Governing Externalities: The Potential of Reflexive Corporate Social Responsibility

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Abstract

Externalities occur where an economic actor takes a decision which results in actions that affect other parties without their consent. In most cases, the creator of the externality will be a corporation because they are the most important actors in modern economies. There is a market failure as the corporation obtains all the benefits of the activity but does not bear all the costs.

Since Ronald Coase's seminal work, economists have generally argued that externalities should be dealt with either by instrumental regulation or by bargaining between the creator and victim. The regulator should choose between these two options on the basis of cost-benefit analysis. In particular, the costs associated with government intervention should be compared with the transaction costs confronting parties where they attempt to deal with the externality by means of a contract. Most economists assume regulatory costs (including the costs of producing and enforcing regulation and the distortions of economic activity to which it gives rise) will be very high, so the 'cure' of regulation will normally be worse than the 'disease' of externalities, making government intervention undesirable from an efficiency standpoint. This makes them sanguine about leaving many, or even most, externalities to the market, even though its failure led to the externality in the first place. They then assume that if the parties fail to reach agreement on a solution to a particular externality, this will be for transaction costs reasons, so leaving the externality where it falls is the most efficient outcome in the circumstances.

This paper argues that neither of these methods offers a wholly adequate way of dealing with externalities in a globalised economy characterised by factually and technologically complex chains of causation. As is widely recognised by sociologists as well as economists, instrumental regulation faces massive difficulties in dealing with externalities. It can also be argued that transaction costs are not the only barrier to bargaining. The result is that many externalities go uncorrected, and it cannot simply be assumed that this is an efficient outcome. The paper then argues that this governance 'gap' could be filled by the doctrine of Corporate Social Responsibility (CSR), but only if two conditions are met. First, CSR must be understood as corporations voluntarily taking responsibility for, or internalising, the externalities their operations create. This requires corporate decision-makers to change the frames they use so as to take account of the costs their activities create. Second, corporations must be steered towards a socially adequate identification and internalisation of those costs by the careful use of procedural, or reflexive, regulation. A reflexive regulatory approach to CSR would require corporations to meet with those who consider themselves affected in order to construct the 'facts' about the externality, and then require corporate decision-makers to internalise that externality in a manner which is acceptable to all concerned. This would arguably result in many externalities being identified and corrected in a cost-effective way, and should be considered as an alternative or complement to other methods of governing externalities.

Keywords: Corporate governance, corporate social responsibility, externalities, reflexive law

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Introduction

A negative externality occurs where a decision is taken that results in an event which has adverse, uncompensated effects on another party who does not consent to it.[1] Prima facie, this is a market failure because it results in an inefficient allocation of resources: those who gain the benefits of the activity do not bear all the costs. A portion of the costs are transferred onto other economic agents. Pollution is a well-known example of an externality, while the 2007 Stern Report on the Economics of Climate Change claimed that

> 'In common with many other environmental problems, human-induced climate change is at its most basic level an externality. Those who produce greenhouse-gas emissions are bringing about climate change, thereby imposing costs on the world and on future generations, but they do not face directly... the full consequences of the costs of their actions.'[2]

Less obvious examples of externalities include the (as yet unknown) side-effects of new technological processes such as genetically modified crops or 'fracking' to extract coal seam gas, as well as the costs to the public of medical treatment for obesity from eating processed food. However, much of the economic literature examines not complex 'socio-technical externalities' of this kind but the classic territory of the law of nuisance: sparks from railways affecting crops and noise and vibration affecting doctors' surgeries.

It follows from the definition offered above that an externality can occur even though the parties are in a contractual relationship.[3] Externalities where the parties are in a contractual relationship give rise to greater controversy, because it is commonly argued that the 'victim' of the externality consented to it. So for example, the dominant economic approach to corporate law and corporate governance assumes that where a contract has been concluded between the corporation and a stakeholder such as an employee or a consumer, that contract by definition makes the stakeholder better off (or else they would not have entered it); that their ability to go elsewhere implies that if they do not do so, they have consented to any harms they suffer; and that the terms of their contracts fully protect their interests.[4] This assumption can be challenged in relation to employees who make investments in firm-specific human capital.[5] For various reasons, these investments – and the employees' claim to the returns they generate – cannot be protected by complete, legally binding contracts.[6] As with the company's shareholders, this creates a relationship of dependence or economic 'agency' between the employees in question and corporate decision-makers. In other words, these employees become – like shareholders – residual claimants in the sense that their returns depend on the exercise of management discretion. If management decides unilaterally to renege on an implicit undertaking to remunerate the employees in line with the gains (or quasi-rents) their specialisation generates, they will suffer an economic loss. This risk was not allocated by the contract, nor will the employees have consented to the decision. Their only alternative is to go elsewhere, and if they do this, they will suffer a significant and long-lasting decline in income.[7] This example of an externality demonstrates that corporate decision-making can create significant externalities for employees despite the fact that they are in a contractual relationship with the corporation. This argument has not been dealt with adequately by proponents of a shareholder value model of corporate governance, and remains one of the weakest links in their normative model.[8]

A similar – although less compelling – argument can be advanced in relation to consumers. David Yosifon argues that it is difficult for most consumers 'to inspect or understand the relevance of nicotine levels in cigarettes, trans fats in french fries, or escalating interest rates in home mortgages.'[9] Consumers are not only on the wrong side of an information asymmetry; they also have limited cognitive powers which must be exercised across the whole basket of their consumption choices. In Simon's terms, consumers are 'boundedly rational', which means they intend to do what is best, but 'satisfice because they have not the wits to maximize'.[10] This means that they may 'choose without first examining all possible behaviour alternatives' and 'leave out of account those aspects of reality – and that means most aspects – that appear irrelevant at a given time.'[11] This too is arguably an externality because harm is inflicted on these consumers without their informed consent to it. The normal economic response to this is that misleading advertisements, esoteric contract terms and seriously harmful products are dealt with by regulation. However, a quick glance at Yosifon's examples shows us that, even where it exists, the efficacity of this regulation is at best questionable.

This brings us to the argument of this paper. Economists argue that, where an externality exists, the regulator must decide whether it should be dealt with – or governed – by means of ex ante regulation or left to bargaining between the parties. Since Ronald Coase's seminal 1960 paper, 'The Problem of Social Cost', economic theory has for the most part offered regulators a binary choice for governing economic externalities. They can either regulate or tax the activity which gives rise to the externality, or they can leave the matter to bargaining between the parties. Regulators are instructed to choose between these two methods on the basis of a complex, fact-intensive cost-benefit analysis, which takes account of both the costs of the method of governance and any second order effects produced by the intervention. In this paper I am going to argue that neither of these methods offers a wholly adequate way of dealing with externalities in a globalised economy, characterised by factually and technologically complex chains of causation. The failings of these two methods of governance mean that many externalities go uncorrected, something about which, it is suggested, economists are unduly sanguine. In this paper it will be argued that this ‘governance gap’[12] can be filled by the doctrine of Corporate Social Responsibility (CSR), but only if two conditions are met. CSR must be understood as corporations voluntarily taking responsibility for, or internalising, the social costs, or externalities, or impacts their operations create, and corporations must be steered towards a socially adequate identification and internalisation of those costs by the careful use of procedural, or reflexive, regulation. In some cases, this will be a more efficient means of governance, and in other cases, it will permit externalities to be governed which otherwise would not even be identified. CSR would therefore become a third method of governing social cost, to be used as an alternative or complement to the other, more conventional methods.

This is a provocative argument, but one which is beginning to gain some currency with policy makers. Apparently inspired by the Ruggie Principles,[13] which require corporations to undertake due diligence in relation to their human rights impacts, the European Commission recently announced a new approach to CSR.[14] It is abandoning its longstanding approach to CSR as ‘a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment’.[15] Under the new approach, CSR will refer to ‘the responsibility of enterprises for their impacts on society’. Inter alia, this will require that corporations ‘have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders, with the aim of maximising the creation of shared value for their owners/shareholders and for their other stakeholders and society at large; [and] identifying preventing and mitigating their possible adverse impacts.’ In terms of ‘identifying, preventing and mitigating’, corporations are ‘encouraged to carry out risk-based due diligence, including through their supply chains.’ This change in approach is potentially of great importance as it appears to extend the Ruggie framework far beyond human rights concerns. Under the old approach, CSR encompassed any ‘socially responsible’ action which improved the corporation’s reputation, and therefore its profitability. This meant that spending on charity and the arts, for example, was viewed as socially responsible, even though there was no connection between the beneficiaries of this largesse and the corporation’s business activities. Under the new approach, CSR should be more firmly connected to the effects of the corporation’s business activities. An important question is whether corporations will go beyond what the law requires where there their managers cannot advance a ‘business case’ for doing so. As discussed below, this may be legally problematic. More importantly from the perspective of this paper, CSR will become *one* possible mechanism by which corporate activities can be governed so as to align them with the public interest or common good.

