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Shyam Sunder

Better Corporate Governance: Whot, Why and How

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On 28th of March, 2008 Leon Kozminski Academy of Entrepreneurship and Management was visited by Shyam Sunder – James L. Frank Professor of Accounting, Economics, and Finance at the Yale School of Management and Professor in the Department of Economics and at the Yale Law School – who gave a lecture entitled "Better Corporate Governance: What, Why and How?".

Prof. Dorota Dobija: Ladies and gentlemen, on the kind invitation of Professor Kozminski, Rector of the Kozminski Academy, TIGER and the Center for Corporate Governance, we are privileged and honoured to host today's distinguished lecturer, Professor Shyam Sunder.

I have had the privilege to know Professor Sunder over many years, met with him on several occasions, and discussed with him issues of common interest to us. I am glad that today we can host him here, and that the students and the

faculty of the Kozminski Academy, as well as the invited guests, have the opportunity to meet him.

Professor Sunder was born in India. He was educated in India and at Carnegie Mellon University. Before coming to Yale, he taught at The University of Chicago, University of Minnesota and Carnegie Mellon University. Currently, he is the James L. Frank Professor of Accounting, Economics, and Finance at the Yale School of Management. He is also a Professor in the Department of Economics and at the Yale Law School.

When I looked at Professor Sunder's website a couple of years ago, I discovered something which surprised me: Professor Sunder, the researcher, has two different lives. To accounting and management faculty he is a world-renowned accounting theorist. Economists, on the other hand, know Professor Sunder for his pioneering work in the field of experimental finance and experimental economics. As Professor Sunder's research interests are wide, the list of his research contributions is long and includes among others: financial reporting, dissemination of information in security markets and design of electronic markets. He has published an enormous amount of work in a number of languages various leading research journals of accounting, economics and finance as well as in popular media. Professor Sunder

has been president of the American Accounting Association, and the Director of the Yale Center for Corporate Governance and Performance.

The topic of his research that he will talk to us about today – corporate governance – is most important. Professor Sunder looks at corporation as an entity generating economic income not only for shareholders, but also for other participants, and he explores ways of measuring the total value of a corporation to society. He also views good governance as a way of maximizing this value. In today's lecture entitled *Better Corporate Governance: What, Why and How?* Professor Shyam Sunder will share his ideas and thoughts with us. Professor, we are eager to hear your lecture. The floor is yours.

Prof. Shyam Sunder: Thank you Prof. Dobija, Rector Kozminski and friends. I am delighted to return to the Kozminski Academy, and to this room with these beautiful stained glass windows, after ten years. Thank you for this opportunity. We shall talk about corporate governance; let us start with an outline.

Corporate governance is frequently interpreted narrowly to mean organizational processes and practices, related to corporate boards. I propose a broader perspective of gover-

nance. First, I shall discuss conceptualizing organizations as alliances among various people, each of whom pursues his or her own goals. Second, I shall discuss the concept of culture of an organization as the shared expectations of the behaviour of one another held by its participants. Third, through these concepts of organization and culture we can define good governance as a balance or match between the expectations and self-interests of the participants. Why should we ask for good governance? The advantage of good governance is that it makes all participants better off. To achieve good governance, we need to create a judicious balance among regulations, market forces, and social norms of the society in which the organization functions.

The match of expectations and self-interest in good governance, once established, is under continual threat of perturbation by a variety of forces. Most threats arise from changes in the organization, or in the environment. Sustaining good governance is like riding a bicycle; it calls for strategic management to anticipate and address the threats to the necessary balance.

How can we evaluate the quality of governance in an organization? I suggest the sum of surplus received by participants of an organization as a candidate. I shall define this measure and discuss its use.

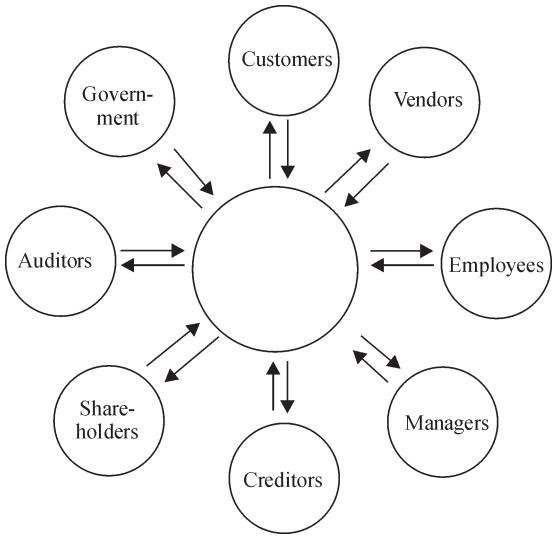
Finally, it is good to keep in mind that governance is never perfect. Running organizations well has been a long struggle in human history. We should think of good governance as a process or journey, not a destination.

