholder democracy . . . emphasizes the importance of democratic participation in corporate decision-making" (Schneider and Scherer 2010: 22).

In short, at a very general level, much of the stakeholder democracy debate defines democracy in terms of the basic organizational principle of participation and then transfers this organizational principle from the political sphere to the corporate context and, in particular, to the context of organizational decision-making.

One consequence of this perspective is that the quality or degree of "corporate democracy" hinges on whether it lives up to what scholars define from their specific perspective to be the "ideal" organizational standards for participation. Following this logic, O'Dwyer (2005: 29, emphasis added) maintains that his discussion of organizational process criteria provides "*a framework for assessing the level of democracy*" in corporations. Since participation is seen as the hallmark of democracy, O'Dwyer (2005: 30) argues that the degree of democracy depends on organizational criteria, such as the "extent of participation," on the principle that "contributions are equally valued," on "representativeness," and on the "degree of influence," used to compare the real-life corporation against the "'ideal' of a more participative democratic form" (O'Dwyer 2005: 31).

In her piece on stakeholder democracy in global governance processes, Bäckstrand (2006) similarly looks at representation and accountability as quality standards for participation and thus democracy. Likewise, Gray, Dey, Owen, Evans, and Zadek (1997) discuss the degree of stakeholder representativeness (inclusiveness of participation) and influence (scope of participation) as determining the quality of democratic accountability.

Other attempts to specify the essence or quality of corporate democracy in terms of general organizational principles include the four criteria put forward by Courpasson and Dany (2003) that highlight once again, among other criteria, the principle of equality. In a more critical piece, Kerr (2004: 84) summarizes four organizational

principles in the implementation of participation, including equality and inclusive representation.

To "enhance democratic control over corporate action," Scherer and Palazzo (2007) also focus on general organizational features, highlighting the "importance of democratic procedures" (Scherer and Palazzo 2007: 1114). Similarly, Scherer, Palazzo, and Baumann (2006: 520) discuss stakeholder democracy in terms of the "application of standards of democratic deliberation outside governmental institutions." In this vein, Scherer and Palazzo (2007: 1114) argue that democracy needs to be measured against "deliberative criteria such as broad participation." Again, participation is seen to be the essence of democracy, with the consequence that more democracy can be achieved only by broadening participation.

However, *who* should be allowed to participate? For O'Dwyer (2005: 28), it is those stakeholders whose welfare is impacted by the decision. Drawing on Young's (2004) idea of social connectedness, Schneider and Scherer (2010: 26, emphasis added) make the case for corporate governance reforms that (a) "secure corporate accountability to all those affected by corporate action, *even indirectly*" and that (b) allow "for the influence of these stakeholders on organizational decision-making" (for a discussion of stakeholder influence, cf. Phillips 2003). Again, the degree of democracy is defined in terms of the organizational principles of broad and maximally inclusive participation.

Interestingly, it is not only the proponents but also the critics of stakeholder democracy who take a type I perspective on this issue (see also Henderson 2004: 76). In his classic essay, Milton Friedman (1970) strongly condemns a stakeholder orientation for the firm—doing so "on grounds of political principle" that evoke type I notions of democracy. Friedman (1970: 122) argues that if managers are to act in a socially responsible way, "they must be elected through a political process"—a point that resonates with stakeholder democracy proponents such as Scherer and Palazzo (2011: 907). Friedman, too, thus seems to focus primarily on organizational principles in a type I sense and maintains that corporations lack democracy in this regard. At the same time, however, Friedman (1970: 122) also explains his notion of democracy in type II terms by stressing that the purpose of the democratic process is to make decisions "so far as possible in accordance with the preferences and desires of the public"—thus pointing to the importance of the consent of the governed.

The only article we found in our literature review that explicitly departs—at least partially—from a type I democracy perspective is the interesting piece by Gomez and Korine (2005). The starting point for their article is the question of under which conditions stakeholders can *consent* to a regime of corporate governance. Just like in our type II perspective, Gomez and Korine (2005) then treat democratic procedures as a *means* to achieve the *end* of consent. More specifically, they (Gomez and Korine 2005: 740) "highlight the critical role played by the procedures of democracy in achieving consent by the governed."

This idea of defining democracy as the legitimation principle of consent is the exception to the rule in the literature, however; stakeholder democracy is widely measured and discussed in terms of participation and subsequent organizational principles that view certain process criteria as inherently valuable. Scherer and Palazzo

(2011: 916), for example, claim that "the ideal conditions of a power-free discourse" can serve "as a normative yardstick for the democratic quality of . . . private actors."

