# Employees as Stakeholders: The Challenges of Building An Employee Ownership Culture

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## Abstract

A substantial body of research has been devoted to study the impact of cultural values on human progress and economic development. Other studies focus on employee ownership and the cultural factors from the point of view of management.  In the transition countries, cultural values pose significant challenges to implement enterprise reform. Private sector reform agenda must accomplish profound improvements in corporate governance so that enterprises could gain better access to finance. One of the elements of enterprise reform must take place in improving the relationship between the enterprises and the stakeholders of the firm.  The role of employees as significant stakeholders in an enterprise is challenged by cultural values that may impede the expedience of success in reform. This paper focuses on the demand side of the employee ownership issue and provides a discussion of the cultural factors that influence the effectiveness of employee ownership. These ownership challenges are: *technical, ideological, psychological* and *structural* in nature.  Especially on the ideological aspect, challenges are to strengthen the balance between the rights and responsibilities and the risks and rewards of employee equity ownership as stakeholders. The paper attempts to offer recommendations in developing an effective ownership culture which in turn would improve their impact as stakeholders in corporate governance reform.

This paper has benefited from the work of my partner and colleague Dr. Chris Mackin, President of Ownership Associates, Cambridge, MA, USA. Any errors or omissions are mine.

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## *Introduction*

In her work entitled, "*Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century* (Brookings, 1995)," Margaret Blair provides a thorough discussion on the employee ownership as a structure for total wealth creation and how it can be an effective tool in the governance of a firm.

A significant body of literature exists on employee ownership. These studies look at the phenomenon as a way by which employees can participate in the wealth created by their firms by connecting their wages and earnings to the performance of the firm (Joseph Blasi and Douglas Kruse, 1991; Michael Conte and Jan Svejnar, 1990, and several others).

Its proponents argue that employee ownership provides a fair and an equitable mechanism that offers a democratic workplace environment, and recognizes the rights and responsibilities of ownership for employees as stakeholders and shareholders by having employee representatives on the boards of the firms.

Several studies look into the impact of employee ownership on the performance of the firm and show that there are significant productivity improvements in firms where employees hold ownership.

It is also noted that one of the biggest obstacles to employee ownership may be cultural. Blasi and Kruse (1991) identify a number of ways in which culture affects the governance of firms. These are listed as '**feudal culture**' (top down); '**investor culture'** (promotes shareownership-denies active participation); '**participatory culture**' (empowers employees by free exchange of information); '**shareholder culture**' (employees are significant shareholders given their level of control); and '**entrepreneurial cultures**' (expect employees to be activist and aggressive shareholders).

The cultural bias seems to matter not only at the micro firm level, but also at the macro level that causes impediments to economic development of nations. The impact of cultural values on shaping of human progress has been the subject of significant studies by social anthropologists, economists, development professionals and the like.

Samuel Huntington (*The Clash of Civilizations and the Remaking of the World Order*) argues that cultural values play a significant role, in addition to many other factors like hard work, in explaining human development. He emphasizes that cultural factors explain the modernization, political democratization, military strategy, behavior of ethnic groups and alignments and antagonisms among nations and countries.

Contemporary US politician Daniel Patrick Moynihan once observed that "…the central *conservative* truth is that culture, not politics, determines the success of a society. The central *liberal* truth is that politics can change a culture and save it from itself." The question is to what extent do cultural factors help shape economic and political development?

If cultural factors do have an impact, how can those cultural obstacles to economic and political development be removed and changed so as to facilitate progress?  To do this, Huntington describes what he understands by culture in its purely subjective terms as the values, attitudes, beliefs, orientations and underlying assumptions prevalent among people in a society.

Lawrence Harrison (*Underdevelopment is a State of Mind*, 1985) identifies the following five major issues in the culture paradigm: (1) the linkage between values and progress; (2) the universality of values; (3) geography and culture; (4) the relationship between culture and institutions; and, (5) cultural changes. He argues that the principal reason for the shortfall in human progress since WWII is due to the failure of the governments and developments institutions to take into account the power of culture to thwart or facilitate the progress.