Let me elaborate on these points before opening the floor to comments and discussion.

First we can think about any organization as an alliance among various people or participants. For example, Figure 1 shows a company as an alliance among shareholders, mana-

Figure 1.

Organization as an Alliance among Various Participants



gers, creditors, employees, customers, vendors, government, and auditors. Each party is linked to the organization by two lines; one line represents the resources contributed by the participants to the organization and the other represents the resources from the organization flowing to the participants.

Each participant contributes resources to the organization in exchange for the inducements he or she expects to receive from it. The participants seek to serve their own interests; they enter the organization only if they profit from doing so. The difference between opportunity cost of contributed resources and the resources received from participation, i.e., the excess, is defined as the participant's share of the surplus. For example, if I work for Yale University in exchange for X, and my opportunity cost is Y, the difference (X-Y) is my share of the surplus. Similarly, every party who participates in an organization gets a share of the surplus. Parties involved with the university include students, employees, professors, donors, and the government. Many parties contribute to a university. Why does a student come to a university and pay fees? If they think what they get from the university is more than the opportunity cost of what they contribute, they will join in; otherwise they will not. This is true for all other participants.

I mentioned earlier that we can think of an organization as a bundle of contracts. The word contract is used in a bro-

ad context here: a contract is the mutual expectations of two parties. We can make a contract to meet for lunch tomorrow: I expect you to show up, you expect me to be there. I came here to give this lecture and had some expectations of your behaviour and attendance, just as you expected me to be on time and say something interesting. Not all aspects of a contract are made explicit. Many aspects of contracts are implicit, defined by the social system which tells us how we should act and what we should expect from people in our society. Social norms are instrumental in the definition and execution of contracts.

Under this perspective, we focus our attention on personal goals of each person in an organization. The organization itself may, or may not have a goal. In any case, the organization's goal does not play an important part in this perspective. The organization is like a stadium where players play a game, seeking their own, self-interested goals. The stadium and its goals do not matter much for the players. We can apply this way of looking at organizations to companies, universities, government, or other organizations.

For now, let us focus on business organizations. Who are the participants in a business organization? It is an alliance of people who supply capital, labour, and other factors of production, customers who provide cash, the government

which provides public services and many other parties. Each party contributes resources in exchange for something in return. Shareholders receive dividends, creditors receive interest, managers get salaries, vendors get money and customers get goods and services.

What is the role of accounting and control systems in organizations? It serves as an operating mechanism for contracts. It is necessary to assemble, communicate, implement, enforce, modify and maintain the contract set. The accounting system has five functions. First, it measures the contributions from participants. Second, it monitors resource outflows, so that too many resources do not flow to some agents. Third, it links the outflow of resources to the inflow of resources to ensure fulfilment of contracts. Fourth, it helps maintain liquidity in factor markets; potential participants may be reluctant to transact with the firm in factor markets if they have less information, leading to low liquidity unless information is provided to them by the accounting system. Fifth, the accounting system builds shared knowledge, which facilitates renegotiation of contracts. Shared knowledge is important in economics: it means that participants know that others know, and it makes it difficult for people to bluff during negotiations. Shared information makes renegotiations less likely to fall due to attempted bluffing.

We have defined the organization as an alliance or a set of contracts in which various parties contribute resources in order to receive what they want. Every organization has its culture. We can think of the culture as the shared expectation of behaviour of the participants. Culture of a group is what members expect from one another. For example, in some places people will start a meeting on time, in other places they may tend to start 10 minutes late. In some places, people wear a certain kind of clothes to work; faculty will wear ties in certain institutions, while in others they wear jeans. It is what we collectively expect from one another that constitutes our culture. Most of this is developed through social transactions of which we are only vaguely aware. Culture develops bottom up, not top down. It is difficult to impose culture on a group, for example, by a directive. Culture is maintained through social, not formal, sanctions imposed by one's peers.