Measured against these "democratic" ideals and procedural principles such as representation, inclusiveness, equality, power-free discourse, elections, majority votes, etc., many authors deplore the "democratic deficit" of corporate decision-making (O'Dwyer 2005: 36; Scherer, Palazzo and Baumann 2006: 519; Scherer and Palazzo 2011: 907), but as Matten and Crane (2005b) point out, these "commentators from a business perspective appear to be fairly certain as to what 'democracy' actually means and how it would translate into an organizational context"—even though doing so could be highly problematic. Against this background, Kerr (2004: 81) sees much of the stakeholder democracy debate as standing on shaky conceptual ground because the transfer of organizational principles from "political democracy provides little guidance for organizational democracy." Kerr (2004: 82) concludes that a misguided notion of democracy "distorts our thinking and colors our expectation of what democracy in organizations should look like and how it should work." For Kerr (2004: 82), one of the roots of this problem is the "lack of clarity regarding the essential elements of democratic process." We take a slightly different perspective, and believe that the problem is not that too little attention is given to "essentially democratic" organizational principles, but that these organizational principles are often seen as an actualization of democratic legitimation, while in fact they are possible instruments for achieving it. Therefore, we want to point to the danger of confounding ends with means.

THE TYPE II DEMOCRACY MENTAL MODEL AND THE NOTION OF STAKEHOLDER DEMOCRACY

Much of the stakeholder democracy rhetoric treats type I democracy organizational principles and their adaptation to the corporate context as having an intrinsic democratic value. From a type II democracy perspective, in contrast, type I democracy organizational principles constitute a potential means for building institutional arrangements that create conditions for democracy as legitimation through consent. Whether type I democracy organizational principles actually promote democracy in the wider type II sense, therefore, depends on their functionality in a given context.

The following section takes the wider type II democracy perspective in critically discussing the type I organizational principles put forward by stakeholder democrats. The key insight is that these governance proposals are highly ambiguous: they can indeed improve institutional functionality and strengthen type II democracy in some specific contexts, but they actually erode accountability and are not in the best interests of the democratic public in many other situations.

Functional Applications of Type I Democracy

The type I democracy model demands that numerous supposedly democratic mechanisms, such as participation through elections, representation, and voting, be applied to the corporate context. Instead of discussing all these mechanisms in detail, we will

use two examples to show that the implementation of such type I proposals can be functional and thus also promote type II democracy under specific circumstances.

(1) A widely discussed concept in the stakeholder democracy debate is the idea of co-determination. Typically, the term "codetermination" refers to specific provisions in the German legal system of corporate governance that require publicly held corporations to constitute employee representation on supervisory boards (cf., e.g., Boatright 2004: 1). In this paper, however, we use the term "codetermination" in a much wider sense to include not only employees but also other stakeholders in corporate decision-making, thus implementing type I notions of equal participation and collective self-governance.

An example of codetermination is when firms are organized as partnerships. In a partnership, all partners own the firm, have equal status and thus participate collectively in the firm's governance. This type of "codetermination" can work very well for small groups (Campbell 2006: chap. 4). Figure 3 (p. 548) illustrates the underlying logic. Forging a partnership brings both advantages (A) and disadvantages (D). Advantages accrue if team production creates a higher yield than the sum of individual production efforts. However, in general, one can assume that the marginal benefits of additional team members decline with increasing group size, which is why the concave curve A flattens. Disadvantages arise due to two effects. First, there is an incentive problem. Without partners, a self-employed producer receives the full return on his or her work effort. With partners, the returns of one's effort are divided among the group so that the individual bears the full work burden but receives only 1/n of the yield. Second, although this incentive problem can be overcome when homogenous partners monitor their peers' work effort and quality, with increasing group size the partners will run into other problems of collective action (Olson 1965, Buchanan 1965). The combination of these two effects results in the convex curve D that has a progressively steep slope. Figure 3 thus illustrates why, in the real world, we observe partnerships of only relatively small group size (n_{opt}), and why bigger groups tend to change their form of corporate governance, usually by introducing employer-employee relationships, thus reducing elements of type I democracy.

(2) Within a corporation, codetermination can take the form of a labor democracy where workers participate in decisions about the production process. Under what conditions will this type of co-determination be functional for a capitalistic firm? We develop an answer in two steps.

(a) According to Boatright (2011), the conventional model of shareholder-oriented corporate governance rests on three basic premises: first, that only shareholders bear residual risk; second, that corporate decisions mainly affect shareholders; and third, that only explicit, not implicit, contracts matter in corporate governance. These assumptions are based on the idea that other stakeholders, such as employees, suppliers, and debtors, can secure their interests through contracts that fix the return on their investment in the firm, whereas shareholders cannot. If stakeholders are no longer satisfied with these cooperative deals, they can simply leave the cooperation and make use of an exit strategy (Hirschman 1970).