The structure of the paper is as follows. Section two looks at the limitations of governing externalities by means of instrumental regulation. Section three looks at the barriers to market solutions to externalities, also known as 'Coasean bargaining' between the parties, and examines the extent to which the failure of the parties to bargain about a particular externality justifies the assumption that the existing pattern of economic activity produces net benefits for society. Section four looks at the advantages of governing externalities through CSR. A brief conclusion follows.

2. Governance of Externalities through 'Regulation'

Economists accept that economic activity sometimes produces externalities, or 'external diseconomies' for outsiders or third parties. They also accept that this is a market failure, in the sense that where social cost exceeds private cost, the market does not necessarily achieve an efficient allocation of resources. Until 1960, the conventional economic approach to externalities was in line with that suggested by Pigou in 1920.[16] He argued that governments should always intervene to correct externalities by means of taxation or regulation because the 'divergence between private and social net product' 'arises out of a disservice rendered to persons other than the contracting parties' and so cannot be 'mitigated by a modification of the contractual relation between any two contracting parties'.[17] However, this 'natural' divergence could be removed by the state by means of ''extraordinary encouragements' or 'extraordinary restraints' upon investments in that field', the 'most obvious examples' of which being 'bounties and taxes'.[18] In this way the state could require that negative externalities be internalised by those who benefited from their production, whilst producers of positive externalities could be subsidised by the state.

With his seminal paper, 'The Problem of Social Cost',[19] Ronald Coase launched a serious challenge to Pigou's approach. Coase argued that government intervention would not necessarily result in the greatest social wealth for a number of reasons. First, there are costs associated with government intervention, and since these do not in themselves contribute to social wealth, they should be taken into account in deciding whether to intervene. Second, government intervention distorts the incentives of actors within the economic system and so changes their behaviour. These second order effects of intervention also need to be taken into account by the regulator. Coase argued that the alternative to regulatory intervention is to do nothing, and to leave the matter to bargaining between those concerned with the externality in question.

Coase argued that, as long as property rights are clearly defined in law, one party will have the right either to create the harmful effect or to be free of it. In those circumstances, it is open to those concerned with the social cost to bargain around the law's default allocation of rights. If there were no transaction costs (i.e., the parties could identify each other, strike a comprehensive bargain and enforce it costlessly), then the possibility of bargaining would mean that the right in question would always be allocated to its highest value use. Of course, as Coase explicitly recognised, there will always be transaction costs. This means that it cannot be assumed that bargains will alwats be struck wherever they would be wealth-enhancing; conversely, the absence of a bargain does not necessarily indicate that resources are allocated to their highest value uses in absolute terms. However, Coase's argument offers a regulator faced with an instance of social cost an alternative to Pigovian taxation or regulation: they can do nothing, and leave the particular social cost issue to possible negotiation between the creator and victim. As long as the transaction costs are lower than the gains from trade, the argument goes, self-interested economic agents will trade. In choosing between regulation and leaving the matter to the parties, the regulator should compare the costs and benefits of government regulation with the costs and benefits of doing nothing and leaving the matter to the parties, including the transaction costs facing the parties.

Whereas Pigou had adopted conventional assumptions about the causes of externalities and the morality of allowing them to continue, Coase argued that problems of social cost are reciprocal, in the sense that they entail competing claims to scarce resources, such as clean air or silence.[20] Coasean economists therefore abstract from moral reasoning and argue that what needs to be determined is which allocation of resources will produce the greatest social wealth. Coase's approach is counter-intuitive to lawyers because he 'not only rides roughshod over notions of corrective justice; he also undermines fundamental notions of causation.'[21] It requires a much broader inquiry into how society's resources should be allocated in order to increase aggregate social wealth.

The assumption that the regulator can make a socially adequate choice between intervening with taxation or regulation and doing nothing requires some heroic epistemological assumptions. In order to compare the costs and benefits of regulation versus doing nothing, the regulator must try to anticipate how the parties will respond to regulation and how that response will affect total social wealth. I will say no more about that here, other than to note that any attempt to predict the impact of a regulation on something as complex as a large, modern economy is certain to be wrong.[22] Nevertheless, regulators pay lip service to this requirement and produce clear cost-benefit analyses of the impact they expect proposed regulatory schemes to have. Coase's view was that the costs of government intervention were likely to be very high, making it 'very likely that most 'externalities' should be allowed to continue if the value of production is to be maximized.'[23] To the extent that transaction costs prevent bargaining around the law's allocation of rights, social wealth will not be maximised in absolute terms. However, social wealth will be higher than it would be under the alternative of government regulation or taxation.

Coase's view that regulation will rarely be able to deal efficiently with social cost has garnered support not only from neoclassical economists, who view interference with market outcomes as likely to do more harm than good as well as infringe on individual liberty,[24] but also from legal sociologists such as Gunther Teubner. Teubner claims that instrumental regulation faces a trilemma, which means that law 'is either irrelevant, or produces disintegrating effects on the social area of life or else disintegrating effects on regulatory law itself'.[25]

The application of the trilemma to the context of governing externalities requires some further explanation. There are many ways in which law might become irrelevant, such as where corporations produce externalities which produce harm across borders. It may be difficult for the regulator to identify social costs before they occur. Where the regulator does not know even the nature of the externality, let alone the harm it causes or the extent of its effects, it will of course be impossible to design legislation which deals with it. Vatn and Bromley emphasise that externalities are 'basically novelties' which are 'mostly... recognized *after* they have been produced'. This is compounded by the fact that there are often 'large time spans between when a physical act (eg emission) takes place, and one becomes aware of the external effects it creates'.[26] It is very difficult, if not impossible, to govern unpredictable externalities, such as the socio-technical externalities which result from new technology, by means of ex ante regulation.

The law may produce disintegrating effects on the social area of life where the nature of the harm is known, even if the regulator attempts to regulate in the least disruptive way possible. A good topical example of this aspect of the trilemma is the Basel II agreement on banking regulation.[27] The type of harm to be avoided was clear to the regulator: national taxpayers would suffer significant losses in the event of a bank becoming insolvent because states implicitly guarantee banking liabilities in order to prevent contagion and systemic collapse. This is a clear externality. The method of occurrence was also clear ex ante: a bank would become insolvent because it took excessive risks. Basel II therefore sought to govern risk-taking in financial institutions to prevent this happening by requiring banks to hold minimum amounts of capital. It even endeavoured to avoid distortions in resource allocation by incorporating fact-sensitivity: capital requirements were calculated according to a system of weighting which took account of the risks associated with different asset classes. The aim of this was to prevent banks from loading up their balance sheets with riskier, and therefore higher yielding assets. However, the use of minimum capital requirements to achieve this regulatory goal clashed with the market imperative to increase profits (measured in terms of return on equity), which gave executives powerful incentives to move lending off balance sheet and into the far riskier ‘shadow banking system’, which consists of unregulated hedge funds, special purpose vehicles, conduits and so on. So Basel II not only created a high level of regulatory costs as national regulators had to deal with the complexities of an agreement among national central bankers which ran to hundreds of pages; it also resulted in the disintegration of the banking system it was sought to regulate, which actually led to more risk-taking and less transparency.

Basel II demonstrates the bind in which regulators find themselves: if they seek to avoid disintegrating effects on the social system by being less prescriptive and placing greater reliance on self-regulation, the law risks becoming irrelevant. Basel II allowed banks to adopt the Internal Ratings-Based (IRB) method of risk-weighting as an alternative to the standard risk-weighting approach. It allowed authorised banks to assign risk weightings according to their own internal models and therefore to determine for themselves how much capital to hold.[28] The IRB too appears to have failed to control risk-taking in any meaningful way, despite the fact that it was far less prescriptive than the standard approach.

Finally, if the law tries to avoid the first two aspects of the trilemma, it is likely to produce disintegrating effects on itself: as production processes become more complex and supply chains become longer, regulation has to abandon general principles applicable to entire industries or the economy as a whole in favour of an approach which differentiates between, and is directed at, individual firms, or even individual activities.[29] This not only undermines the coherence of the law; it also greatly increases regulatory costs. A good example of this is the response to the financial crisis, which was focused on ‘crisis management’ at the expense of underlying principle.[30]

The costs and likely distortions of instrumental regulation mean that regulators who follow Coase’s prescription and carry out a cost benefit analysis of a proposed law are likely to plump for leaving the question of social cost in the hands of the parties. Moreover, as scholars such as Orts and Yosifon emphasise,[31] preventing regulation that reduces profitability is now viewed as a core aspect of management, so even if regulation is feasible on a cost-benefit basis, a political choice problem arises as well-capitalised corporations can lobby against change, taking advantage of their relatively small numbers to overcome collective action problems. For both these reasons, then, regulation of particular externalities will frequently be lacking, and the matter will, as Coase anticipated, be left in the hands of the parties. However, as the next section will demonstrate, not only are transaction costs a formidable barrier to wealth enhancing reallocations of rights in relation to social cost, there are also other barriers to bargaining between those concerned by an externality.