It takes time for new people to learn the culture of a group, because it is difficult to learn through instruction or reading. They need to see how people react, and to see what works and what does not. For example, certain aspects of Kozminski Academy's culture may be unique to it, and differ from the culture of other education institutions, even here in Warsaw. Since it takes time for new entrants to learn the culture, fast growing organizations risk diluting if not losing their

culture if the new entrants are not able to learn and adapt to the expectations of other participants.

The concept of good governance can be derived from these elements of organizations: alliance of participants, contracts, shared expectations, knowledge and culture. When we put these elements together, we can think of an organization as a group which is governed well when each of its participants finds it in her own best interests to do what is expected of her by the other members of the organization. I shall work with this definition: when I find it in my own interest to do what others expect of me, the organization is governed well. For example, when I come here for a lecture I have expectations as to the organization of the meeting. And you have expectations about the topic of the lecture. If we fulfil the expectations we have of each other, we are all satisfied. What will happen if there is bad governance? If I do not fulfil the expectations, you will be dissatisfied, complain, and perhaps get up and leave.

This is a critical part of what I shall talk about. If there are any questions or comments regarding governance defined by the self-interest and mutual expectations, this is a good time to ask.

Prof. Andrzej K. Kozminski: Would you elaborate on the concept of bad governance? I think good governance is de-

fined by bad governance, and it would be useful for you to give us some more examples of bad governance.

Prof. Shyam Sunder: Suppose I run a bank. The bank teller is expected to respond to customer calls in a prompt manner. But the teller has been given a work environment in which the teller finds it in his best interest not to respond promptly to customers, and instead finishes his coffee first. He makes the customer wait for an extra 10 minutes, while the manager expects the teller to attend to the customer immediately. Perhaps the incentives are structured in the bank so there are no consequences for the teller when he does not attend to the call. The manager has to ask himself: have I created the incentives so that it is in the teller's own best interest to attend the call in a manner I expect him to do? If the answer is no, it is bad governance.

Prof. Andrzej K. Kozminski: So you assume that the teller is rational?

Prof. Shyam Sunder: Yes. I assume the teller is rational and he responds to the incentives created by the manager. I believe that most people are rational in this sense: they recognize what is in their best interest. Suppose the manager has been rewarding tellers who are friendly with him, and go to the bar with him, but do not attend to the customers

promptly. Suppose he is not rewarding tellers who attend to the customer unless they do him personal favors, it is not in the teller's best interest to respond to the customer calls. The teller will recognize that the expectation of the manager is not to attend to calls. The same can be applied to other organizations. What does the university expect of its faculty? They are expected to teach their classes to the best of their abilities, and to make students excited and interested in the topics they teach. The university also expects them to conduct and publish research and provide other services. Is it in their best interest to do what is expected of them? If the environment is such that the best interest of the faculty is not to spend their time teaching students and doing research, but to run their consulting businesses, then they are going to do something that is not expected from them. They will do that because they are rational: the consulting business brings them additional money, while the university pays them the same, whether they have the consulting business or not. Then there is going to be a mismatch between the expectations of the university and self-interest of the faculty. Such a mismatch is another example and evidence of bad governance.

Prof. Wojciech Gasparski: In concept, what is the purpose of the organization? Who is the owner of that purpose?

Prof. Shyam Sunder: In this contract theoretic approach, the goal of the organization is derived as an outcome of individual goals. An organization is just an arrangement among people. It's purpose does not matter. Each individual is trying to draw as much as he can for himself. This way of looking at an organization is different from the standard organization theory. If you look at the annual report of a car maker, you may see a statement of its purpose such as "the purpose of VW is to produce high quality cars for its customers". This statement of purpose says little of any substance. Suppose the next day the German government came to VW and said: please produce trucks instead of cars. If VW had the technical capability, and all its participants found it to be in their interest to make the switch to trucks, they would soon be producing trucks. The purpose of VW will change. In this way of thinking, the organization is just an inanimate, interactive arrangement among people with its goals derived from the goals of its participants.

Prof. Tadeusz Tyszka: If the organization is just a collection of people, than the concept of self-interest becomes crucial. Let me try to complicate this problem and ask you to elaborate on the following situation. Let us assume that you love teaching. So a part of the reward is your satisfaction and that is part of your surplus. And now you retire and are replaced by a new teacher, but he hates teaching. So the ob-

jective situation does not change, but because of difference in individual motivations, the reward or the surplus received by the teacher changes. If governance is something that involves intentional acts, as you said, everybody should be informed about others' interest to make decisions. What can we do about the part of the surplus that is impossible to measure, especially non-pecuniary rewards?