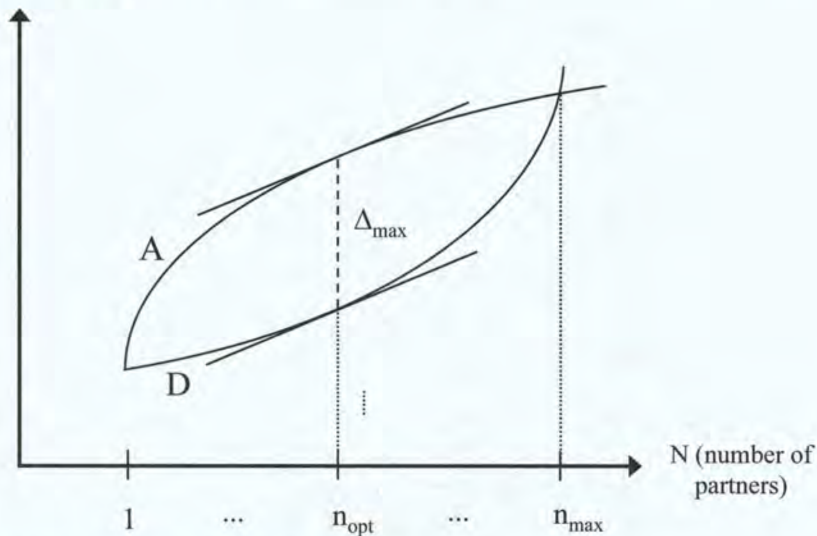

Figure 3: Advantages and Disadvantages of a Partnership

(b) In the modern knowledge economy, however, these assumptions no longer necessarily hold (Zingales 2000). Firm-specific investments may result in a situation where other stakeholders, such as employees, suppliers, or even clients, might bear substantial residual risk and be highly affected by corporate decisions as explicit contracts fail to cover the complexity of knowledge-intensive cooperation (Blair 1999, Blair and Stout 1999). Since specific investments create the problem of hold-up (cf. Klein, Crawford, and Alchian 1978; Williamson 1985), these stakeholders might be discouraged from fully investing in intra-firm cooperation in the first place. The consequent problem of underinvestment, however, leaves all members of the firm worse off. Figure 4 illustrates why, in such a setting, codetermination might be in the joint interest of all parties involved. Without codetermination, employees may fear that the firm will exploit their specific human capital investments. The emergent equilibrium (squared solution) would amount to a Pareto-inferior solution that harms not only the employees but also the firm.

In this situation, "democratizing" corporate decision-making by including non-shareholding stakeholders in corporate governance processes might safeguard their specific investments. Since exit options are less feasible because of specific investments, codetermination establishes a mechanism of "voice" (Hirschman 1970) that can be used to safeguard these specific investments, thus creating an arrangement that encourages mutually beneficial cooperation (circled solution). Under these circumstances, the type I democracy notion of codetermination does indeed contribute to a social arrangement that better reflects the interests of all stakeholders, improving acceptance of corporate governance and thus type II democratic quality.

Dysfunctional Consequences of Type I Democracy

The previous section showed that context-sensitive application of certain type I democracy organizational principles can be functional. In this section, we show that a general, context-insensitive, application of these principles may lead to undesirable outcomes that undermine democracy in the wider type II sense and therefore call for a careful situational analysis of the relevant social structures. We offer three simple applications to illustrate this point.

(1) As argued above, "codetermination" in the form of partnership democracy can improve the basis for type II democracy under certain conditions, particularly for small firms, because the principle of participation proves functional. The review above, however, showed that according to many stakeholder democrats, participation is itself essential for democracy, and that further democratization requires participation to be as inclusive, as equal, and as substantial as possible. Viewed from this type I perspective, applying partnership governance to as many firms as possible would promote democracy.

Yet, Figure 3 reveals that partnership governance is an ambivalent means to this end. While it proves functional for small groups, it can leave bigger groups actually worse off ($n > n_{opt}$) and ultimately even prove to be unviable ($n > n_{max}$). As the curves illustrate, the disadvantages of partnership governance increase more with group size than do its advantages. This situation occurs because the problems of collective action, shirking, incentives, etc. affect bigger groups more than small groups. As a result, the net effect of partnership governance for big firms is a drastic reduction of organizational performance. Campbell (2006: chap. 4) provides numerous empirical examples in support of this point, some of which involve Yugoslavian workers-owned companies and East German collectively owned and operated firms.