3. Governance of Externalities through 'Coasean Bargaining'

Most neoclassical economists misrepresent Coase's argument as the 'Coase Theorem', which states that in a world without transaction costs, resources would move to their highest valued use and regulation would be unnecessary. The 'Coase Theorem' carries the normative implication that the role of law is either to reduce transaction costs to make bargains to reallocate rights easier, or to allocate rights to the party which values them most highly, thereby avoiding the need for a transaction entirely. In other words, law's only function is to bring the world closer to the zero transaction cost world. Coase has distanced himself from this extreme position, which focuses primarily on judicial decision-making and rarely gives explicit consideration to the role of regulation. It also ignores the various costs associated with going to court and therefore runs counter to Coase's project of encouraging economists to consider and compare the costs associated with the various possible methods of governing economic activity.

This section will focus on two important weaknesses in Coase's assumptions. First, like most economists, he assumes that property rights are given, or a datum.[32] He assumes that courts are capable of laying down a comprehensive and clear ex ante allocation of property rights which can provide the basis for subsequent bargaining between the parties concerned by a particular social cost. This assumption may arise from the fact that Coase's analysis is based on a detailed examination of decided cases. However, this does not correspond with the experience of most lawyers, and it is increasingly recognized, at least in legal scholarship, that rights are very rarely if ever clearly allocated ex ante.[33] Where rights are allocated by reference to the application of a standard (as in negligence and most nuisance actions), the outcome depends on the selection of a number of variables which cannot be predicted with any degree of confidence. With regard to questions of law, there may be no clear precedent, or it may be difficult to identify which precedents the court will apply. As for questions of fact, a court's findings of fact from the evidence presented are also unpredictable, and this makes questions of causation and responsibility unpredictable. The allocation of property rights is beset by even greater uncertainty where the process which is claimed to create an externality is technologically or scientifically complex. There are numerous barriers to the parties knowing what their rights are in these circumstances, both because precedents are lacking and because it is difficult to ascertain the legally relevant facts about the externality in question. Where the law's allocation of property rights is not clear for these reasons, parties which are risk averse may simply give up and endure the externality. Accessing the courts is expensive and risky, and if the other party to the externality is well-resourced, this will have a significant deterrent effect on litigation to clarify where rights lie.

Economists have gone to great lengths to deny that the legal allocation of rights may be radically uncertain in the Knightian sense that the parties do not at least know the probabilities of different allocations. They insist that the parties can derive objective probabilities from legal advice and the information that is disclosed during discovery. This requires that both the facts of the case and the court's decision on the law have to be treated as issues of pure information asymmetry which are cured by the litigation process.[34] In this account, the law is reduced to a formal or mechanical process of applying existing rules to objective facts in order to generate ex ante predictable outcomes. This, of course, is a description of adjudication which few, if any, lawyers would recognise, and is a perfect example of the legal formalism or reification critiqued by, among others, Campbell and Picciotto.[35]

Uncertainty about the law does not cause lawyers great concern, and they are well aware that litigation is often compromised to reduce cost and stress, or to prevent reputational harm, with both parties giving a little ground to escape the traumas of litigation. Simpson offers an important critique of Coase's assumption that bargaining between the parties will result in assets being allocated to their highest value use. He compares the process of finding a 'mutual accommodation' to 'the manner in which large numbers of people contrive, by a process of cooperative adjustment, to use a sidewalk without colliding with each other.'[36] The point is that the law produces outcomes which 'work', but which can by no stretch of the imagination be described as optimal. In contrast, economists have gone through theoretical contortions to demonstrate that the parties are able to work out the probability of particular allocations of property rights because this is essential to their assumption that bargains allocate resources to a more valuable use. By allocating rights clearly, the law provides an initial endowment, or distribution of costs and benefits, and that distribution can then be improved by bargaining between economic agents as long as transaction costs are not prohibitive.[37] In contrast, if the parties do not know how a court will allocate rights in relation to a disputed resource, there can be no assumption that a bargain struck between two parties reallocates rights to a higher valued use, and therefore the presence or absence of a bargain between the parties carries no normative implications. In short, if the law is not clear, rational calculation becomes impossible and so-called 'Coasean bargaining' becomes indeterminate.

The second weakness is Coase's assumption that transaction costs are the only barrier to wealth-enhancing bargains to reallocate those property rights in relation to a particular social cost. If this is not the case, then a regulator who carries out a cost-benefit analysis will not identify all the relevant costs and may not select the most appropriate governance structure for the externality in question. Moreover, it is essential for a regulator examining a situation in which no agreement is reached to understand why because this will influence the regulator's decision on whether regulation can be justified on efficiency grounds. It may be because the rights are allocated to their highest value use; because transaction costs are too high; or because there is some other barrier to a bargain. In order to sustain Coase's argument that transaction costs are the crucial dimension for determining how social cost should be governed, the notion of transaction costs has been considerably broadened. At first it included costs such as identifying the other party, bargaining, drawing up a binding contract, verifying performance and enforcement.[38] However, since then, the notion of transaction cost has been broadened. Transaction costs are no longer simply the costs of physically producing an agreement; they include the cognitive demands placed on the parties and the behavioural risks they face. For example, Williamson argues that transaction costs arise because bounded rationality and asset specificity (essentially co-specialisation) prevent the production of fully contingent contracts, and therefore allow one party to behave opportunistically at the expense of the other.[39] We saw above that these are the costs which make employees vulnerable to externalities despite the fact that they have a contract with their employer. In addition, dispersed victims will encounter all the obstacles to collective action, such as free rider problems, and will have to bear the costs of setting up a governance structure to coordinate their dealings with the corporation.[40]

This expansion of the concept strengthens Coase's argument that transaction costs are the only barrier to wealth-enhancing reallocations, but also makes it more difficult for a regulator to identify them, and therefore further complicates the already difficult task confronting regulators when they seek to identify whether regulatory intervention can be justified on efficiency grounds, or whether the costs of the economic activity should be left where they fall. Moreover, there are other, more behavioural and sociological barriers to wealth enhancing reallocations of resources, which can only be brought within the category of transaction costs with considerable difficulty, if at all. Whether they are brought within an extended notion of transaction costs or not, they are difficult to evaluate but greatly reduce likelihood that the parties to an externality will strike a bargain.

First, where one agent acts or takes decisions in a way which harms the well-being of another, this will give rise to acrimony, especially among geographical neighbours. Some people will refuse to bargain for 'psychological or sociological' reasons. People rarely want to talk to, let alone bargain with, someone who has been impinging on their quiet enjoyment because this creates antagonism, and they are disinclined ‘to think of the rights at stake in these cases as readily commensurable with cash’.[41] So for example, people rarely if ever bargain around nuisance injunctions, and they are highly unlikely to be willing to pay a polluter so that they can have the clean water they believe they are entitled to.[42] While Coase’s model attempts to abstract from moral considerations, people’s willingness to bargain depends to a considerable extent on the perceived fairness or morality of the other party.[43] This means that people may value something highly, but be unwilling to pay for it because they do not consider it appropriate to pay for something to which they believe they have an entitlement. These effects may be reinforced by the well-documented endowment effect,[44] according to which people value rights they possess more highly than rights they might acquire. This effect presumably extends to rights people believe they possess on the basis that they enjoyed access to particular resources in the past. So, if a corporation interrupts a person’s existing quiet enjoyment, the idea that they might pay the corporation in order to regain their quiet enjoyment appears fanciful. The absence of an agreement here tells us plenty about how angry people can get, but little or nothing about whether resources are allocated efficiently.

Second, and relatedly, Vatn and Bromley emphasise that individuals may be unwilling to pay to preserve the environment because they consider it incongruous to treat environmental ‘goods and services’ in the same way as commodities.[45] They refer to survey evidence in which people say that species diversity is very important for non-instrumental reasons, showing that they value it highly. However, when they are asked to pay to preserve species diversity, most people refuse to pay. This may be because it is incongruous to choose between a moral principle and ordinary consumption goods. It may be because they view preserving species diversity, along with other public goods like a clean environment, as a public matter.[46] It may be because there is no institutional framework which helps them overcome the uncertainty they face as to how these things should be valued.[47] Whatever the exact reason, this line of research strongly suggests that the people’s unwillingness to enter private transactions to preserve the environment does not necessarily mean they do not value the environment highly.[48] This means it cannot be assumed merely because of an absence of bargains that social wealth is maximised by destroying the environment.[49]

Third, the parties may not even agree on the nature, existence and extent of the externality. Before bargaining can occur, there must be a set of facts in relation to which the parties concerned can bargain. The work of Michel Callon, which is discussed in more detail in the next section, suggests that facts must be constructed before the most appropriate method of governance can be considered.[50] Like transaction costs, the costs of constructing facts are highly relevant to any analysis of which form of governance will be the most cost effective in dealing with a particular externality.[51] The difficulty of course is that, before a regulator can consider whether intervention can be justified, it must incur the costs of constructing facts. In some cases, costs considerations will deter a regulator from constructing facts, while in other cases, the regulator will construct a set of facts even though they could have been constructed more cost-effectively in a different governance setting. One only need think of the costs associated with a commission of inquiry to see that governments face high costs of fact production. Already at this stage, economists are beginning to look at the costs of producing the facts about an externality and wondering whether it might simply be more efficient to leave the externality where it falls. Since facts have to be constructed before the most appropriate governance can be identified, it follows that this method is unsuitable to prevent irreversible harms. By the time a regulator comes to construct the facts about an alleged externality, the harm from it will frequently already have occurred. In the case of a complex system like the environment, the consequences of this kind of ex post governance may be catastrophic.[52] If the regulator refrains from constructing the facts, leaving the matter to those concerned, any bargaining process will have to confront both transaction costs and the costs of fact production. At present, the only institutional structure of fact production available to the parties is litigation, which gives rise to very high costs. As will be suggested in the final part of this paper, fact construction within the corporate decision-making process may well be a lower cost alternative.