Prof. Shyam Sunder: This is an extremely important problem. Not all rewards and costs can be measured. Some important elements of our rewards are beyond reasonable and accurate measurement. This is an important challenge for the manager to assess the pecuniary as well as non-pecuniary rewards, and create a working environment which is attractive for each individual so the organization can hold together.

This is a good segue to my next point. The difficult task for management is to match the expectations and self-interest of participants. They can influence but not entirely control these expectations. Every action of the manager affects expectations for the future. For example, if the company is doing well, the management may decide to be generous and announce a PLN 10,000 bonus for everyone. What will be the effect of this generosity on the employees' expectations of bonus for the next year? Perhaps an even larger bonus. But next year the

company does not do well, the manager may not give them a bonus. If his earlier generosity changed their expectations, they may be disappointed the next year. The problem is that individual expectations are not fully known to the manager and individual's self-interests change continually.

Why should one care about good governance? Is it because it is required by law? No. It is important because it is a more reliable way of creating wealth, a satisfying work environment and a better life for the participants. On occasion, individuals may gain advantage for themselves by surprising others (i.e., behave in ways not expected of them). It creates opportunity for individuals to gain but such gains are ephemeral; such actions create personal and social anxiety and disruption in the organization, and they are ultimately counter-productive.

I mentioned earlier the elements needed to develop good governance for an organization: rules, incentives, communication, monitoring, and enforcement are used to align participant behaviour and expectations. Let us talk about these elements briefly. Consider, for example, two traders. The buyer expects to have the appropriate goods delivered by the seller. The seller expects to be paid. When expectations of all participants are met, the system of these relationships is being governed well.

Another example: a patient goes to the doctor for a 10 o'clock appointment. He gets there at 10 o'clock, because the doctor expects him at that time. If he is there at 10, the doctor is there, because he expects the patient to be there on time. What if the patient arrives at 10.30 instead? You waste the doctor's resources and time. The next time, expecting that the patient will arrive late, the doctor will ask the patient to arrive earlier than he plans to be available, again leading to wasted time.

We can talk about any organization and the same concept applies. This concept of governance extends well beyond the traditional scope of corporate governance limited to the board of directors and senior executives. Good governance applies to all participants, including employees, managers, shareholders, customers, vendors, directors, and others.

Good governance requires a well-thought out balance between government (laws and regulations) on one hand, and guidance from the market forces on the other. A good system of governance recognizes that both government actions and market forces are susceptible to failure, so total dependence on either is unlikely to provide a satisfactory outcome.

When government fails, we tend to think of replacing it by markets. But markets fail too. We need to supplement regu-

lation and market rules by self-discipline. This is a matter of social norms. Many markets operate on the basis of trust. Recently, we have seen significant problems in the investment community in the U.S., due to the subprime mortgage securities crisis. Most of Wall Street operated on social trust. Once this was weakened – and with Bear Stearns, the trust was gone over a weekend – and led to large losses. Bear Stearns was trading at $20 per share on Friday, and on Sunday it was sold for $2 per share (a few days later it recovered to $10 per share). This shows how quickly trust can collapse. Self-discipline requires not only trust in social norms, but also vigilance on the part of the shareholders.

What are the threats to good governance? Even if we establish a good system of governance where everything is in balance, there will be changes in the environment, changes in the market, and in self-interest of the participants as Professor Tyszka mentioned in his example of the two teachers. A contract set which is in good governance today may not be in good governance tomorrow if the conditions change. We set up a good system of governance so everything works fine today and yet the next month nothing works. Why? Because the market or people changed. People for whom such changes are disadvantageous change their actions. They may even leave. If these are essential people, the organization will collapse. In this respect managing an

organization is like riding a bicycle. You cannot just hold the handle in a fixed position after you get going; you have to adjust to changing conditions. Each individual looks at her self-interest and considers whether it is advantageous to continue to participate in the organization under continually changing conditions.

