POLYCENTRIC STAKEHOLDER ANALYSIS: CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY UNDER VALUE HETEROGENEITY

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This paper presents a method of stakeholder analysis based on recent developments in the theory of polycentricity and co-production. A polycentric system of governance is a collection of heterogeneous decision centers acting independently, but under a common system of rules and/or norms limiting negative externalities and free riding, and the theory of co-production describes how the different stakeholders are involved in establishing these over-arching rules. We use this theory to model the interactions between different stakeholders of a corporation and the corporate management, providing a new perspective on the broad business case for corporate social responsibility (CSR). The Polycentric Stakeholder Analysis (PSA) framework accommodates stakeholders' heterogeneity of preferences, beliefs and values, and the complex nestedness of stakeholders' governance systems; it is realistic in capturing the imperfect rationality, limited information and potentially opportunistic behavior, while also preserving the key elements of the normative democratic ethos that drives CSR more broadly. We show how CSR managers can determine who the salient stakeholders are, without adopting unrealistic homogenizing assumptions about "hypernorms" or "integrative social contracts", and we provide a simple public economics model, inspired by the calculus of consent, showing how to allocate CSR resources efficiently.

Typology of business-case theories for CSR (*italic* - existing theories; PSA - our proposal)

Locus of value / **World view**	**Individuals**	**Value communities**	**Integral commons**
Reductionist	*Shareholder theories*	---	---
Pluralistic	---	*Stakeholder theories*	---
Complex emergence	Polycentric Stakeholder Analysis (PSA)	---	*Social integration theories*

(...)

...The next section delves more deeply into the issue of stakeholder salience, and provides a systematic way by which we can conceptualize CSR efficiency. Section 5 then provides the fuller framework of analysis about how to consider the salient stakeholders.

4. A calculus of consent strategy for estimating CSR efficiency

The claim that the stakeholders system relationships and governance should stay as close as possible to the democratic standards is a key idea pervasive throughout the stakeholder analysis literature and CSR more broadly. Ideally, one may say that a stakeholders' governance system should be democratic. Its legitimacy and efficiency may hinge on this. Democracy may be seen as an attitude, culture, way of life, set of values etc. but ultimately, it is about collective decision making and preference aggregation (Popper, 1960; Buchanan & Tullock, 1962; Dryzek, 2000; Knight & Johnson, 2001; 2007; 2011; Held, 2007). Usually, this insight is related to the twin notions of control and legitimacy. First, democracy is a mechanism for generating, operating and controlling power and authority, via a set of voting arrangements. Second, majoritarian control and preference aggregation is the major source and determinant of legitimacy. The aggregative model of democracy thus links in a coherent framework the key themes of preference aggregation, control, authority, and legitimacy.