Others, such as Michael Porter (*Competitive Advantage of Nations*, 1990), Jeffrey Sachs, Francis Fukuyama, Michael Fairbanks, Hernando de Soto, George Soros, and scores of well known experts have made observations discussing the importance of culture in progress. These observations have been richly evidenced in scientific research conducted by World Bank, IMF, EBRD, OECD and other academic and think tank institutions.

In the increasingly globally integrated world, the importance of a level playing field for business and investments has been well understood especially following the major financial crises of the 1990s and recently the financial scandals experienced in the US. In an effort to establish and maintain financial stability in the markets, a number of global standards in business have recently been emerging.

These global standards range from international accounting, auditing, securities regulation, insurance, pension, and financial markets, to trade and last, but not in the least, the well known OECD Principles of Corporate Governance.

The OECD Principles of Corporate Governance underscores the role and importance of stakeholders, along with the role of shareholders, the role of the board and disclosure in corporate governance. My remarks will focus on the impact of employees as shareholders, as well as stakeholders of a firm.

Working for such leading international development institutions as the World Bank and the USAID in the region of post socialist transition countries during the last 10 years has provided me with enriching experiences in development. I would like to take this opportunity to share my insights with you about the major challenges of ownership by employees and employee as stakeholders in the privatized firms that impede effective corporate governance practices.

In the following sections, I address the difference between shareholders and stakeholders model of corporate governance, expand on the four important challenges to employee ownership, their role on corporate governance as stakeholders, the profound impact privatization had on ownership, and my concluding recommendations and implications on development agenda.

## *Changing the Perceptions of Corporate Governance*

Corporate governance is affected by the relationships among participants in the governance system. Controlling shareholders, who may be individuals, family holdings, bloc alliances, or other corporations acting through a holding company or through cross shareholdings can significantly influence corporate behavior. As owners of equity, institutional investors are increasingly demanding a voice in corporate governance in global financial markets. Many of these investors could be pension investors representing the interests of employees to employee share ownership plans, or financial institutions such as mutual funds, that constitute the powerful external elements of corporate governance (Exhibit 1).

Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management. Proper conduct of corporate governance by management will give the assurance that they will receive a return for their investment, whether it is a positive or a negative one.

Creditors play an important role in some governance systems and have the potential to serve as external monitors over corporate performance. Creditors, like the shareholders are incentivized to extend loans to companies with the assurance that their contract will be honored by the company management and that they will service their debt to the creditor on a timely basis and in full.

Employees and other stakeholders play an important role in contributing to the long-term success and performance of the corporation, while governments establish the overall institutional and legal framework for corporate governance.

## Stakeholders in Corporate Governance

◈ **Primary Stakeholders**

- Shareholders
- Boards of Directors/Managing Boards
- Executive Management

◈ **Other Stakeholders**

- Managers
- Employees
- Customers
- Community
- Suppliers
- Financial Markets
- Environmentalists

The role of each of these participants and their interactions vary widely among countries. These relationships are subject, in part, to the legal and regulatory frameworks and, in part, to voluntary adaptation and market forces.

### *Shareholders and Stakeholders Model of Corporate Governance*

There is no single model of good corporate governance. Some common elements that underlie good corporate governance have been identified by OECD and they form the basis of The Principles of Corporate Governance. These principles will be undergoing revision soon, so that the issue of implementation could be better addressed. Existing best practice knowledge in the common elements of corporate governance have been formulated in the principles in order to embrace the different models that exist.

Corporate governance, in its narrow sense, has been associated with the ***principal-agent*** or ***agency*** problem. The ***principal-agent*** problem arises when there is an actual separation between the owners of the firm and those who have effective control of it.

This occurs when shareholders (***principals****)* hire managers (***agents****)* by delegating their authority to run the firm on their behalf. Investors need the managers as specialized agents, and managers need the principals because they need the funds provided by investors since they do not have their own capital to invest.

In this sense, then, there must be a clear degree of alignment between the interests of shareholders and managers. Effective corporate governance practice ought to accomplish this task, by making sure that managers focus on the ultimate goal of the maximization of the wealth of the shareholders. This goal is achieved by applying strategic management decisions so that the scarce resources available to the firm are utilized in the most efficient manner.