For a firm to continue to operate, it has to be able to use all of the resources contributed by participants to produce enough output to return to everybody the opportunity cost of their contribution plus some shares of the surplus to each participant. No participant would work for mere opportunity cost; everyone wants something extra. Does a customer want more from the supplier than the opportunity cost of the price? If my cost is $3,000, but the return is $4,000 I get a surplus of $1,000.

The matching of agents' actions to expectations has to happen without force, because in a free society you cannot force people to contribute. It also has to be based on good information, and without false promises. Benefits of false promises are short lived; they cause huge problems for the organization in the future. When actions do not match the expectations, people are disillusioned and quit. This is how organizations disintegrate. Miscalculation, coercion, misunderstanding, or misrepresentation by agents, destroys governance.

What are the governance functions of top management in an organization? This function goes by many labels such as long term planning, strategic management, etc. It always means the same thing: monitor your environment, anticipate changes in factor and product markets, redesign contracts to be in balance under the new conditions, renegotiate contracts, communicate and implement new contracts. The role of the management is to perform perpetual revision of corporate plans to retain their desirability from the point of view of all the participants.

Let me summarize. Good governance is a key concept in management. The alliance or contract model of organizations can help understand good governance. The culture of a group is the set of shared expectations its members hold about the behaviour of one another in the group. An organization has good governance if the behaviour of its members matches the expectations of others. It is the job of the management to keep the expectations in line with the incentives in a changing environment. Good governance is a state of balance between expectations and actions.

We have looked at organizations from the point of view of the individual participants so far. The next question is about the role and assessment of organizations in society. How do we evaluate organizations from the point of view of the socie-

ty as a whole? Is an organization being governed well in the sense that it is contributing more to society than it is taking from society? Let us return to the model of organization as an alliance among people, where each participant contributes and receives resources. Each participant earns an income or share of surplus from participation, which is the difference between the value of the reward received and of the opportunity cost of the resources contributed. The contribution of the organization to society is the sum of everyone's share of the surplus. Each party gets at least a little bit more than they contribute. The net contribution of the organization is the sum of all the individual surpluses. If this sum is positive, the organization is increasing the welfare of society.

Looking from an investor's point of view, income or share of surplus is the difference between the return to investment and the opportunity cost of capital. However, shareholders are not the only ones who earn an income from the organization. We can apply a similar perspective to other participants in the firm. For example, what is the economic income to employees? Employees receive wages, benefits, and enhancement of human capital from the firm. Their contribution is the opportunity cost of time. The difference between these two values is their share of the surplus.

Customers make an "investment" in the organization in the form of search, learning, negotiation, payments, or settle-

ment of disputes. Expected present value of the benefits from goods received should exceed the present value of these investments. Another participant, the government, receives taxes and contributes non-priced services as well as some priced goods. The difference is the government's share of the surplus. For example, the government may subsidize a university to educate the workfare, which is beneficial for the society. The difference between the subsidy and gains is the economic income to the government from the university.

The income to the whole society can be defined as the sum of income to all participants, government, community (including positive and negative externalities). Income to shareholders, who are the main targets of financial statements, is just one element if this extensive income. This extensive income is a better measure of the benefit from the organization to society. Extensive income is a reasonable criterion for making social policy and decisions.

There is no simple solution for achieving good governance. Good governance is a constant struggle that calls for design and redesign of the organization's alliance in response to changes in its environment. There is no single solution that fits all and no solution remains effective for long. Even if we strive for a solution which is ideal today, it may be no good tomorrow. Ensuring that the self-interest of each participant is aligned with what he or she is supposed to do

should be the top priority of the directors and senior management of organizations.

Let me summarize. Organization can be seen as an alliance among various people, each of whom pursues his or her self-interest. Culture of an organization can be seen as the shared expectations of the behaviour of one another held by its participants. Good governance is achieved when there is a balance or match between the shared culture (mutual expectations) and self-interest of the participants. Good governance is supposed to make everybody in the society better off. The elements of good governance are the balance among regulation, market forces, and social norms. There are also threats: changes in environment, markets, and the self-interest of participants. For that reason organizations require strategic management, which would anticipate and address those threats. From the point of view of the society as a whole an organization is evaluated by the sum of surplus received by all participants. And finally, there is no Holy Grail: good governance is a constant struggle to maintain balance under ever-changing conditions.