Finally, economics generally proceeds on the basis that the initial distribution of resources is a matter for the political system, and that the efficiency of resource allocation is determined in relation to a given distribution of resources. Yet even if we accept this, and ignore the adverse distributional consequences of requiring 'victims' of externalities to pay to free themselves from harm, the likely disparity in resources between a corporation and a private citizen cannot but have an influence on the outcome of any negotiations or litigation between them. The initial distribution arguably becomes relevant to economic analysis where it becomes an obstacle to the operation of the governance structure which the regulator expects will deal adequately with social cost. Individual citizens who claim that they have been affected by the activities of large corporations are likely to be risk-averse with regard to starting litigation. If – as was argued above – the outcome of litigation is often radically uncertain and the parties do not know the probabilities, this will have a deterrent effect, which will be compounded by rules about legal costs which expose private plaintiffs to catastrophic economic loss if they are unsuccessful. Individuals will face greater stress from legal proceedings, both because they have a personal interest at stake (in comparison with the corporation's managers and shareholders) and because they are more likely to be directly involved in the proceedings. All of this will be well understood by corporations (or at least their lawyers), and will therefore influence any negotiations which take place between them. The corporation will certainly put the complainants to proof, which has the effect of transferring all the fact construction costs onto them. They may also be able to use their superior resources to increase those costs by hiring all the available local experts, and using procedural rules strategically to overwhelm the complainants. If affected individuals seek to pool resources and form a group to advance their complaint, the corporation can respond to the threat or initiation of litigation with ‘divide and conquer’ strategies. Finally, the corporation can supplement these legal strategies with a public relations campaign, claiming that the issue is one that should be dealt by government, whilst retaining lobbyists to persuade the government in question not to intervene.[53]

Together, these arguments suggest that – in legal practice rather than economic theory – Coasean bargaining is, and will always be, a rare occurrence. If this is the case, the absence of a bargain dealing with a particular externality cannot necessarily be equated with resources being allocated efficiently. Whether these obstacles to bargaining are subsumed into the transaction cost category, or whether they are viewed as a separate category of costs, they suggest that bargaining will be a rare – and expensive – way of dealing with corporate externalities.

The economist’s answer is that if these costs are high, making bargains unlikely, and if government regulation is also costly, then the social costs should simply be left where they fall, and that this is the best possible outcome in the circumstances.[54] This might be acceptable if externalities were a rare outcome of economic activity, allowing economists simply to assume, without empirical analysis, that the social gains from particular economic activities outweigh the social costs. However, once we move away from neoclassical economic models with their operating presumption that markets do not fail, there is growing acceptance that externalities are pervasive. For example, Coase refers to the ‘ubiquitous nature of ‘externalities’’,[55] while Kapp argues that ‘empirical analysis has yielded new evidence of social losses and has reinforced the hypothesis that social costs are not minor exceptions to the rule but are typical phenomena’.[56] This suggests that, before we can be sanguine about leaving social costs where they fall, we ought to attempt to identify them and quantify their economic impact. It will be argued below that the production of this knowledge is one of the advantages of governing externalities through CSR.

These arguments suggest that it is not appropriate to govern social cost on the basis of a starting assumption that economic activity does not create externalities. Instead, governance structures should be designed to identify whether economic activities give rise to social cost, and if so, to find ways of correcting, or otherwise dealing with, those social costs so as to increase social wealth. This paper suggests that CSR is one method by which this might be achieved.

4. Governance of Externalities through Reflexive CSR

The above discussion has shown that both instrumental regulation and bargaining between the parties face considerable difficulties in dealing adequately with externalities, and suggested that externalities are widespread. In light of this, it is suggested that the possibility of governing externalities through the corporate decision-making process should be considered more carefully. Coase did not explicitly consider the governance of social cost through the firm or corporation, although in a 1937 paper he did set out his pathbreaking theory that firms supersede the market as a resource allocation mechanism where transaction costs are high.[57] Using the existing label 'corporate social responsibility' to refer to the process whereby corporations voluntarily decide to internalise their externalities serves to emphasise that only corporations which do so can claim to be socially responsible. However, it is important to note that linking CSR to externalities in this way differs in important respects from conventional approaches to CSR.

One understanding of CSR is that it is simply one way of pursuing shareholder value by developing a reputation for 'doing good' through undertaking philanthropic activities. Examples of this are the fast food chain which sets up hospice facilities for terminally ill children, or the investment bank which funds nonprofit organizations that assist disabled veterans. Decisions to fund these projects may be taken out of genuine concern, but they can be justified for their instrumental value.[58] The argument is that the organization will be more profitable if it develops a reputation for doing 'good' in the community. The approach to CSR being suggested in this paper differs radically from this philanthropy model because corporate decisions to make social expenditures are identified by reference to the effects that the corporation creates on its environment.

Another understanding of CSR is 'sustainability CSR', which is akin to the concept of 'enlightened shareholder value'. It describes the practice of corporations which understand that their 'long-run prosperity depends on the well-being of its various stakeholders, including workers, suppliers and customers', and so take account of these interests in making decisions.[59] This approach (which is permissible, but not mandatory in common law systems) comes closer to what is being discussed here because it describes corporations taking account of the effects of their decisions on various stakeholders. However it still falls some way short for two related reasons. First, corporations will be highly unlikely to take account of affected groups unless they have the ability to affect its bottom line. In contrast, CSR as externality internalisation focuses on the harm done to the affected group rather than the effect of internalising a particular group's interests or expectations on corporate profitability. Second, and relatedly, within the current institutional framework, corporations will only be likely to internalise externalities where their management can articulate a 'business case' for doing so. Corporations will not voluntarily internalise externalities where this requires a sacrifice of profits which is not expected (or at least claimed by management in a convincing manner) to generate returns in the future. In some circumstances, managers may be able to make a case that a company which internalises its externalities signals the quality of its products to consumers, and therefore will be more profitable in the long run.[60] However, in the more normal case where no convincing shareholder value case can be made for internalising a particular externality, it may even be unlawful to internalise it in many common law jurisdictions.[61] Thus at present it would be surprising if corporations were voluntarily to internalise externalities which have not attracted public attention, concern disputed issues of fact, or threaten long-term harm without immediate symptoms. Yet these are precisely the characteristics of many of the externalities which threaten the most serious harm.

This brief outline shows that conventional approaches to CSR always have at least one eye on the business case for voluntary action; in contrast to this, treating CSR as externality internalisation moves beyond business case justifications for particular decisions and focuses on whether corporate decisions and activities are producing unacceptable social costs.

The theory of reflexive law provides a powerful justification for using the corporate decision-making process to govern externalities. Advocates of reflexive law claim that it can be used to regulate social systems, including corporations, 'that otherwise would be impossible to regulate'.[62] It is particularly appropriate for complex, functionally differentiated societies where prescriptive interventions in the legal system create interference or 'irritations' in other social subsystems like the economy or corporations.[63] Reflexive law avoids the regulatory trilemma by understanding and working with the autonomy of corporate decision-making processes, but steering them so that they are more likely to identify and take account of the effects they have on their environment. In autopoietic systems theory, which forms the basis for the theory of reflexive law, corporations are understood as the law's reconstruction and personification of the organizations which it observes in its environment and which meet specified criteria laid down by the law itself.[64] Organizations are social subsystems which consist of linked decisions, and those decisions determine both what the corporation selects as relevant from its environment, and how it responds to those selections. They are 'autopoietic' because they themselves produce the decisions of which they consist according to their own logic and without direct input from their environment. In other words, they have qualified autonomy from their environment, which they construct within their own internal communications according to their own procedures. Within organizations, each decision forms the premise for the decisions which follow it, which means that it serves as 'a normative point of reference' to be 'taken into account in the process of generating, recognizing, and connecting operations as decisions to prior decisions.'[65] Those decisions in turn motivate actions in the organization's physical environment, and those actions may produce outcomes which are externalities because they are not consented to by those affected. Reflexive law therefore seeks to influence the way in which decisions are made, rather than prescribing ways of acting in pursuit of specific goals.