The debate on the framework by which corporate governance can affect firm behavior and economic performance is often conflicting and there are many different views on this phenomenon.

This debate ranges between how institutions actually operate and what the firm's actual purpose ought to be. Somewhere in between lies the common ground for what is perceived as effective corporate governance practice.

In defining the economic approach concerning the impact of corporate governance on performance, two basic models are advanced to explain corporate governance practice: **Shareholder model** and **Stakeholder model**.

In its narrow sense, the ***shareholder model*** of corporate governance describes the formal system of accountability of senior management to shareholders through the Board.

In its broadest sense, the ***stakeholder model*** of corporate governance is used to describe the interaction of formal and informal relationships involving the corporation.

The ***stakeholder approach*** emphasizes that the participation of stakeholders in the affairs of an enterprise can contribute to the long-term performance of the firm and shareholder value maximization concept.

The ***shareholder approach*** also recognizes that business ethics and stakeholder relations can also have an impact on the reputation and long term success of a corporation. In this regard, the difference between these two approaches is not as clear and it is rather a matter of emphasis.

The lack of any consensus regarding the definition of corporate governance is also reflected in the debate on corporate governance reform. This leads to many different solutions offered by participants in the reform process.

### *The Current Debate on Corporate Governance*

The currently emerging debate on corporate governance surrounds the actual definition of the phenomenon. This debate draws a fundamental line between a narrow definition of terms and possibilities, and a broader, more comprehensive vision of good governance.

The primary challenge of good governance is creating a sea change in business values and practice, through the adoption of what the OECD refers to as the four values of good governance; ***transparency, accountability, responsibility, and fairness*.**

Those who support a narrower definition of the term, seek to define corporate governance as a question of "***principal-agent***" relations, that focuses on the relationship between shareholder, board, and management.

In well-established economies with well-developed institutions, the principal-agent approach is a highly valid argument. However, in most transitional economies, the institutional framework and cultural values required to promote this narrow definition do not exist. Furthermore, the existence of additional conditions such as privatization adds more confusion to the implementation of effective governance practices.

For effective corporate governance to exist in transition countries, a broader definition of corporate governance needs to be observed by all players active in reform. This approach and definition would require an additional emphasis on developing a broader ***"stakeholder"*** model, as compared to the "***shareholder***" focused model of corporate governance.

In addition, it necessary to build a common vision that corporate governance is a series of values, practices, and codes that reflect a common goal and build a system of social and legal checks and balances.

In effect, the term corporate governance, and its widely-known narrow definition can become a hindrance to broader acceptance of these practices and principles, a successful program will need to transcend the language of ***"principal-agent"*** and build support from the broadest possible community of stakeholders.

## Stakeholders in Corporate Governance

OECD principles recognize the importance of the role and the rights of stakeholders in corporate governance as established by law. In this regard, the principles encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

To begin with, OECD principles strongly recommend that the rights of stakeholders as protected by law be respected. Secondly, stakeholders should have the opportunity to obtain effective redress for violation of their rights. Third, the corporate governance framework should permit for more performance-enhancing mechanisms for stakeholder participation. Lastly, all stakeholders that participate in the corporate governance process should have access to relevant information.

In order to strengthen the **stakeholder** approach, defining enterprise reform activities through public-private sector partnerships is necessary. Among the ongoing international development agenda, building coalitions among competitive but cooperating businesses is seen to be the best way in which the fundamental but complex practices of good governance can be discussed.

There are many cases that illustrate the key conflict between protection of rights of shareholders/investors on one hand and the need for the "***effective and efficient ownership***" of enterprise on the other hand. These types of conflicts will have far reaching implications on the corporate governance environment.

The "***efficient ownership"*** here means sufficient concentration of control rights by majority owners to be able to monitor and influence management effectively, particularly where the enterprises are being restructured.

The majority refers to one approach as "*balance of power*," in which a large controlling shareholder improves monitoring of management, but with the commensurate danger of abuses of the minority.

Block privatization approach may be useful in transferring ownership into two or three large private strategic investors more rapidly. The block owners could be expected to monitor each other. The down side however is that it may be hard to attract risk taking "noyeaux dure" (patient long term) investors under this scenario.