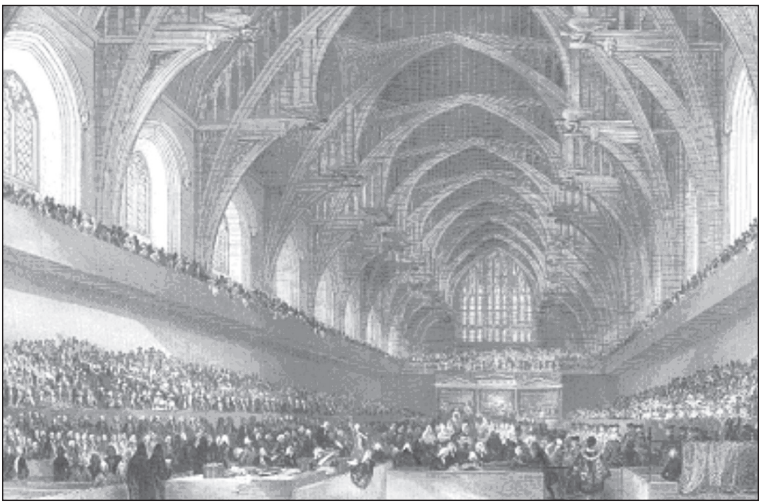
Before I end, I should mention that the problem of good governance is as old as human civilisation. The greatest corporation in the history of the world – the British East India Company – had serious governance problems throughout the 258 years of its existence until it was taken over by the

British government in 1858. During those long years the company constantly struggled with its governance. In the minutes of its Board, they discussed corporate governance issues often. Both Robert Clive as well as Warren Hastings were accused of wrong doing and tried after returning from India to England.

In the late 1780's London, the trial of Warren Hastings was to best show in town. Society ladies would dress up to go and listen to the oratory of Edmund Burke who had been appointed the prosecutor by the British Parliament (see Fig. 2).

Figure 2.

Westminster Hall
Trial of Warren Hastings
London: Published for the by
Proprietor J. Mead, 10, Gough Square, Fleet Street



The trials lasted for seven years, until the popular opinion turned in favour of the accused. During this period, the battle for public opinion was fought in the press. In one cartoon (Fig. 3) Warren Hasting is a white knight under attack by his opponents, depicted as cartoon characters. In the second cartoon (Fig. 4), Hastings is a circus juggler, breathing fire, and fooling the gullible public.

Figure 3.

Warren Hastings Controversy
– Fox, North and Burke Assailing
'The Savior of India'

Figure 4.

Pitt, Hastings and Thurlow as State Jugglers

To sum up, there is no easy or permanent solution to the problem of devising good governance. But the problem is too important for us to allow this difficulty to force us to give up trying to address it. Democracy does not function

well without a judicious combination of citizen docility and vigilance. The same is also true of corporate governance: it requires the participants, especially the minority shareholders, to constantly strive to maintain vigilance and to exercise intelligent watch for the system to function efficiently.

Prof. Dorota Dobija: Thank you, Professor Sunder. The floor is open for comments and questions.

Prof. Tadeusz Tyszka: With such a broad approach you have a lot of different kinds of values: you are talking about the self-interest and monetary gains and prestige and other gains. The problem is that we don't know the trade-offs among those different kinds of values, neither on the individual level, nor the organizational level. So what kind of analogies can you propose with those different values?

Prof. Shyam Sunder: It seems to me that even though at an organization's level the trade-offs between tangible and intangible things are difficult to make, at the individual level we make them all the time. For example, one day we may go to one restaurant where a meal costs PLN 200, and on another day we may go to a different restaurant, where we pay PLN 400. We choose the more expensive restaurant because we have expectations as to the satisfaction from eating the meal which cannot be monetized except by our willingness

to make such trade-offs. We make this kind of trade-offs in most of our decisions every day.

Prof. Tadeusz Tyszka: That is true, that we make thos trade-offs on the personal level. On the other hand, there is a strain of psychological research, which shows that people tend to resist making any kinds of trade-offs between what they consider sacred values and monetary values. So, in many cases the trade-offs will be difficult even at personal level.

Prof. Shyam Sunder: It is very interesting that you mention this problem of values. Let me give two more examples. What you mentioned about the psychology literature may suggest that some values dominate others. For example, one may say that he would never lie, no matter what the consequences. Others might say that each person is honest only to a certain level, beyond which he breaks down. These are two alternative approaches: the values, and the lexigraphic approach. The lexigraphic approach in economics renders one thing to be always better than another, leading to the first always being chosen over the second. In law, rules and regulations, the same kind of duality exists. Some people think about laws as absolute: you cannot steal, it is prohibited. The other approach looks at the benefit and the costs of stealing. What is the chance that if I steal I will get caught and punished? If I steal, what are my benefits and costs?