One decision which exercises a strong normative influence over subsequent organizational decisions is its goal. Corporate law is highly permissive with regard to goals, merely requiring that decisions be made in 'the interests of the corporation', and giving management a broad margin of discretion under the 'business judgement' rule. However, under market pressure, many corporations have adopted the goal of producing shareholder value, commonly expressed in terms of return on equity. As a system of recursively linked decision premises, corporations as organizations tend to continue to do things which worked in the past, unless and until a decision to do things differently can be justified and gains acceptance among decision-makers. The main insight that systems theory contributes to corporate governance regulation is that corporations observe law in their environment and reconstruct its demands. Corporations then decide whether and how to comply with the law. Since law can threaten sanctions (which corporations reconstruct as a financial cost), it will be taken into account in making decisions, but the regulator can never be sure how a corporation will respond to a particular law. Where law is instrumental, corporations may make decisions to act in ways which frustrate the regulatory goal, even if they formally comply with the regulation in question. Again, Basel II is a good example of this, with financial corporations complying with the rules about capital, but doing it in a way – moving assets and liabilities off balance sheet – which frustrated the aim of the regulation – controlling risk-taking. They did this because the rules threatened their goal and other decisions linked to it – namely producing shareholder value as expressed by return on equity.

Reflexive law therefore abandons instrumental regulation in favour of procedural regulation aimed at steering the decision-making process but without attempting to impose particular outcomes on it. It is a means by which a regulator can steer corporations towards greater internalisation of their externalities without producing second order effects, or distortions. In order to achieve this, two procedural norms might be suggested. First, corporations might be required to consult with those who consider themselves affected by the corporation's decision-making so that they learn about their effects on their environment and identify means of mitigating or internalising those effects. Second, decision-makers such as directors and managers might be required to take decisions in good faith in the interests of the corporation (or perhaps the shareholders – depending on the jurisdiction in question), whilst internalising any externalities of which they become aware in the course of consulting affected groups. Procedural norms such as these would bypass the regulatory trilemma, and, by bringing the corporation and affected groups together for dialogue at a relatively early stage, sidestep many of the barriers to 'Coasean bargaining' discussed above. In this way, it would mark out a middle ground between the two alternatives conventionally proposed, a form of 'regulated self-regulation'.

Besides avoiding the trilemma and the difficulties of bargaining, requiring corporations to identify and address externalities in this way offers a number of other advantages over the more conventional alternatives discussed above, and could therefore be used as an alternative or, more likely, a complement to them.

The work of constructivist sociologist Michel Callon demonstrates some of the advantages of proceeding in this way. In his work, Callon emphasises that externalities occur because they overflow the 'frames' used by actors and decision-makers, and are therefore not taken into account. The frame is the boundary within which the interactions in question 'take place more or less independently of their surrounding context'.[66] What falls outside the frame is 'bracketed' and removed from consideration by the relevant actors. Where corporations have adopted the goal of shareholder value, they will have built up structures of decision premises which frame decisions and exclude anything that cannot be argued to advance that goal. Corporate managers and shareholders have 'agreed' that managers should make decisions using a frame which includes effects on shareholders (measured by reference to the share price or return on equity), while effects on third parties will only come within the frame if management considers that they are likely to have consequences for returns to shareholders. This may be the case, for example, where a particular action is illegal or where it is likely to harm the corporation's reputation. Other consequences of corporate activity, such as long term and diffuse effects on the environment or other, difficult to measure externalities, will be bracketed outside the corporate frame and will not be taken into account by management. Like Coase, Callon recognises that externalities are 'the rule' rather than an exception.

The solution is for decision-makers to expand their frames so that they include more externalities. Callon describes the place where decision-makers and affected groups meet so that this broader process of framing may occur as a hybrid forum because 'facts and values... become entangled' and specialists and non-specialists have to work together to construct an image of the overflows in question.[67] The forum mixes together scientific construction of facts with decision-making and rule-making, all of which is carried out by a variety of actors with different interests and expectations.[68] Callon's recent work has focused on the role of hybrid forums in constructing acceptable solutions to issues of public concern such as deep burial of nuclear waste or the spread of BSE in the United Kingdom.[69] However, his earlier work established the ubiquity of the overflow and demonstrated that, whether an overflow is to be governed by a corporate decision, a contract or regulatory intervention, it has to be traced or mapped first. It is the task of the hybrid forum to trace the overflow and identify an appropriate means of governing it. The solution does not necessarily have to be a bespoke way of dealing with a particular, fully specified externality. In the corporate context, it could be a decision premise which tells corporate decision-makers how to act where they identify specific facts in the corporation's environment, or it could involve the creation of norms about how the hybrid forum ought to proceed in relation to a class of externalities.

Callon and Rip emphasise that the role of the hybrid forum (or 'expertise' as they term it) is to establish 'an acceptable alignment between what one knows (or believes one knows), what the actors want and expect (which is often contradictory) and the procedures to follow to elaborate norms.' The norms which emerge from these forums must be 'scientifically plausible', 'socially viable' and 'juridically acceptable'. Where all three criteria are satisfied, the norm will 'stabilise for a certain period an agreement on what one knows, what is socially acceptable and the rules for reaching agreement'.[70] Like corporate decision premises, these norms are always revisable, and simply represent an arrangement or accommodation which is 'by no means perfect, but is acceptable' because it is 'collectively elaborated, constructed, and by which we reconcile our differences, at least for a limited period.'[71] Although his work is not explicitly normative and does not address the governance of externalities through the corporate decision-making process, Callon's approach could be used to inform the design of reflexive regulation designed to steer corporations to identify the social costs their operations create and appropriate means of internalising them.

This proposal that corporations should constitute hybrid forums to guide their decision-making gives rise to a number of questions. The first concerns the procedures to be followed by the hybrid forum. Research into reflexive governance emphasises that the rules governing interactions between stakeholders should be established by the participants and revised in the light of experience.[72] While desirable in theory, this proposal, like all proposals for collective action or decision-making, must confront a number of difficulties. For example, must everyone concerned by a particular activity agree on the facts which are constructed and the proposed solution, or will a majority suffice? How are the procedural norms that apply to operations of the hybrid forum to be established? There is clearly potential here for hold-up, for example, or for more socially or economically powerful groups to dominate proceedings. It may be that these are questions which can be left to the forum itself. It may be that the law – perhaps the judiciary through the imposition of standards to ensure fair participation[73] – would have to intervene in some way if the proceedings of hybrid forums become unduly long or unruly. However, this is not a fatal objection to this suggestion; after all, corporate law had to deal with similar problems regarding relations between majority and minority, and between board and shareholders, and it managed to avoid deadlock while remaining, for the most part, permissive and facilitative. In principle there is no reason why the same outcome should not be achieved in relation to a hybrid forum.

The second question concerns how to guarantee that the forum will be a place of mutual learning and dialogue which transcend narrow self-interest. These are problems that all reflexive law or 'new governance' proposals must contend with. One thing that is clear is that they will not be solved by a regulator laying down prescriptive rules because the regulator cannot anticipate the factual context of particular decisions. It is possible that the public nature of proceedings would constrain some of the most intense self-interest seeking. It may be that by embedding CSR considerations in the corporate governance process, the law brings about a change in people's conceptions of the role of corporations in society, making the parties to an externality less antagonistic. All of this remains to be seen and answers to these questions will only be identified through experimentation.

Once the facts about the externality and a mutually acceptable solution are identified, we might expect corporations which have a CSR programme voluntarily to internalise them, at least where it can be argued that there is a business case for doing so. This would link with earlier decisions that rationalise the CSR programme as a means to achieve the corporation's goal of shareholder value. In contrast, where no business case for internalisation can be made out for an externality which has been identified, internalisation will not occur in corporations which have adopted the goal of shareholder value in the absence of the procedural legal intervention discussed above. The proposal to elevate externality internalisation to the status of a corporate goal would be absolutely crucial here, because it would provide a decision premise that exercises a normative influence on all corporate decision-making.

While reflexive governance raises a number of difficult questions, Callon's approach highlights a number of advantages of governing externalities in this way. Instrumental regulation requires the regulator to identify in advance at least the type of externality and to prescribe how corporations should respond to the occurrence of that kind of externality. Without detailed knowledge of the context, this is extremely difficult. Reflexive governance has greater capacity both in terms of identifying externalities on an ongoing basis, and in terms of generating mutually acceptable solutions. A hybrid forum might also be a more effective, efficient and fair way of constructing facts than interest group lobbying in a political process. Callon's approach also offers advantages when compared with litigation. Although judges only have to deal with one specific factual context, their adversarial procedures make courts a very expensive method of constructing facts, and give rise to antagonism between the parties. Moreover, courts are limited as to the remedies they can award. As for 'Coasean bargaining', it is far from clear that the parties to an externality ever get together of their own accord to agree on the facts about a particular externality. If the law were to require companies publicly to consult those who consider themselves affected, there would be a better chance of a mutually acceptable set of facts emerging, and there is also greater scope for the parties to identify a remedy which satisfies everyone. This argument suggests that a hybrid forum may well be a lower cost means of governing externalities than instrumental regulation, litigation or Coasean bargaining. Moreover, since all concerned consent to the decisions of the forum, it cures the externality without producing second order effects. At the very least, therefore, regulators should consider reflexive CSR as an alternative mechanism for the governance of externalities, especially where it seems likely that there are complex, 'socio-technical' externalities.