It is important to keep in mind that reduced organizational performance *per se* neither increases nor reduces democracy. What actually counts from a type II de-

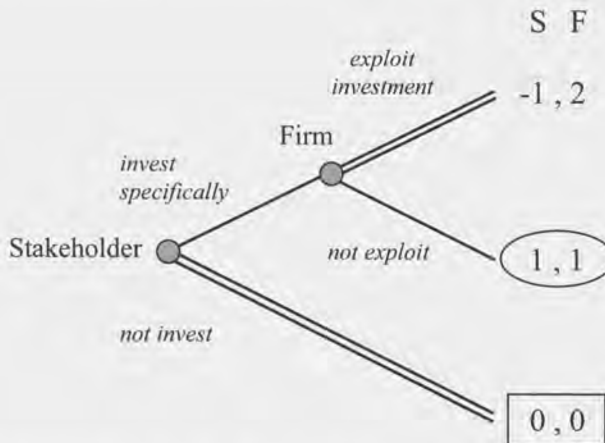

Figure 4: Specific Investments and the Resulting Hold-Up Problem as a One-Sided Dilemma

mocracy viewpoint is whether the people governed by this arrangement can or could, in principle, consent to it. However, given that drastically reduced organizational performance results in drastically lower returns for each democratic partner, consent might erode. Moreover, switching to an alternative governance arrangement that improves organizational performance and that results in higher returns for every member of the firm could be generally acceptable and receive democratic consent. Historically, this is what largely happened with the emergence of the owner-manager firm. Here, workers give their deliberate consent to renouncing participation rights by entering into—voluntary!—contractual relationships with the firm. As a result, *capital hires labor* and capitalists, as single owners of physical (machine) equipment, divide the rent of joint production among each other and leave workers a fixed contractual income (Campbell 2006; Leijonhufvud 2007: 10, 11).

In principle, any stakeholder group could *bargain* for corporate control and, as Boatright (2014: 178) put it, "make its interests the objective of the firm." That is, workers can deliberately decide to become capitalists themselves. Labor can also hire capital. Yet despite widespread claims for stronger employee participation rights in corporations (Dahl 1985, Pateman 1970, Brenkert 1992 or McCall 2001), worker-owned companies empirically remain a rarity compared to capital-owned firms. Why is this so? The following four factors can explain why worker ownership is rather the exception than the rule in the industrialized economy (for a discussion cf., e.g., Hansmann 2000: 1–52, McMahon 1994: 262–284; Boatright 2004; or Bainbridge 2008: 37–60):

- First, assume workers own a factory collectively and their team production determines the overall output of the firm. However, each workers' contribution to team production is costly to observe and, thus, team members have an incentive to shirk (cf. Alchian and Demsetz 1972: 779 et passim). In principle, a monitoring specialist could incur the costs to reduce shirking by determining his colleagues' individual efforts. Yet, she would lack the incentives to do so if only paid a fixed salary, because an increase in marginal team production would not result in higher remuneration. In addition, ineffective monitoring involves further adverse effects, because workers will also have an incentive to overuse resources, and they will reduce maintenance efforts for factory equipment. Thus, a worker-owned company will typically face difficulties in maintaining high productivity. A solution is to give the monitoring specialist an additional right to residual revenues as owner, which will increase his incentives to monitor effort levels more effectively.
- Second, although the rarity of employee ownership is commonly explained with insufficient wealth of workers to finance machinery for joint production, it is not a strong argument. Workers could simply borrow the money. Yet, this option is quite unattractive due to the incentive problems associated with monitoring the effort levels and the use of assets. To cover the costs for the associated risk, lenders will typically demand a premium, leaving worker-owned corporations with a competitive disadvantage vis-à-vis capital-owned firms.

- Third, low risk levels taken in labor-owned companies aggravate the problems associated with external financing. Workers with limited wealth are usually more risk-averse than shareholders who are able to diversify assets to reduce the overall risk of their portfolio. Due to a lower capability of diversification, workers will usually take a lower level of risk than shareholders will do in their firm (Gintis 1989). Again, this translates into lower productivity and higher capital costs for labor-managed firms.
- Fourth, collective action by workers faces another incentive problem: While shareholders are united in the goal to maximize profits, employees pursue multiple ends, including job satisfaction, personal development, and compensation. Yet, maximizing a single objective as in the shareholder-controlled firm may be superior because optimizing on multiple goals increases decision costs (Jensen 2002) and indeterminacy (Hansmann 2000).

Taken together, all four factors provide an explanatory background for why workers may (and actually do) deliberately opt *against* ownership and *for* a contractual relationship with a firm: In many cases, the workers' individual cost-benefit ratios for firm ownership simply seem to be highly unattractive, resulting in capital ownership to be the "least-cost assignment of ownership" with "welfare-maximizing" features for all involved parties (Hansmann 2000; Boatright 2004: 16; for a critical account of this view, cf. Heath 2011).

