How Stakeholder Theory Undermines the Rule of Law

Whenever I lecture about markets, wealth and poverty, I always make one point which invariably shocks students: if you want to understand why some countries have successfully transitioned from widespread poverty to material affluence, and others haven’t, the rule of law is far more important than democracy.

Part of the stunned reaction flows from the fact that the word “democracy” functions today as a synonym for everything nice and wonderful. Once, however, we get past the inevitable “Are you saying that you’re against democracy!?!” protestations, followed by my assurance that I favor liberal constitutionalism rooted in natural law premises (quite a few students pick up on the nuance), the more the students recognize that while things like universal suffrage have their own worth, they have little to do with economic growth per se. Moreover, as students grasp the meaning of rule of law, they gradually recognize how countries with similar starting points in terms of demographics, natural resources, geography, religion, culture, etc., can end up in very different economic places.

Rule of law’s centrality to free, just, and economically prosperous societies is the subject of Nadia E. Nedzel’s The Rule of Law, Economic Development, and Corporate Governance (2020). Her approach is to engage in comparative analysis of two Western legal traditions. Broadly speaking, one is the Anglo-American conception of “rule of law.” This, Nedzel says, concerns “equal treatment under the law, limited government, the jury trial, separation of powers, established judicial procedure, and problem solving by means of inductive, analogical reasoning to determine what decision would be consistent with prior custom.” The other is the continental European tradition of what she calls “rule through law”—rechtsstaat. While it has many of the same institutional features, rule through law “emphasizes equality and community over liberty, and posits that the law should prevent conflict, not merely manage it.”

Nedzel proceeds to illustrate the different ways in which these systems shape economic life in general and, more specifically, the legal treatment of corporations. That last topic, Nedzel demonstrates, has direct implications for a set of ideas that she believes has great potential to undercut the roots of Western prosperity. This concerns stakeholder theory: the claim that any company has a responsibility to all those who conceivably have a stake in the business—employees, customers, local communities, suppliers, the environment, past and future generations, etc.—besides those who actually own or have invested capital in the company.

In Nedzel’s view, if stakeholder theory becomes cemented into Western legal systems, the damage to businesses and market economies will be considerable. Resisting that trend, she indicates, requires those nations forged in the Anglo-American rule of law tradition to hold fast and not embrace stakeholder concepts of the purpose of business presently being advanced in civil law jurisdictions.

**Common v. Civil**

Nedzel is a distinguished scholar of comparative law who teaches in Louisiana. Her focus matters because Louisiana is the only jurisdiction in the United States in which private law has been heavily shaped by the legacies of French and Spanish colonial legal codes. These influences have certainly been overlaid with more distinctly common law ideas and state legislation. But the French and Spanish background means that Louisianan judges, lawyers, and law professors are especially attuned to the workings of European civil law codes and how they differ from common law jurisdictions.

This is certainly true in Nedzel’s case, but she supplements this knowledge of current arrangements with considerable historical appreciation of how common law and civil law systems emerged over many centuries. This is the focus of Nedzel’s opening chapters. These lay out key points of development like the Norman Conquest, Magna Carta, and the Glorious Revolution which helped ensure that England took a dissimilar path to what was occurring on the other side of the Channel.

When combined with the influence of figures such as Sir Edward Coke, common law’s bottom-up accent on custom, tradition and experience developed into a predilection for individualism and limited government. This differed significantly from the type of legal systems which became dominant throughout continental Europe. Rather different forces were at work in these countries.

Among others, these include a revived attention to Roman law; the growth of political absolutism; the sway of Cartesian philosophy; Rousseauian General Will theories; the French Revolution; the subsequent implementation of the Code Napoléon in France and other countries; and the emergence of somewhat authoritarian conceptions of rechtsstaat in which the only restraint upon the state was what it chose to impose on itself. The end-result was legal codes in which a type of hard-communitarianism, as opposed to “the Rights of Englishmen” stressed in the Anglo-American world, became the interpretive framework deployed by those exercising political and legal authority.

**An American Legal Conflict**

The Anglo-American and continental European traditions have never existed in splendid isolation from each other. There is no shortage of judges or legal philosophers who pay attention to developments in other jurisdictions. Nedzel illustrates that, over time, there have been various and often successful efforts to import rechtsstaat-like ideas into America via law schools, legislation, and judicial rulings.