Thus there is a trade-off approach and a moral approach to law. Different social scientists and philosophers look at this problem in different ways. You are right that I look at it as a trade-off function. I know there are many members of society, for whom this view is unacceptable. Still, for others it is fully acceptable.

Prof. Mieczysław Dobija: I welcome your lecture with great pleasure. Your lecture suggests that the economy and economic interaction is a non-zero game. And in this situation the surplus value is possible and good governance is the state that allows all participants to have a share of the residual or surplus. Is this a correct understanding of your argument?

Prof. Shyam Sunder: Yes it is. Good governance creates additional net resources and wealth in society for its members to share. In order for it to work well, the surplus must be shared in some reasonable way. I have not discussed how it is divided up because this is a matter of some controversy. I am trying to understand now how the surplus is distributed in organizations. My initial, rough estimates suggest that most of the surplus goes to one party – not the employees, nor investors, but to the customers. Shareholders actually stand at the end of the line. The party that benefits the most is the customer. One wonders why. Consider this computer, running on Windows and Microsoft

Office software. Its producer Microsoft was created some 30 years ago. Mr. Gates may have made, say, $100 billion. That is his profit. The Microsoft managers and employees may have made, say, another $500 billion. What is the customer's share of the surplus – opportunity benefit less the price paid? If this surplus is $10,000 per person, you multiply it by 500 million and you get some $5 trillion. What about cars, and TV sets? If you can get a nice TV for PLN 2,000, and you might have been willing to pay PLN 10,000, PLN8000 of the surplus from creation of a TV set ends up in the customers' pockets.

Who should be expected to get most of the surplus? It seems reasonable to assume that agents who transact with the firm through relatively imperfect and liquid markets earn more of the surplus. Of the labor, capital, and product markets, which is least imperfect? If the answer is capital, we should expect participants in this market to get the smallest surplus. This is a new way of thinking about the return to shareholders. This return is just a small section of the pie, or the total wealth generated by the organization. Looking at the whole pie and its distribution provides a better basis to address issues of corporate governance.

John Mulenga: Could you define the product of good governance? What are the defining products of good and bad

governance? Also, what is the distinction between corporate culture and social culture – for example, the culture of IBM fusing into Polish culture?

Prof. Shyam Sunder: The defining product is the total surplus, the net income that is distributed to all participants. That is the net contribution of an organization to society. What I propose is that the governance be judged on the basis of its net contribution.

I talked about culture as shared expectations of a group about the behaviour of one another. It doesn't matter if it is a corporation, a university, the city of Warsaw or a country. If a foreigner visits another country, and the host concludes that he does not know the local culture, what do they mean? He must have done something in a way which is different than what was expected of him. So the culture of France, Germany or China is just a set of expectations shared by the people in that society. Uncultured behaviour is actions contrary to the expectations. For example, it is fine for my students at Yale to call me by my first name, but it would be rude in India. The students would be shocked, the faculty would be shocked, and I would be shocked. Expectations differ across groups.

Student: You said that governance of an organization is good when it makes a positive contribution to society. Do

you define society in local or global terms? Can good governance vary across societies?

Prof. Shyam Sunder: The criterion for good governance across societies is the same, but the method of achieving it may vary because of variation in shared expectations or culture. We talked about the organization as an alliance among participants. Another aspect of your question concerns who should be included among the participants. For example, in considering the governance of an army by its general, should we include the enemies as participants? In the evaluation of the net contribution of this army, do we include the losses inflicted on the enemies? To answer the question of governance we have to fix a certain point of view as reference. In the case of armies, we usually exclude the enemies from the set of participants. In economics, the concept of externalities is important. These are the effects of the organization's actions, which reside beyond the defined boundaries of the organization. When we change the boundaries of the reference group, we include or exclude some of the effects, which may change conclusions about the quality of governance. A steel factory may appear to be well governed until we include the effect of its pollution on the health of the citizens in calculation of its surplus.

Prof. Dorota Dobija: Thank you very much Professor Sunder for the lecture and your answers to the questions.

So far appeared:

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