In short, participation for all reduces under certain circumstances the efficiency of the joint endeavor. Firms who depart from full participation can therefore offer higher wages, lower prices, or better products etc. to stakeholders willing to forgo participation rights. In a free market, workers who, as Boatright (2004: 5) put it, prefer "non-democratic firms for the sake of higher wages" are then free to choose to work for a company without full-fledged participation, thus generating legitimacy for this arrangement through their voluntary consent. In other words, participation may well produce many different "goods," not only material goods such as high wages but also immaterial goods. Accordingly, some workplace democracy proponents argue that democratic participation has an inherent value for the ends of achieving, e.g., a reduction in political coercion (Dahl 1985), personal dignity and individual freedom (Brenkert 1992; McCall 2001) or self-respect (Hsieh 2008; Moriarty 2009; Hussain 2012; Blanc and Al-Amoudi 2013). However, the participatory technology can also limit the production of specific goods. In such cases, workers are free to choose between alternative institutional arrangements. Faced with the option of a well-paid job in a hierarchical firm or a not-so-well-paid job in a self-run worker cooperative, many prefer the former over the latter. Their voluntary consent thus contributes to the legitimacy of the capitalistic firm.

Our perspective differs from the view held by Harrison and Freeman (2004: 49). They argue that "any action, structure, or process that works to concentrate decision power and management influence into the hands of one or a smaller group of people is a move away from democracy." We disagree. Although it is true that concentration of decision power reduces type I democracy, it is also true that such concentration can be so efficient and mutually beneficial that it meets the consent

of all parties involved, thus increasing type II democracy. We conclude that it can be *democratically* desirable to renounce participation rights if all members, and particularly those who delegate their rights, are actually made better off by this delegation and therefore approve of it. Clinging to type I notions of democracy in such circumstances leaves people worse off, decreases their ability to consent to their organizational governance, and thus undermines democratic legitimacy.[3]

(2) The second application looks at the claim in the stakeholder democracy debate that "all those affected by corporate action, even indirectly" (Schneider and Scherer 2010: 26) should be allowed to have a say in corporate decision-making (O'Dwyer 2005). Again, as in the example of specific investments above, giving "voice" to those affected by corporate decisions can be a functional governance solution that promotes consent and democratic acceptance under certain circumstances. Yet, taken as a general rule prescription, the problem is that such "a move toward democracy" (Harrison and Freeman 2004) might erode functional governance arrangements that are actually in the interest of the general public.

To illustrate, let us look at a few examples outside the corporate realm. Should students in a university participate in the grading process? If the right to participation hinges on personal impact, should students have a bigger say in their own grade than they do in other students' grades? In the judicial system, should a plaintiff be allowed to participate in determining the verdict? Should politicians be allowed to decide what the press writes about them as they are heavily affected by press coverage? Should research institutes include oil corporations in the decision-making process for reports on global warming because the results may impact the oil companies?

Absurd? Well, yes, but the examples make an important point. In each case, the decision-making may influence stakeholders that are not represented in the process. Yet, at the same time, we are typically less inclined to label these situations as outright undemocratic. Why? One reason, and an important one, is that we understand that the independence of these institutions—schools, courts, media, research institutes—is important, not only for the "privileged" decision makers in each institution, but for society at large and also for those "excluded" from participation such as students, citizens in court or the democratic political players. For this reason, the seemingly "undemocratic" (type I) independence of these institutions can be democratically justified because its functionality earns society's consent (type II). Dismantling such governance arrangements in an effort to "democratize" them could very well erode democracy in a wider sense.

By analogy, the same problem arises if the organizational principle of inclusive participation is applied to the corporate context and destroys important corporate functions that the democratic public would prefer to remain undisturbed. Should competitors be allowed to participate in decision-making about an innovative technology? After all, according to Young's (2004) idea of social connectedness as presented by Schneider and Scherer (2010), they would be heavily affected by such decisions. Should purchasers be able to decide on the price of products? Workers decide on their wages? Banks decide on the terms of their loans? Suppliers decide on their contracts? In all these cases, a type I democratization would erode a corporation's function to innovate, to allocate scarce resources effectively, and so forth, and would

lead to severe problems in terms of higher transaction costs and huge premiums on rent-seeking activities (Murphy, Shleifer, and Vishny 1993).

Yet, this argument in favor of the potential functionality of established governance mechanisms does not mean that the *status quo* of corporate governance is sacrosanct. In fact, as processes of value creation change, non-shareholding stakeholders might require novel "voice" mechanisms to sustain and encourage their specific investments in human capital, specific machinery, infrastructure, etc. As already shown in Figure 4, these stakeholders would otherwise refrain from their productive investments, thus leaving everybody worse off. This perspective also explains why universities typically include student representatives in their examination boards: while students do not participate in the actual grading process, they participate in devising fair grading rules that safeguard their specific investments into university (Kreps 1990).