One example highlighted by Nedzel is the impact upon the English-speaking world of the British legal philosopher H.L.A. Hart and his highly influential book The Concept of Law (1961). She portrays Hart’s work as playing a significant role in advancing what amounted to a social democratic conception of government and law. Hart’s highly positivist account of law encountered opposition in America, most notably from Harvard’s Lon L. Fuller, especially in his important work The Morality of Law (1964). Yet despite such resistance, many of Hart’s ideas entered America’s legal and political bloodstream. This occurred precisely as a slew of progressive legislation was flowing out of Washington D.C. and many state capitols.

Nedzel presents America’s present legal landscape as one in which two Western legal traditions (“rule of law” versus “rule through law”) exist in an uneasy tension that occasionally breaks out into outright conflict. That has many implications, but her focus is upon the consequences for economic growth. Her argument, which is not a new one, is that those countries closer to the Anglo-American rule of law tradition generally outperform in economic terms those nations who have followed other legal paths.

An emphasis on stability and maintaining levels of employment, for instance, exacts a cost in terms of organizational dynamism, not least by discouraging risk-taking and entrepreneurship.

The correlation and causation between rule of law and substantive economic development is not hard to show. Nedzel draws upon the research of economists like Hernando de Soto and the late Svetozar “Steve” Pejovich to illustrate the point. It is, however, at this juncture that Nedzel’s primary target looms into view. Her contention (and herein lies her book’s most original part) is that stakeholder theory reinforces continental European rule through law inclinations and vice-versa, not least because of shared hard-communitarian foundations.

**In Whose Interests?**

According to Nedzel, corporate law in common law jurisdictions is very different from that found in civil law countries. The differences do not, she stresses, flow from dissimilar challenges. Business problems (and business malfeasance) tend to have universal characteristics. Instead she considers the ways in which corporate law in America presently retains a shareholder focus accompanied by soft law provisions which encourage sound business leadership and management, often through industry standards and codes of conduct.

This contrasts significantly with civil law jurisdictions. The weight given to hard-communitarian concerns, Nedzel holds, translates into heavy-handed business regulation by the state. In many European nations, this extends as far as mandating seats on boards of directors for representatives of banks, governments, and company staff (invariably union officials). That results in priority being given to 1) continuity of employment and general stability; 2) pleasing many groups besides shareholders; and 3) trying to realize multiple goals that include but range beyond profit.

Such goals undermine the ability of corporations to produce prosperity. An emphasis on stability and maintaining levels of employment, for instance, exacts a cost in terms of organizational dynamism, not least by discouraging risk-taking and entrepreneurship. These habits certainly upset established structures and patterns of behavior within companies and eventually generate change and often rapid turnover in employment markets. Without such adjustments, however, a business will become complacent and uncompetitive. Eventually it will disappear, along with all the jobs once provided by the business. Likewise, if boards of directors are not focused on delivering shareholder value because profit is considered only one of many company objectives, a decline in earnings is sure to follow.

These priorities help explain the weaker economic performance of many corporations in civil law jurisdictions compared to those businesses located primarily in the Anglo-American sphere. Corporate law in Anglo-American systems isn’t without its problems. But Nedzel maintains that the (present) shareholder focus helps to incentivize the flexibility and innovation which is key to producing the wealth that benefits shareholders but also, albeit unintentionally, millions of people who have never owned a share in their lives.

Herein lies Nedzel’s core concern with the flirtation with stakeholder theory by many American businesses and corporations. At present, much of the romance is rhetorical and, it seems, primarily a public relations exercise designed to appease the woke and various left-leaning groups. What the author dreads (rightly) is that countries like America, Britain, and Australia will start wandering down the path of many civil law jurisdictions which have started mandating stakeholder-oriented ideas via national legislation and European Union directives. Not only will this facilitate serious accountability and transparency problems by effectively making boards of directors accountable to numerous stakeholders; it will also, Nedzel establishes, lead to diminished economic performance in those countries that have hitherto adhered to Anglo-American rule of law expectations.

Neither a shareholder focus nor stakeholder theory, Nedzel cautions, will eliminate corporate wrongdoing. As long as humans are human, some people will behave badly in business. But no cure should be worse than the sickness. To the extent that stakeholder theory draws upon hard-communitarian principles which it shares with continental European rule through law models, it risks undermining already fragile commitments to rule of law in America and elsewhere. That’s just one more reason to shore up the priority of shareholder interests throughout corporate America. For once rule of law is gone, the path to its restoration is a long and difficult one indeed.

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