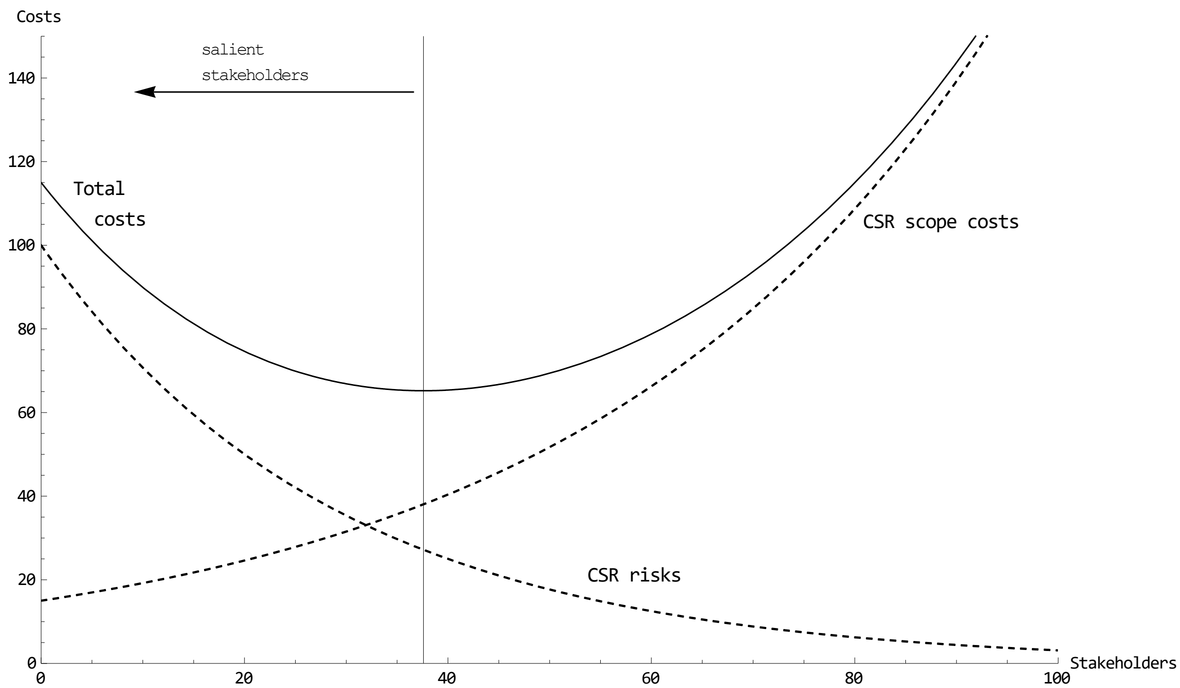
Seen in this light, the problem of democracy (including in stakeholders's systems) appears deceivingly simple. This simplicity evaporates once we start looking at the details. First of all, there are multiple ways of preference revelation and multiple ways for a group to decide by voting (unanimity rule, first-preference majority rule, etc.). Each of these methods may lead to different final results (Arrow, 1951; Riker, 1982; Heap et al, 1992; Shepsle & Bonchek, 1997; Sen, 1999; Hartvisgen, 2008). Outcomes are, at minimum, sensitive to the rules used to aggregate opinions. In other words, what is a "majority" differs from one case to another, and it may depend on the collective decision-making institutions, as much as they depend on the preferences of the members of the grou Thus, "combining individual preferences into group choice by majority rule or some other method is not a straightforward undertaking" (Shepsle & Bonchek, 1997), as it is contingent on institutions. There is "no magic wand that transforms this individual clarity about preferences into collective clarity" (Ibid.). And "when the group size is large, when individual preferences are heterogeneous or when there is a large number of alternatives for group members to consider" things become even more problematic.

We cannot fully account and counteract for such problems in our present account. We can, however, point to a simplified model that alleviates *some* of the key issues mentioned above, in particular the issue of homogenizing a heterogeneous group of stakeholders. We propose that a particular model of democracy, namely the "calculus of consent" model (Buchanan & Tullock, 1962), can be adapted to the problem of CSR management, and used to estimate efficiency. This model shows how CSR managers can give priority to some of their core salient stakeholders, even if they are a minority among their larger group of stakeholders.

Let us assume that, based on the PSA identification criterion discussed in the previous section, CSR managers can create an ordered list of stakeholders from the highest salient stakeholders to the lowest salient stakeholders. Mitchell et al. (1997) procedure (looking at power, legitimacy, and urgency) can also be alternatively used for the same purpose of ordering the list of stakeholders. The question is how far should the corporations' CSR resources be spread out, and thinned out, from addressing the needs of the most salient stakeholders to the needs of the least salient? As Dunfee (2008: 357) pointed out, "[t]he stakeholder literature … does not provide sufficient guidance for managers facing allocation issues". Dunfee considers this problem to be so difficult that he is deeply skeptical that it could be addressed any time soon. The problems with any aggregation mechanism, highlighted by the social choice literature, give us some hints to how difficult the problem indeed is. Nonetheless, despite Dunfee's skepticism, we *can* provide here a preliminary solution.