Unsurprisingly, given their guiding assumption that returns to shareholders are the best possible proxy for increases in social wealth, shareholder value theorists are implacably opposed to using the corporate decision-making process to govern externalities and prefer bargaining between the parties.[74] However, their arguments rest on a number of assumptions which were questioned above, namely that it is possible comprehensively to allocate property rights ex ante; that transaction costs are the only barrier to market reallocations of rights; and that the parties have access to the facts about the nature and extent of the externalities. Moreover, the preceding reform discussions highlight that the corporation is a social construct, so, unlike humans, its goals and the frames it uses to make decisions can be changed by law.

Under contractarian models of corporate governance, the corporate goal of shareholder value is justified on the basis that it produces more social wealth than any other means of governance.[75] Yet this justification is based not on empirical research but unjustifiable assumptions about the ability of the law to deal adequately with social costs by means of instrumental regulation and the parties to use market-based contracting. Where these solutions are not viable, the social costs of corporate decision-making are not even identified, which means they are not accounted for and deducted from the benefits of corporate activity.[76] It is then simply assumed that if the regulator abstains from intervention on the basis of cost-benefit analysis and the parties do not bargain for a solution, the best possible outcome in the circumstances is achieved because the costs of the solution must exceed the benefits. Yet as was shown above, the parties may leave externalities where they fall for cognitive and behavioural reasons, as well as for reasons of transaction cost. Moreover, by limiting regulators in this way, the dominant economic model actually prevents the empirical identification of social costs and closes off the argument that, as currently configured, corporate governance does not produce the best social outcomes. Finally, granting managers greater discretion to take social costs into account is opposed on the grounds that it would result in managerial unaccountability to shareholders. Yet where managers are incentivised to pursue only the interest of shareholders as expressed in the share price, and even to externalise costs onto society wherever this is not explicitly forbidden, those affected face an uphill struggle to hold management and corporations to account.

Transaction costs, however, remain central to most analyses. Economists say that without transaction costs, there would be no externalities, and they prove this with their models. Other scholars emphasise that it is impossible to eliminate transaction costs entirely because transactions 'can only take place within a constitutive social system. If one really took away all the costs of exchanging, the exchange would not take place cost-free. It simply would not take place at all.'[77] Coase too observed that 'It would not seem worthwhile to spend much time investigating the properties of' a world without transaction costs, in which 'externity can be experienced in a split second.'[78] Since transaction costs can never be completely eliminated, true followers of Coase, as we have seen, use comparative institutional analysis to compare the costs of different governance structures and make a selection between the market (Coasean bargaining) and the law (regulation or taxation). Yet in both of these Coasean approaches, it seems as though transaction costs, rather than human decision-making, are somehow to blame for creation and continuance of particular externalities. Vatn and Bromley offer a powerful critique of this assumption. They argue that transaction costs are a 'deus ex machina' in economic theory because they simply appear on the scene with no explanation of where they come from.[79] Vatn and Bromley offer a radically different account of market failure which proceeds as follows.

Externalities are inevitable where an economy is organized in line with the market model, which calls for control over resources to be divided between self-interested atomistic agents as a means to the end of increasing social wealth. This very division is 'the mechanism responsible for creating some of the limitations of that very same model. Through atomization, the number of borders among economic agents increases, thereby amplifying transaction costs and hence contributing to the generation of externalities.'[80] Externalities arise because, as Callon would put it, the consequences of decisions overflow the frames used by actors to make those decisions, yet those frames are part and parcel of the institutional structure of the economy. The greater the atomisation of economic actors, the more externalities there will be and the higher the costs of governing them will be. Economists then claim that these externalities cannot be solved efficiently on the basis that, if the benefits of correcting the externality exceeded the costs, atomised agents would strike a bargain to cure the externality. It follows from this that social wealth is maximised by not intervening. However, since externalities and transaction costs necessarily arise from the organisation of the economy along market lines, this means, say Vatn and Bromley, that 'the issue of efficiency is caught up in a severe circularity.'[81] The unspoken assumptions underlying the economists' argument is that social wealth is increased by more where economic activity is organised and governed as it is at present than under any possible alternative configuration,[82] and that externalities are an exception rather than the rule, so their costs are outweighed by the benefits of market organization across the economy as a whole. Yet these are matters of faith rather than empirical evidence.

It is possible to go further and argue that where this atomistic market structure is combined with corporate governance structures intended to prioritise and incentivise managers to pursue shareholder value, externalities will actually increase. Corporations will shift costs wherever this can be done 'without violating any previously established and enforceable rights'.[83] Wherever cost shifting is not clearly unlawful – for example where the law or the relevant facts are unclear – the morality of doing so is not clear, and in fact, 'shifting costs in a permissive rights regime can be equated with good business practices'.[84] Within a corporate governance regime that rewards decision-makers for increasing return on equity, cost-shifting within the law and even within areas where the law is unclear, is strongly incentivised. Moreover, as Vatn and Bromley point out, successful (because it increases return on equity) cost-shifting is likely to be emulated by competitors, with the effect that 'externalities will almost certainly increase over time.'[85]

Once we view externalities as inherent in the market form of economic governance, then it becomes desirable for them to be addressed in a socially satisfactory way by the institutional structure of the economic system.[86] One way of doing that is to begin by assuming that corporate decision-making within a market structure produces the common good most of the time, but to recognise that this assumption must sometimes give way where decisions produce effects which overflow the frames used by managers. Where the facts constructed through the collective, discursive processes of a hybrid forum show that a decision adversely affects non-consenting parties, corporations should be required to change their decision-making frame so that they allocate resources in a way which takes account of, or internalises, the social costs which have been identified. In this way externalities are governed by the very decision-making structure that creates them. The role of the hybrid forum is to identify when frames need to be changed and what the new frames should encompass; the role of the law is to constitute the hybrid forum and to require corporate decision-makers to use that new frame.

One final objection to this method of governing externalities can be anticipated here. Since the hybrid forum does not generate prices which can be used as the basis for allocating resources, there is no way of assessing whether corporate decisions to internalise externalities enhance social wealth in a given case. It is true that this method of governance does not rely on prices. However, as we saw above, where property rights are unclear, as will often be the case, the prices demanded by the parties for giving up particular rights are not a reliable guide to efficient resource allocation. Prices will be lacking entirely where, for the various reasons discussed above, the parties do not bargain about a particular externality. Finally, since the market's failure to price third party effects is inherent in its structure, another means of assessing value must be adopted. That other means is the social construction of value through dialogue among all concerned. As Bromley points out, 'there is no such thing as a priori truth about preferences or about what various parts of nature are 'worth' – either structurally, functionally, or monetarily. Individuals must sit down together and figure out what these things seem to be worth.'[87]

5. Conclusion

This paper has argued that externalities of economic activity are ubiquitous, yet the standard economic prescription for dealing with them leaves many of them unsolved, claiming that this is the best possible outcome in the circumstances. It is widely recognised that government regulation is likely to give rise to considerable costs and to create second-order effects. Most economists therefore prefer to leave a particular externality to bargaining between those concerned, and where no bargain is struck, they are content to assume that the externality in question cannot be solved in a cost-effective manner. However, there are many barriers to bargaining which do not fall within even the broadest notion of transaction costs, and therefore it is essential to consider other ways of governing externalities. This paper has suggested that externalities could be governed in a cost-effective manner through the corporate decision-making process. The establishment of a hybrid forum in which those affected by an externality trace the existence and effects of externalities and find mutually acceptable solutions would enable many more externalities to be governed than at present. This process would have to be supported by law, but the use of reflexive regulation would not produce second order effects because it would impose procedural rather than substantive outcomes. Finally, the paper suggested that, since externalities are an inevitable product of the institutional structure of the economy, they can only be dealt with systematically by requiring economic actors to change the frames they use when making decisions. Together these arguments suggest that reflexive CSR would be a valuable addition to the regulatory toolbox for dealing with social cost.

Notes

[1] Meade offers the following definition: 'An external... diseconomy... is an event which... inflicts an appreciable damage... on some person or persons who were not fully consenting parties in reaching the decision or decisions which lead directly or indirectly to the event in question.' J. Meade, *The Theory of Economic Externalities* (Leiden 1973) at 15.