Efficient enterprise ownership can produce measurable results and benefits to all owners with benchmarks for conditions of concentrated ownership.

In this context, we believe that any firm, as an economic entity, bears social responsibilities, and must be operated ethically, responsibly, and fairly, with accountability and transparency as it seeks to materialize the ultimate goal of the firm: ***"maximizing the wealth of its shareholders."***

**Impact of Employee Ownership Culture and Challenges**

Earlier, we have discussed the observation that business culture in any given country has an impact on the way in which ownership is understood. While there may be a larger set of factors for it, the reasons for effective pursuit of stakeholders rights in the context of employee ownership in a transition country environment may be attributed to several cultural factors. Our experience in the region has been that there may be four important challenges of building an ownership culture that will have a profound impact in achieving corporate reform.

These challenges are: (1) technical; (2) psychological; (3) ideological; and (4) structural challenges.

***1. Technical Challenge:***

The main technical challenge facing employees as stakeholders is to understand the circumstances about actual ownership as employees, whether as individual shareholders, group of employees or as management.

The legal framework surrounding ownership relates to the circumstance of ownership. This refers to the actual ownership structure of the firm, such as in which form the ownership has been acquired, through equity purchases, private holding, etc. How was the stock acquired, how can the ownership be transferred and the like.

Additionally, technical challenge of employee ownership also refers to understanding that the legal **rights** and **responsibilities** of holding a part ownership of the enterprise will mean taking calculated **risks** inherent in any business. Thus, employees must know that ownership will provide ***expected rewards only*** in return for ***risks*** taken by owning the shares.

The important issue here is how the employees as owners and stakeholders will interact with the management in demanding transparency, timely disclosure of relevant financial and non-financial information about the enterprise, and how they can be rational investors given the uncertainties that surround the business along with all other stakeholders.

Another dimension of technical challenge of ownership is the adequate understanding of the financial and managerial issues surrounding the operations of a business enterprise. Most shareowner employees do not have a good understanding of accounting, financial management or even financial statements to extract rational investment decisions. These issues need to be clarified through public investor education campaigns, or through the efforts of investor protection organizations. Concerted training efforts would be necessary to create the competence among employees about the fundamental aspects of being an employee as a stakeholder and a shareholder.

Considering that private sector institutional frameworks are usually inadequate in most transition countries, public sector would need to be more actively involved in encouraging the development of democratic civil society organizations that will help protect the rights of employee share owners, as with all minority owners.

Some of the employee owner training education efforts may include the introduction of a variety of interactive training methodologies to teach business concepts and legal and financial components to impart a better understanding of fundamentals of a business ownership in the society.

With adequate skills training and effective incentives including taxes, this may also trigger the entrepreneurial spirit that is an inherent virtue in all humans but which needs to be released from dogmatic social value judgments.

## *2. The Psychological Challenge*

One of the most complex and vast issues surrounding the employee ownership culture in the transition countries could be attributed to the ***psychological challenge*** of ownership. This type of challenge would result from the well known social phenomenon known as the "***resistance to change***" against the profound implications of social, political and economic changes of transition.

Overcoming resistance to change in an organizational setting has been extensively studied. Strategic decisions envisioning reform in the economic, social and political spheres of emerging countries requires the complete overhaul of the system. Privatization in the transition countries, for one, has had profound implications on the notions of ownership, and the way in which people must modify their behavior and expectations.

Privatization process imparted options, or rights of ownership to citizens of transition countries without having to place own risk equity in a firm. Thus, not much liquidity changed hands initially. In this context, expectations from share ownership in a transition environment, especially as employees, differ from counterparts elsewhere, where traditions of market economy are better established.

Given the progress in information technology and the ever expanding globalization of the commodities and financial markets, the world is changing more rapidly. The culture shock experienced by many in emerging societies is enormous. This change is met with resistance and poses challenges to effective restructuring, increasing competitiveness and the viability of the enterprises.

Affecting changes in the way people do business in a transition country may range from benign democratic consensus building, referenda and voting processes, to top down autocratic measures.