Once the stakeholders are ordered from the most salient to the least salient, we can look at the CSR costs of satisfying them. The more of them the corporation tries to consider, the bigger the cost. Hence, the CSR *scope costs function*, $S(n)$, is monotonously increasing as the number of stakeholders, n, is increased. By contrast, we can also consider the CSR *risk function*, $R(n)$, that would cover all three types of business cases for CSR mentioned in section 1, from simple risks associated to public relations disasters to more complex risks associated with reputation and legitimacy (e.g. the risk of failing to attract talent) and all the way to the most complex risks associated with social learning and the failure to pursue the CSR goals. This risk function is monotonously decreasing. The more stakeholders the corporation takes into consideration, the less likely it is to miss something important.

Figure 1: Calculus of consent model for determining CSR efficiency



If we put together these two costs, we obtain a graph like the one in figure 1. The minimum of the total costs determines the optimal spread of CSR activities, i.e. the set of salient stakeholders that the corporation should take into consideration. If the set of stakeholders is smaller than this, the CSR scope costs will be smaller, but the risk increase will disproportionately outweigh this reduction of scope costs. If, by contrast, the set of stakeholders is larger than this optimum, the risks will be even further diminished, but the increase in scope costs will make it not worth it. This optimal set of stakeholders determines whose opinions and values should matter for the CSR managers. This is a similar economic logic (in terms of marginal costs and marginal benefits) to the one used by McWilliams & Siegel (2001) and Husted & Salazar (2006), but it is using a theory of *public* economics. McWilliams & Siegel (2001) and Husted & Salazar (2006) theorized CSR as if it were a private good, thus missing the democratic ethos at the heart of CSR.

We have thus provided a simple theory of CSR efficiency, which, at least in principle, solves the allocation problem and provides a guideline to CSR managers as to how to think about the range of stakeholders that they need to be considered. This, however, is only the beginning of the problem. The even more difficult part is, once having identified the salient stakeholders, to determine the system of rules and criteria that governs the actual CSR activities. The theory of polycentricity briefly discussed in the next section offers a further guideline for addressing this more difficult problem.

5. The PSA framework: A technical tool for CSR management

At first glance, refusing to take the heterogeneity of evaluators off the table makes the problem of CSR management impossibly complex. How can one possibly map out all the possible stakeholders, with their divergent perspectives on how to understand the world and how to judge firm activities? The homogenizing assumption had the advantage of simplifying the problem as there would be only one frame of reference. The idea of business ethics "hypernorms" shared across industries would simplify matters even more, offering the promise that firms could learn from each other's CSRs even across different spheres of activity. The downside, however, is one of losing realism.

The previous section showed how to delineate the set of relevant (salient) stakeholders, but these stakeholders still form a heterogeneous group. Fortunately, the theory of polycentricity has been better systematized in recent years, allowing us to better deal with heterogeneity. This section explains how to turn this systematization into a practical tool or framework for CSR management.

Until recently, the literature on polycentricity has been a long string of various applications ranging from the analysis of the scientific community (Polanyi, 1951) to the study of common law (Fuller, 1978) to the analysis of federalism (V. Ostrom, 1987) and of metropolitan governance (McGinnis, 1999), and to the study of public economies more generally (V. Ostrom, 1999; E. Ostrom, 2005: chapter 9; 2010). Aligica & Tarko (2012) have looked at various types of systems that have been labeled "polycentric" and analyzed their key commonalities, as well as differences. According to their conclusion, the diversity of possible polycentric systems can be understood as laying on a foundation of three key common characteristics: (1) a multiplicity of autonomous "decision centers"; (2) the actions of these "decision centers" are circumscribed by an over-arching system of rules and/or norms, and (3) the content of this system of rules and norms is as such that it creates "incentive compatibility", i.e. it aligns the incentives of individual actions with desirable social outcomes, thus setting the stage for a productive emergent order.