(3) The third application relates to the discussion about democratizing the 'political role' of the firm in so-called new governance processes. Referring to Habermas's (2001) "post-national constellation," Palazzo and Scherer (2006), Scherer and Palazzo (2007, 2011), Scherer, Palazzo, and Baumann (2006), as well as Schneider and Scherer (2010) highlight that democratic governments increasingly lose their ability to regulate, thus requiring corporations to transcend their purely economic role and to take on a distinct political role. Yet, when arguing that this novel political role needs to be 'democratized,' these authors present two different approaches. On the one hand, when discussing the role of companies in prominent global governance initiatives such as the Forest Stewardship Council (FSC), Scherer and Palazzo (2007: 1110) focus on type I democracy properties of the *societal* discourse and are very clear that democratic accountability does *not* require "[inviting] stakeholders into [firms'] internal decision-making processes." On the other hand, Scherer, Palazzo and Baumann (2006: 520, emphasis added) maintain that companies need to open up their "*internal* structures and processes [to] public control" to overcome an alleged "democratic deficit" of global governance, thus seeking to apply type I democracy within the firm.

We agree with Scherer and Palazzo's (2007) contribution that corporations are well advised to prepare for a more active role in political processes. The regulatory problems these authors focus on concern the rules of the game at the level of the market, for example, setting fair standards for the use of natural resources on a global level. Therefore, the *internal* democratization of an individual firm's corporate governance fails to solve this industry-wide issue because the industry is of a collective nature. What is needed is a "democratic" procedure for global governance processes: that is, joint rule-finding and rule-setting processes that are governed by rules to which companies, states, and civil society organizations can in principle consent. It depends on the relevant alternatives whether type I principles of inclusive participation that bring together civil society, public, and business actors prove functional in this regard.

Moreover, the internal "democratization" of the business firm also runs the danger of undermining the ability of established democratic mechanisms to publicly control business firms. Stakeholder democracy proponents argue that corporate decision-making should move away from the allegedly one-dimensional corporate

profit motive. The profit principle, however, is arguably the most powerful mechanism democracy can employ to hold corporations accountable. Not only does the profit principle subordinate corporations to consumer sovereignty (Hutt 1940), as "the market is a democracy where every penny gives a right of vote" (Fetter 1905: 394). The profit principle also provides a powerful lever that democratic societies can employ to motivate corporate activity in the direction of democratically desirable goals. To illustrate, many governments levy taxes on fossil fuel consumption in an effort to reduce pollution and to slow global warming. Yet, this democratic tool will work only if companies have a profit motive. If companies no longer try to make a profit, but instead base their decisions on diverse and highly idiosyncratic stakeholder interests, democratic governments—no matter at what level they operate—will find it much harder to effectively regulate an industry. As a result, type I democracy at the corporate level could erode type II democracy at the market level and thus damage society at large.

CONCLUSION AND IMPLICATIONS

Should corporations be run according to democratic principles? This essay in conceptual clarification argues that the answer to this question depends on the mental model of democracy one chooses.

We distinguish between two related, but fundamentally different, mental models of democracy. The first—type I—defines democracy in terms of "democratic" procedures such as participation, elections, voting, and the like. The second—type II—defines democracy in terms of the legitimation concept of factual or hypothetical consent. The distinction is whether the governed are actively involved in governance decisions (type I) or whether they can agree to a governance structure (type II) because it serves their interest.

Both mental models are closely related because democratic procedures (type I organizational principles) can be used as a "means" of achieving the "end" of democratic consent (type II legitimacy). In the debate over stakeholder democracy, however, type I organizational principles are rarely viewed in this way, and are generally mistaken for democratic legitimacy itself. This is problematic because type I democratic organizational principles such as equal and inclusive participation, though functional under certain circumstances, can be dysfunctional under others. When they result in leaving stakeholders worse off, the application of type I democratic principles may ultimately decrease the basis for consent and thus erode type II democracy.

The goal of this paper is to shift the debate about democratizing the firm away from a narrow type I democracy model toward the broader consent-oriented type II democracy model. We contend that such a shift is necessary to rescue the idea of democracy from well-meant but inappropriate type I notions of stakeholder democracy. We now illustrate some implications of this change in perspective in providing an answer to three key questions in the debate on stakeholder democracy:

(1) Do corporations need to be democratized to secure their legitimacy?

From a type I perspective, capitalistic firms are perceived as undemocratic, and thus need "their internal structures and processes . . . to become more democratic" (Scherer, Palazzo, and Baumann 2006: 517). Democratization then requires giving diverse stakeholders meaningful say in corporate decision-making. Proponents of type I stakeholder democracy argue that such democratization creates a higher form of legitimacy (or, in Suchman's (1995) terms, "moral legitimacy") through discourse.