[2] N. Stern, *The Economics of Climate Change: the Stern Review* (Cambridge 2007) at 27

[3] This was recognised by Bator as long ago as 1958 who noted that 'the notion of external economies... belongs to a more general doctrine of 'direct interaction'. Such interaction, whether it involves producer-producer, consumer-consumer, producer-consumer, or employer-employee relations, consists in interdependencies that are external to the price system, hence unaccounted for by market valuations.' See F. M. Bator, 'The Anatomy of Market Failure' (1958) 72 *The Quarterly Journal of Economics* 351 at 358.

[4] So for example, Easterbrook and Fischel argue that a 'corporation's choice of governance mechanisms does not create substantial third party-effects... Investors, employees, and others can participate or go elsewhere.'

[5] See for example, M. Blair, *Ownership and Control : Rethinking Corporate Governance for the Twenty-first Century* (Washington, D.C. 1995) pp. vii; A. Johnston, *EC Regulation of Corporate Governance* (Cambridge 2009) , chapter three.

[6] For a discussion of transaction costs and the other barriers to contracting, see O. Williamson, *The Economic Institutions of Capitalism* (New York 1985) , chapter one. Williamson recognises that a legally binding contract may be impossible for various reasons, including asset specificity (essentially co-specialisation), bounded rationality, uncertainty, information asymmetry and transaction costs. This creates scope for one party opportunistically to take a decision or act in a particular way which benefits them at the expense of the other. Williamson suggests that where these factors create a risk of opportunism, or 'self-interest seeking with guile', the parties will voluntarily put in place an appropriate governance structure to rein opportunism where they view this as justifiable on a cost-benefit basis. To the extent that we do not see this kind of governance structure, the conventional view would be that – just as it is where Coasean bargains are not struck – that the costs of a new governance structure exceed its benefits. However, although Williamson's approach takes transaction costs seriously as a barrier to contracting, he does not examine their

role in preventing the parties from designing a governance structure which meets their needs. Why would the parties be any better equipped to design a governance structure than to draw up the terms of an ex ante contract? Moreover, the parties will be focused on their own returns rather than social wealth in the aggregate. As Sadowski et al put it 'A selfish rational agent will prefer a constitution that strengthens his absolute position in ex post bargaining, even if this is detrimental to firm value.' Since we cannot expect the parties to bargain for an efficient governance structure for corporate contracts, they ask: 'Are legal interventions an efficient way out?' (D. Sadowski, J. Junkes and S. Lindenthal, 'Labour Co-Determination and Corporate Governance in Germany: The Economic Impact of Marginal and Symbolic Rights' (1999) 60 *Quint-Essenzen* at 9)

[7] Meade argues that if an employee is dismissed without his or her consent, there is no externality as long as there is a perfectly competitive market because dismissal will 'inflict no damage' on them. The employee can 'obtain at the same market wage another job of equal attractiveness' without 'additional costs of movement or training'. J. Meade, *The Theory of Economic Externalities* (Leiden 1973) at 18. However, there is considerable evidence that employees who invest in FSHC lose large wage premia and follow a lower wage trajectory when they change jobs: for a summary see M. Blair, *Ownership and Control : Rethinking Corporate Governance for the Twenty-first Century* (Washington, D.C. 1995) pp. vii at 263-4.

[8]For example, Easterbrook and Fischel simply deny that employees are residual claimants, which means that they have to rely on their 'explicit, negotiated contract'. Any gaps in the contract are their fault. F. H. Easterbrook and D. R. Fischel, *The economic structure of corporate law* (Cambridge, Mass. 1991) at 37.

[9] D. Yosifon, 'Towards a Firm-Based Theory of Consumption' (2011) 46 *Wake Forest Law Review* 447 at 451.

[10] H. Simon, *Administrative Behavior* 4th ed., (New York 1997) at 118.

[11] Ibid at 119.

[12] Ruggie refers to the 'governance gaps created by globalization': see 'Protect, Respect and Remedy: A Framework for Business and Human Rights', A/HRC/8/5, 2008, para 3.

[13]See Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework, A/HRC/17/31. The Guiding Principles, inter alia, require corporations to respect human rights through 'an ongoing process of human rights due diligence, whereby companies become aware of, prevent, and mitigate adverse human rights impacts.'

[14] 'A renewed EU strategy for Corporate Social Responsibility', Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions (COM(2011) 681 final, 25.10.2011) Similarly, the Indian government is considering requiring companies with dispersed shareholders to set up a 'Stakeholders Relationship Committee' to 'consider and resolve stakeholder grievances'. See Clause 158(12) Companies Bill 2009 and S. Deva, 'Sustainable Development: What Role for the Company Law?' (2011) 8 *International and Comparative Corporate Law Journal* 76 at 86.

[15] *Green Paper on Promoting a European Framework for Corporate Social Responsibility*, COM(2001) 366 final, 18 July 2001 at 4-6.

[16] A. Pigou, *The Economics of Welfare* (1952). Pigou set himself the task of examining 'some of the ways in which it now is... feasible for governments to control the play of economic forces in such wise as to promote the economic welfare, and through that, the total welfare of their citizens as a whole'.

[17] Ibid at 192.

[18] Ibid; 'bounties' are forms of government expenditure.

[19] R. Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, reprinted in R. Coase, *The Firm, the Market and the Law* (Chicago 1988) . References in this paper are to *The Firm, the Market, and the Law*.

[20] In Meade's categorisation, these are externalities due to a 'shared variable'. The same variable (eg a quiet environment) 'enters into the utility function or the cost function of more than one independent economic decision-maker'. A 'shared variable can, as it were, be imposed upon one agent by a unilateral decision of the other agent', bringing the situation within the definition of externality. See J. Meade, *The Theory of Economic Externalities* (Leiden 1973) at 27-8.

[21] A. Ogus, *Costs and Cautionary Tales: Economic Insights for the Law* (Oxford 2006) at 8.

[22] Both of Pigou's preferred options, regulation and taxation, are blunt instruments of social steering which produce distortions or second order effects. The practical impossibility of anticipating those second order effects means the regulator cannot determine a rate of taxation which will match the environmental cost and produce the common good; it will always be too high or too low. See for example A. Vatn and D. W. Bromley, 'Externalities - A Market Model Failure' (1997) 9 *Environmental and Resource Economics* 135 at 144-5. Hsu argues that taxation might be preferred to command and control regulation as a means of controlling pollution on the basis that, rather than impose a technological solution, it creates market incentives and encourages innovation by making pollution reduction a challenge. See S.-L. Hsu, 'Some Quasi-behavioral Arguments for Environmental Taxation' In N. Chalifour, J. Milne, H. Ashiabor, K. Deketelaere and L. Kreiser (eds.), *Critical Issues in Environmental Taxation Volume V* (New York 2008).

[23] R. Coase, *The Firm, the Market and the Law* (Chicago 1988) at 26. Coase also said that 'it will no doubt commonly be the case that the gain which would come from regulating the actions which give rise to the harmful effects will be less than the costs involved in governmental regulation.' (ibid at 118) Whilst Coase argued that these costs create a 'prima facie case against intervention', he also acknowledged that government intervention is 'not necessarily unwise', (ibid at 26 and 133) and denied the charge that he was 'deeply sceptical' as to the desirability of government intervention (R. Coase, 'Law and Economics and A.W. Brian Simpson' (1996) 25 *Journal of Legal Studies* 103 at 106-8). He insisted that when choosing between markets, with their transaction costs, and government intervention, with its administrative costs, as methods for the governance of externalities, 'we are choosing between social arrangements which are all more or less failures'. R. Coase, 'The Regulated Industries: Discussion' (1964) 54 *American Economic Review (Papers and Proceedings)* 194 at 195 cited in D. Campbell, 'Of Coase and Corn: A (Sort of) Defence of Private Nuisance' (2000) 63 *The Modern Law Review* 197 at 198.

[24] M. Friedman, *Capitalism and Freedom* (Chicago 1962) at 31-4.

[25] G. Teubner, 'Juridification: Concepts, Aspects, Limits, Solutions' In G. Teubner (ed.), *Juridification of Social Spheres : A Comparative Analysis in the Areas of Labor, Corporate, Antitrust, and Social Welfare Law* (Berlin 1987) at 21.

[26] A. Vatn and D. W. Bromley, 'Externalities - A Market Model Failure' (1997) 9 *Environmental and Resource Economics* 135 at 137. This type of externality might be intergenerational as in Meade's example where a farmer's use of DDT enhances his utility but harms an as yet unborn child. See J. Meade, *The Theory of Economic Externalities* (Leiden 1973) at 32. This particular externality could be prevented prospectively by imposing a prohibition on DDT, but this will do nothing about harms which have already occurred.

[27] See International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version, Basel Committee on Banking Supervision, Bank for International Settlements, June 2006 ('Basel II').