The multiplicity of autonomous "decision centers" is essential for maintaining creativity and dynamism, as well as the resilience of the system (E. Ostrom, 2010; Toonen, 2010; Aligica & Tarko, 2014). The diversity avoids groupthink and one-size-fits-all solutions, and also provides insurance against unexpected shocks, avoiding the situation of having the system as a whole affected in its entirety at the same time, as different centers have different vulnerabilities and, from case to case, can come to each other's hel It is for such reasons that polycentric systems often outperform monocentric hierarchical systems, especially when the production of public goods is at stake. But it is the third aspect, which varies in its specific details from case to case, that connects the theory of polycentricity to the theory of public entrepreneurship mentioned earlier. What public entrepreneurs do is either discover and implement such over-arching rules or act as focal points for promoting good norms that create broad "incentive compatibility" for all the actors involved, and, hence, promote productive social orders.

In the context of our discussion, the firm's stakeholders, who evaluate the firm, are the "autonomous decision centers", and the CSR managers play the role of the public entrepreneurs who have to discover a system that promotes the desired social goal. This system can be understood as the set of over-arching rules and norms. For example, the

CSR management usually has to decide what inclusion and exclusion rules to use, e.g. what types of criteria someone should fulfill in order to qualify as a salient stakeholder. Furthermore, an important idea is that, because of the nature of most social goals, the best outcomes are usually achieved when the stakeholders are involved in various ways in the "production" process. This idea, that the consumer is a key part of the production process, is known as co-production and it is of fundamental importance for understanding the production of public goods (Parks et al, 1981; Brandsen & Pestoff, 2006; Oakerson & Parks, 2011; Brandsen, Pestoff, & Verchuere, 2012; Aligica & Tarko, 2013). The concept of co-production is the economic approach to the demands of "social integration" CSR theories. But the co-production theory is not holistic or sociological, but maintains its individual-level perspective and preserves heterogeneity. Hence, we argue, it provides an improved perspective in terms of realism.

We can also better understand now why CSR does not always come naturally to firms, but requires sometimes important changes in perspective and operation procedures. The idea of co-production is to a large extent at odds with the standard operation of most firms and corporations. The management system behind the delivery of most private goods can be understood as a system of team-production (Alchian & Demsetz, 1972; Miller, 1992). In case of team-production, the consumer is not part of the production process, and workers are not (necessarily) consumers of the product. But team-production and co-production systems are addressing the same managerial problem, namely they are systems for preventing shirking and free-riding in the production process, and, hence, they are easily confused (Aligica & Tarko, 2013). But, depending on the nature of the good that is being produced, it is crucial to properly identify the correct system of production. If we are dealing with a co-production problem, as it is often the case with social activities, but a hierarchical team-production system is put in place, the result will be inefficient. This means that CSR practices often have to change their management system, and, in particular, involve the stakeholders in the decision-making process to a much larger extent than they are used to.

CSR activities can involve a wide variety of situations, and, hence, contrary to the idea of business ethics "hypernorms", it is not advisable to propose one-size-fits-all recipes. The theory of polycentricity at the foundation of PSA is indeed broad enough to cover numerous different kinds of possible relationships between CSR management and stakeholders. The chart in figure 2 (adapted from Aligica & Tarko's [2012] systematization of polycentric systems) illustrates the key elements that the CSR management needs to identify, and forms the backbone of the PSA framework.

Figure 2: The PSA elements for CSR management

PSA elements:

- 1. *Diversity of stakeholders*:
  - 1a. *Heterogeneity of views*
  - 1b. *Autonomy of action*
  - 1c. *Aims*: *Collective* OR *Individual*
- 2. *Integrating system of rules*:
  - 2a. *Incentive compatibility*
  - 2b. *Jurisdiction*: *Territorial* OR *Nonterritorial*
  - 2c. *Rule design*: *Stakeholders involvement* OR *No stakeholder involvement*
  - 2d. *Collective choice*: *Consensus* OR *Individuals* OR *Majority rule*
- 3. *Coordination process*:
  - 3a. *Entry*: *Voluntary stakeholder decision* OR *Corporate decision to include stakeholder* OR *Natural inclusion*
  - 3b. *Exit*: *Voluntary stakeholder decision* OR *Corporate decision to exclude stakeholder* OR *Natural exclusion*
  - 3c. *Information*: *Private* OR *Public*