The role of employees as stakeholders of a firm will eventually force the improvements needed to get the enterprises moving in lock step with the rapidly changing global marketplace.  Psychological challenge is an issue that may need to be dealt with in facing these cultural challenges.

## *3. The Ideological Challenge*

This aspect has significant social-psychological dimensions as in the previous one, but it may have more distinct characteristics. The notion of ownership brings the ideological challenge of the political questions about the possible and desirable structural aspects of property concept.

Since ideological challenges are difficult and have the potential to be oversimplified, they need to be approached very carefully.  Ownership, similar to corporate governance, may have many meanings and definitions. In the western culture, lawful property ownership is considered to be the foundation of justice, and it is thus well understood that possession does not necessarily mean ownership.

The legal and regulatory frameworks have made clear distinctions surrounding the possession and ownership of a property. This distinction is prevalent in any corporate governance argument, as the separation of ownership and control between principal and agent.  The patrimonial rights over a property are well recorded and protected in the western culture. Ownership in the post communist world in some countries still requires clarification in ***the cultural*** and ***legal*** sense.

## The cultural meaning of ownership

In the cultural sense of its meaning then, ownership may mean different things to all stakeholders surrounding the firm, bringing certain rights and responsibilities to all interested parties. These rights and responsibilities must be exercised on the patrimony of share ownership by shareholders as they seek to maximize their wealth.

Within the context of the workplace in the firm, distinctions between the perceived and actual ownership can be made. *Perceived* ownership may refer to the impressions or definitions that all employees bring to the organization within the employee ownership setting. *Actual* ownership is a legal and factual concept that is open to debate.

Employee shareholders must also perform their responsibilities by electing a board with clear mandate and expectations, giving the contractual obligation to the management that the board will install. The organizational functions of the firm give rise to the set of distinctions about the rights and responsibilities of ownership.

As the "*organizational"* dimension of the firm gives rise to the distinctions about the **rights and responsibilities** of ownership, the "*economic"* dimension of the firm gives rise to distinctions about the **risks and rewards** of ownership.

In developing good corporate governance practices, the ideological distinctions surrounding **the balance** between the ***rights and responsibilities*** and the ***risks and rewards*** of ownership, and how employee shareholders will apply these notions, whether as majority or minority owners, must be clearly understood.

## *4. The Structural Challenge of Ownership*

The fourth challenge of building effective employee ownership culture in a firm and strengthening the frameworks for corporate governance practice is the ***structural challenge***.

This aspect in a way involves the technical, psychological and ideological contents as its centers around the issues of **power**, **authority** and **accountability**.

These issues must be considered within the context of **transparency**, **accountability**, **responsibility** and the **fairness** notions that are the main pillars of effective corporate governance.

The three concepts of power, authority and accountability are of paramount importance in developing effective understanding of employee ownership in an enterprise.

The **structural challenge** then, involves the institutional framework which will serve the needs of the employee owners, and shareholders in general, and the way in which the owners are able to influence the decision making process at the firm through the mechanisms and elements of corporate governance.

This challenge speaks to the design of various decision-making arrangements, supported by the legal and regulatory systems so that corporate governance practices can be made more efficient and effective.

The success of effective corporate governance practice then should be based on a participatory approach to ownership that ***shareholders*** should be actively involved in the governance of their firms, while the **rights of all stakeholders** are respected and protected.

The success of this effort will also lie in the legitimacy and constitutionality of the ownership rights as represented in the legal frameworks, as well as the effective enforcement of the legal and regulatory frameworks to protect owners.

## Conclusion

The role of stakeholders must be underscored in operationalizing the OECD Principles of Corporate Governance. Stakeholders have a major role to play in reaching the main goal of wealth maximization on behalf of shareholders.

In the complex competitive environment in which the businesses operate, stakeholders at large affect and/or are affected by the enterprise and its activities in reaching its main goal.

This paper focused on the impact of culture on economic development, the importance of the stakeholders model of corporate governance and the employee ownership culture in order to build a successful stakeholder oriented corporate governance practice. The paper emphasizes **employees and employee ownership** as a very important aspect of the greater realm of stakeholders.