From a type II perspective, in contrast, dismantling tried and tested corporate governance arrangements runs the risk of drastically decreasing organizational performance—which ultimately harms all stakeholders, runs against society's interest in functional firms, and thus reduces the basis for consent. As a result, such a "democratization" of the firm would drastically undermine what Suchman (1995) refers to as "pragmatic legitimacy." The fundamental justification of the capitalistic firm as a governance structure is that it creates value and thus benefits its stakeholders and society at large. If the ability of productive value creation is eroded, the most important pillar of corporate legitimacy is bound to collapse.

What are the implications of type II democratization of the firm? First, firms can benefit from carefully scrutinizing the functionality of their governance arrangements—and from reforming them where unproductive conflicts limit social cooperation. This applies not only as regards the internal mechanisms of corporate governance, but pronouncedly so also the new governance mechanisms that corporations are engaging in to fill the gap of nation-state governance on a global level (cf. Scherer and Palazzo 2007, 2011, Boatright 2011). Due to the complexity of these issues, corporate decision makers need to know, understand, and communicate with their stakeholders. Stakeholder dialogue is crucial, not as an end in itself but as a means *to improve the functionality* of corporate governance and, increasingly, the contributions of business firms to global governance. Admittedly, one cannot assume corporate decision-makers to be driven benevolently to consider the interests of their stakeholders per se, but we believe there is much room for mutually agreeable governance initiatives that benefit both the corporation and its stakeholders by overcoming social dilemmas (Pies, Hielscher, and Beckmann 2009; Pies, Beckmann, and Hielscher 2014). Second, firms need to engage in stakeholder dialogue so as to *explain* the functionality of their specific corporate governance and decision-making procedures. The importance of this point cannot be overemphasized. If democracy is about the consent of the governed, then it is not enough that scholars, corporate managers, or other third parties understand and value the functionality of governance arrangements; if and only if the different stakeholders themselves perceive and value that a governance rule is also in their interest, can they consent to and attach legitimacy to it. To say it again, stakeholder dialogue is crucial—not only to gain moral legitimacy, but to sustain pragmatic legitimacy. It is our perception that most corporations are doing a very poor job in this area. Managers seem ill equipped to explain the normative relevance and democratic quality of many market and corporate rules that benefit not only their shareholders, but even more importantly, their other stakeholders and the democratic public at large.

(2) Can the democratization of the business firm increase the accountability of capitalist markets?

Proponents of type I stakeholder democracy argue that "there is apparently no less fundamental way than the democratization of corporate governance . . . to maintain the legitimacy of corporations and of the system of market-economy" (Schneider and Scherer 2010: 33). We contend, however, that type I democratization runs the risk of creating the opposite effect. If dysfunctional organizational principles undermine the functionality of corporations *and* the ability to control companies via profit incentives—be it through consumer action or government regulation—then the accountability of capitalist markets will not be improved but impaired.

In contrast, democratization in a type II sense—that is, win-win oriented governance reform *and* discursive explanation—will not only improve the basis for consent to the market system, but a more sophisticated debate about the functionality of alternative governance arrangements will enrich and stimulate much needed learning processes for better global governance solutions.

Against this backdrop, it might be informative to take a potentially fresh look at the firm as a corporate actor in competitive markets. If considered from a type I democratic perspective, business firms appear to be outright undemocratic because they involve typically no participation or voting schemes for constituencies other than the equity owners. Yet, from a type II perspective of democracy, one can take a step back and interpret the market itself as a forceful participatory mechanism that brings about the firm to be established as a voluntary arrangement to which all stakeholders can give their consent: Capital owners decide to claim firm ownership in exchange for rights to residual returns; workers, suppliers and even consumers decide to renounce ownership rights and enter into contractual relations with the firm. All these decisions take place on a market that allows for broad participation and "democratic voting" of each market participant—be it as consumer or as employee. Hence, from a type II perspective of democracy, an argument can be advanced that type I democratic procedures on the *level of the market* result in the firm as a complex set of voluntary transactions (e.g., as nexus of contracts) that meets the requirement of type II democracy, precisely because some market participants deliberately claim and others voluntarily renounce their participation rights on the *level of the firm*. Thus, from a type II perspective of democracy, it is misleading to argue that "[i]f democracy is justified in governing the state, then it must also be justified in governing economic enterprises" (Dahl 1985: 111). This argument assumes that there is no real difference between economic and political organizations. Yet in a liberal democracy, economic and political organizations serve different purposes: Political organizations are bound to provide legitimate procedures for the provision of *public* goods, including adequate rules for a functioning market competition. In contrast, the role of economic organizations is to serve the general public by providing *private* goods. For strong reasons, this function is not based primarily on a collective formation of will but on individual decisions of market participants, including both purchase decisions and decisions to opt for or against the ownership of the means of production.[4]

Interpreting the market as a powerful mechanism to produce consensus brings with it another interesting implication. Since consensus in a market economy is closely linked to the possibility to choose freely among various institutional arrangements, it remains an important task to make sure that stakeholders de facto have a substantial

capacity to choose. In fact, the capacity of workers, but also of other stakeholders, to choose can be seriously limited by inadequate education and training resulting in low human capital endowments and information asymmetries or by local monopolies and cartels involving dysfunctional dependencies in working relationships. While providing the rules for a functioning market competition is traditionally assigned to state governance, the capacity of nation states to live up to this role is declining with the rise of global governance challenges (Scherer and Palazzo 2007). Insofar as the resulting "governance gap" drastically limits the "exit" opportunities of market participants, consensus might also require that firm stakeholders be given adequate "voice" in relevant areas of corporate decision-making to encourage or maintain their specific investments.