This chart highlights the key elements that CSR management needs to pay attention to. Some of those are not directives about how to do CSR, but guidelines about the type of problem that needs to be solved. Some of these elements are determined by the nature of the problem. For instance: (PSA: 1c) Are the stakeholders acting as disparate individuals or as pre-organized collectivities of individuals with shared goals? (PSA: 2b) Is the problem territorially circumscribed? (PSA: 3a and 3b) Are stakeholders' entry and exit as salient stakeholders a matter of choice or of necessity?

But most elements involve key decisions by CSR management. (PSA: 2c) Depending on the importance of co-production, one needs to decide the level of involvement of stakeholders in the rule-design process, to put it differently, the level of paternalism of the CSR activity. (PSA: 2d) Considering that stakeholders' opinions and values may differ, is the achievement of CSR goals dependent of some form of aggregation (e.g. facilitating consensus forming or deciding by majority rule) or is it possible to achieve the CSR goals while interacting with stakeholders on an individual basis (i.e. some CSR goals require dealing with stakeholders on an individual basis)? (PSA: 3a and 3b) If entry and exit decision are taken by CSR managers, they need to decide (and face the possibility that they are mistaken) whether some stakeholders are not salient enough to be included. As

Dunfee (2008: 353) put it, "because it is impossible for corporations to respond to all of the needs of their stakeholders … [t]riage is required". (PSA: 3c) Finally, and again dovetailing on Dunfee's account, can the relevant information be made public? As Dunfee noted, there are often good reasons why sharing information contributes to CSR goals. But this is not always the case, even if we consider only the CSR goals. For example, sometimes one might want to take precautions to avoid groupthink, especially if empirical evaluation is not easily available.

Conclusion

What are the most effective ways of analyzing corporate agency and responsibility as part of complex, overlapping and competitive governance arrangements? What kind of theoretical frameworks should one use in order to best conceptualize, analyze and design stakeholders-based governance systems? Such frameworks have to satisfy at least three criteria: (a) They should capture and accommodate both descriptively and normatively the heterogeneity of preferences, objectives, beliefs and values of the stakeholders as well as the institutional diversity and the complex nestedness of the various governance systems embedding the stakeholders' system; (b) They should capture and analytically deal with the nature and implications of imperfect rationality, information and potential opportunistic behavior of the agents on the ground; and (c) They should be accommodating to the normative democratic ethos that pervades much of the corporate social responsibility (CSR) perspective.

This paper has advanced a possible response to these challenges. Looking at the relevant institutional theory and political economy literature, the paper has identified and introduced a relatively less known governance theory: The polycentric governance perspective developed by Nobel Prize in Economics co-recipient Elinor Ostrom, and by public choice political economy co-founder Vincent Ostrom. The paper has argued that the current discussions regarding stakeholder governance systems (and more specifically the institutional analysis of corporate governance and CSR) may benefit from incorporating the Ostromian perspective in multiple ways. With this end in view, the paper articulated one possible approach to this task by showing how concepts such as "polycentricity" and "polycentric systems of governance" (a collection of heterogeneous decision centers acting independently, but under a common system of rules and/or norms limiting negative externalities and free riding) and "co-production" (situations in which consumers of good/service participate in the production process – in this case members of self-regulating communities co-producing the rules under which they operate) may be used to model and interpret the interactions between different stakeholders of a corporation, and the parameters and processes constraining or directing its activities.

Polycentric Stakeholder Analysis can thus be seen both as an application of the Ostroms' institutional theory perspective to a new domain and as a contribution to the literature regarding corporate social responsibility. The paper extended the Ostroms' institutional theory perspective by applying it to the domain of corporate governance and stakeholder analysis, illuminating how a framework based on it has the potential to satisfy the major descriptive and analytic criteria required by such a framework, while preserving the key elements of the normative democratic ethos that drives CSR more broadly.

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