**Corporate governance** and **economic performance** will be affected by the relationships between the various stakeholders of the firm. Given the potential consequences of corporate governance for economic performance, corporations have responsibilities to parties beyond shareholders.

Experience in developing an effective employee culture as stakeholders shows that there are four major challenges that can be impediment to effective governance. The four challenges that must be confronted in employee ownership culture are ***technical***; ***psychological***; ***ideological***; and, ***structural***.

Cultural values seem to play a significant role in the success of progress and development. These cultural factors not only affect macro level progress, but also have an impact on micro level enterprise reform agenda.

These four challenges in building the employee culture, once encountered successfully, will improve the employee cultural mindset, and help increase the viability of the firm in which employee ownership is expected to play a significant role for effective corporate governance practice.

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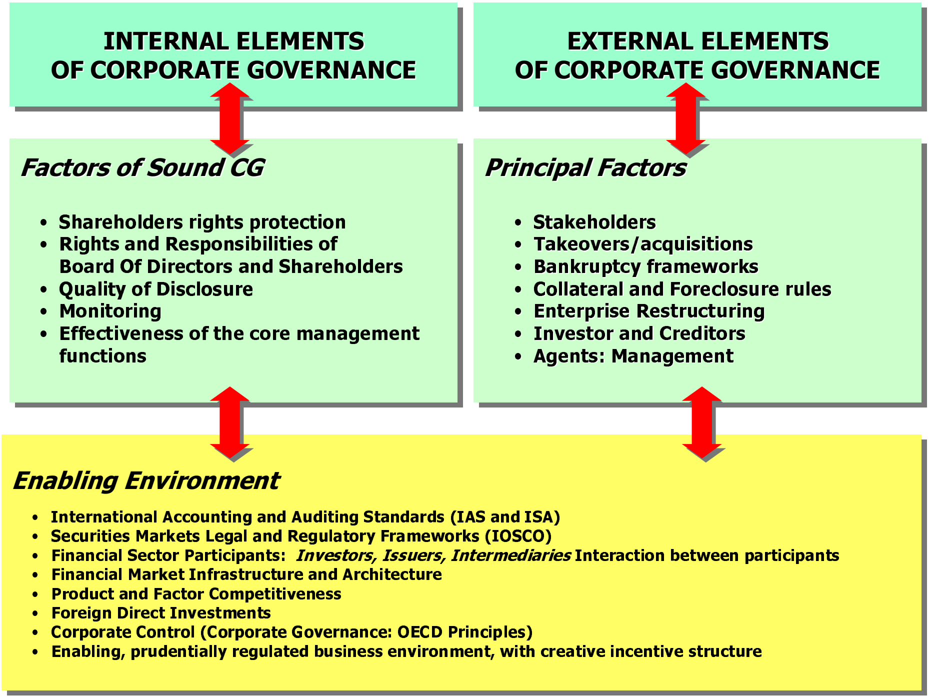
**Exhibit 1**

## Internal and External Elements of Corporate Governance



**INTERNAL ELEMENTS OF CORPORATE GOVERNANCE**

**EXTERNAL ELEMENTS OF CORPORATE GOVERNANCE**

***Factors of Sound CG***

- **Shareholders rights protection**
- **Rights and Responsibilities of Board Of Directors and Shareholders**
- **Quality of Disclosure**
- **Monitoring**
- **Effectiveness of the core management functions**

***Principal Factors***

- **Stakeholders**
- **Takeovers/acquisitions**
- **Bankruptcy frameworks**
- **Collateral and Foreclosure rules**
- **Enterprise Restructuring**
- **Investor and Creditors**
- **Agents: Management**

***Enabling Environment***

- **International Accounting and Auditing Standards (IAS and ISA)**
- **Securities Markets Legal and Regulatory Frameworks (IOSCO)**
- **Financial Sector Participants: *Investors, Issuers, Intermediaries* Interaction between participants**
- **Financial Market Infrastructure and Architecture**
- **Product and Factor Competitiveness**
- **Foreign Direct Investments**
- **Corporate Control (Corporate Governance: OECD Principles)**
- **Enabling, prudentially regulated business environment, with creative incentive structure**