(3) Finally, should there be limits for the democratization of the firm?

In the literature, some scholars maintain that there is "a genuine trade off between efficiency and democracy" (Driver and Thompson 2002: 121). Along these lines, Thompson (2005: 147) warns of the "danger of promoting 'excessive' democracy. There is always a trade-off between democracy and efficiency." He concludes: "Thus one should not always worry about the charge of not being democratic enough. Just like everything else, there must be limits to the extent of democracy." In a similar vein, Harrison and Freeman (2004: 52) agree that democracy and efficiency can conflict and conclude that, as a consequence, "organizational democracy should be pursued only if there is some practical or economic rationale for doing so." Democracy is, then, subordinated to the prerequisite of efficiency.

We contend that this kind of trade-off thinking is closely linked to the type I mental model of democracy. Narrowed down to the organizational principle of participation in decision-making, democracy must conflict with efficiency in those instances where type I democratic procedures are dysfunctional and not in the interest of the governed. Therefore, a type I process of continuous democratization has its limits.

In contrast, from a type II perspective, we disagree with the assumption that there "must be limits to the extent of democracy" because of a tradeoff with efficiency. Instead, we suggest that there are no limits to a continuous process of democratizing the firm and the market. If democratization is about improving governance functionality and increasing awareness of common interests, there is always room for innovation, learning, and improvement. We believe that the type II notion of democracy put forward in this paper provides a better heuristics for such learning processes because it clearly distinguishes between ends and means and thus avoids unproductive conflicts between democracy and efficiency. From a type II perspective, there is no need to subordinate democracy to efficiency; rather, efficiency is instrumental for democratic legitimation.

(4) So, should corporations be run according to democratic principles? From a type II perspective, our answer is yes. Yet, we concede that much more conceptual learning is needed to better understand how type II democracy can be interpreted, applied, and improved in the corporate and market context. As Dryzek (2000: 135) famously argued, "experimenting with its meaning constitutes an essential part of democracy itself." Against this background, we hope that this essay in conceptual clarification stimulates fruitful experiments in theory and practice.

NOTES

1. We gratefully acknowledge the constructive reviews by three anonymous reviewers as well as the valuable guidance by the editors on an earlier version of the manuscript.

2. Consensus as understood here is a strictly *formal* criterion that refrains from a *material* definition of what is good or desirable. Instead of specifying criteria for evaluating the actual content of an outcome, Buchanan (2000: 210) defines "as "good" that which emerges from agreement among free men, independent of intrinsic evaluation of the outcome itself." Conceptually comparing John Rawls with James M. Buchanan, Rawls develops a theory of justice to evaluate the institutional structure of democracy, whereas Buchanan develops a consent-based theory of democracy in order to evaluate the justice of institutional rule reforms. Seen in this light, the Rawlsian approach is more static and tries to define material criteria for what is fair, while Buchanan's approach is more dynamic and remains, at the same time, purely formal since it focuses on whether, given the status quo of a problem at hand, citizens *could* give their consent to an institutional reform. Furthermore, while Rawls works with highly idealized concepts—e.g., assuming strict equality behind a veil of ignorance—Buchanan (2000: 221) is both much more radical and pragmatic in his theoretical approach since he compares real-life alternative situations, assuming "persons who are not equal at the stage of deliberation and who are not artificially made to behave as if they are."

3. This is exactly why Buchanan puts ultimate importance on the rules of democracy and the relevant alternatives to them and, at the same time, completely refrains from judging any single outcome of democracy in normative terms. Seen in this light, it depends on the agreement of the involved parties whether certain values will be implemented in corporate governance mechanisms, while it is completely independent from the judgment of an external observer. In effect, it is especially telling that some proponents of workplace democracy do not seem to like the empirical observation that workers, as Boatright (2004: 5) put it, "value wealth and prosperity over equality." In other words, our perspective is a plea for what Schelling (1984: 10) calls "vicarious" problem-solving: Maybe we are well-advised to attach greater importance to the decisions that are made or would be made by individuals themselves than on the decisions that we think appropriate for other people to take. Theory therefore should focus on helping actors find and invent rule-reforms that result in win-win-solutions for all involved parties.

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