[28] For example, banks could hold far less capital against a particular risk if they concluded that the probability of default or loss given default were low. They could hold minimal capital against a risk if they took out derivative protection against that risk and concluded that there was no risk that the counterparty to the derivative contract would become insolvent. The extent to which these practices contributed to increased risk is not known because the banks' internal models are proprietary, but there is anecdotal evidence that they were widespread. The IRB approach can be viewed as an attempt at reflexive regulation, relying on banks' existing capacity to regulate themselves. However, its apparent failings serve to illustrate Teubner's observation that regulators have to face 'the problem of knowing what it is they are actually trying to regulate' so that they can work with the internal dynamics of the system or subsystem in question. The reason for this is that the subsystems which it is sought to regulate 'deal selectively with legislation and arbitrarily use it, to construct their own order'. (G. Teubner, *Law as an Autopoietic System* (Oxford 1993) at 68 and 75) In the case of Basel II, the regulators needed to gain a thorough understanding of the existing dynamics of banks' autopoietic reproduction, which means understanding how banks construct their environment and make decisions in relation to it. This would of course include the influence of market-based incentives on decisions. However, executive pay was excluded from prudential regulation of banks until after the financial crisis; now see the Financial Stability Board's Principles for Sound Compensation Practices (2 April 2009) and the European Union's implementation of those Principles in the form of amendments to the Capital Requirements Directive (Directive 2010/76/EU, Article 22 and Annex V).

[29] Teubner notes that 'the most painful sacrifice that formal law has to make at the altar of responsiveness is the diminution of internal consistency. Modern responsive law develops legal categories in dealing ad hoc with the various social subspheres. And these, of their nature, can no longer claim universal consistency. They vary from context to context.' Ibid at 105. The solution Teubner advocates to this, as we shall see below, is a move to reflexive law, although, as we saw above with the example of the Basel II IRB approach, reflexive law must be very carefully designed if it is not to become irrelevant.

[30] Renner argues that these political interventions rescued the economic status quo with the disastrous effect that 'the complexity gap between the legal system and its societal environment was almost completely levelled.' See M. Renner, 'Death by Complexity—the Financial Crisis and the Crisis of Law in World Society' In P. Kjaer, Teubner, G and Febbrajo, A (ed.), *The Financial Crisis in Constitutional Perspective: The Dark Side of Functional Differentiation* (Oxford 2011) at 100.

[31] E. Orts, 'Ethics, Risk, and the Environment in Corporate Responsibility' In B. Hay, R. Stavins and R. Vietor (eds.), *Environmental Protection and the Social Responsibility of Firms* (Washington DC 2005); D. Yosifon, 'The Public Choice Problem in Corporate Law: Corporate Social Responsibility after *Citizens United*' (2011) 89 *North Carolina Law Review* 1197.

[32] Aoki emphasises that in the Coase Theorem, 'an initial distribution of private ownership rights is exogenously given'. M. Aoki, *Toward a Comparative Institutional Analysis* (Cambridge, MA 2001) at 36. Likewise, Demsetz admits that 'Economists usually take the bundle of property rights as a datum.' H. Demsetz, 'Toward a Theory of Property Rights' (1967) 57 *American Economic Review* 347 at 347.

[33] Milhaupt and Pistor use the examples of nuisance and minority protection in corporate law to argue that 'a clear allocation of rights ex ante that takes full account of all future claims is simply impossible'. C. Milhaupt and K. Pistor, *Law & Capitalism: What Corporate Crises Reveal about Legal Systesm and Economic Development around the World* (Chicago 2008) at 180-1. Jonathan Morgan suggests that one of the functions of 'any good legal history... is to show repeatedly that the state of the law was (at the time) far less clear-cut than might seem to later generations.' (J. Morgan, 'Review of A History of Water Rights at Common Law' (2005) 26 *Journal of Legal History* 216)). From a more philosophical perspective, see J. Derrida, 'Force of Law: The Mystical Foundation of Authority' (1990) 11 *Cardozo Law Review* 919, arguing in essence that law is not a datum – as economists believe – but an ex post interpretation of an act which cannot be anticipated by reference to a text.

[34] Cooter and Ulen bypass this inconvenient epistemological problem altogether, arguing simply that ‘It is easier to bargain when legal rights are simple and clear than when they are complicated and uncertain.’ (R. Cooter and T. Ulen, *Law & Economics* 5th, International ed., (Boston 2008) at 97) Other economists have sought to get around the absence of a clear ex ante probability distribution by reference to game theory, which eliminates this problem as follows. Knight’s distinction between risk and uncertainty becomes a spectrum, with outcomes arrayed by reference to the amount of available information. Since some information is always available to the parties, they will be able to form subjective probability assessments. This subjective approach also risks becoming indeterminate, as the parties to a dispute form views of their chances of success which bear no necessary resemblance to how the other party would assess the probability because there is neither a common factual framework nor a clear view of how the law would apply to it. This means that there is no objective basis on which to base a rational calculation of the costs and benefits of alternative courses of action. In order to maintain the assumption of rational action, and therefore that bargaining allocates resources to higher value uses, another step is therefore required to ‘fix the beliefs that rational agents hold about each other’. The analysis therefore proceeds by ‘supplementing the assumption of instrumental rationality with the assumption of common knowledge of rationality.’ S. Hargreaves Heap and Y. Varoufakis, *Game Theory: A Critical Introduction* (London 1995) at 23. According to this approach, since each party to a legal dispute will model the other as instrumentally rational like himself, and since each party will have access to the same information (through their recollection of events, through the discovery process in litigation and through legal advice), then each party will be able to model how the other is thinking and assessing their chances of success in litigation. The parties will therefore come to the same conclusion about the probabilities of the case. This assumption is based on the Harsanyi doctrine, which states that two rational individuals with the same information must draw the same inferences and come to the same conclusions: see S. Hargreaves Heap and Y. Varoufakis, *Game Theory: A Critical Introduction* (London 1995) at 25, referring to J. Harsanyi, ‘Games with Incomplete Information Played by Bayesian Players’ (1967/1968) 14 *Management Science* 159. This is not a discussion which can be fully set out here, let alone dealt with definitively. Suffice it to note that there is significant dissent from this position from heavyweight economists: Keynes argued in his *General Theory* that ‘human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist’. J. Keynes, *The General Theory of Employment, Interest and Money* (London 1936) at 162-3. Similarly, Stephen Marglin explicitly rejects this approach, arguing that Knightian uncertainty means that there is nothing to ‘peg probabilities on’ and so ‘decision makers do not and

cannot mobilize the apparatus of calculation and maximization.' S. Marglin, *The Dismal Science: How Thinking Like an Economist Undermines Community* (Cambridge, MA 2008) at 128.

[35] D. Campbell and S. Picciotto, 'Exploring the Interaction between Law and Economics: The Limits of Formalism' (1998) 18 *Legal Stud.* 249 at 263. Campbell and Picciotto critique the tendency to treat law 'as consisting of rules with a fixed and determinable meaning, which directly govern human conduct.' Nowhere is this more apparent than in economic analysis. The notion that law consists of 'rules with a fixed and determinable meaning, which directly govern human conduct' has been criticised from many theoretical perspectives. One pertinent example is sociologist Donald MacKenzie's reference to the notion of 'finitism', which 'denies that the universe of all the items and activities that may ever be encountered should be thought of as divided up in advance into instances of A and of not-A. All we ever have—as individuals or as an entire culture—is a finite set of past applications of 'A' to particulars.' As lawyers are only too well aware, finitism entirely undermines the economist's notion of law as a straightforward application of precedent to facts. As MacKenzie puts it, albeit in the context of book-keeping, 'two directly observable entities or activities are never entirely identical; there are always differences between them that could be pointed to as well as similarities.' See D. MacKenzie, *Material Markets: How Economic Agents are Constructed* (Oxford 2009) at 33.

[36] A. Simpson, 'Coase v. Pigou Reexamined' (1996) 25 *Journal of Legal Studies* 53 at 86-7.

[37] Property rights create a 'protected domain' which cannot be infringed except with the consent of the property owner. The property owner is then able to attach a value to that protected domain based on the utility it creates for him, and to permit infringement of that domain in return for a price which exceeds his valuation. The prices demanded by property owners for infringements of their rights allow other agents to calculate whether they should behave in a way which infringes the property owner's rights and pay the price attached to that behaviour, or behave differently and pay the price demanded by a different property owner, or behave in a way which infringes no-one's property and so has no price attached. Actors can then act rationally by selecting the combination of behaviour and payments which maximises their utility, thereby moving the rights to use resources to their highest value uses. So, for example, in his 'Economic Calculation in the Socialist Commonwealth' at 14, von Mises explains that private ownership of the means of production and a system of monetary exchange are the essential preconditions for economic calculation, without which there 'would be no means of determining what was rational, and

hence it is obvious that production could never be directed by economic considerations.'

[38] Coase referred to the need 'to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure the terms of the contract are being observed, and so on.' R. Coase, *The Firm, the Market and the Law* (Chicago 1988) at 114. See also C. Dahlman, 'The Problem of Externality' (1979) 22 *Journal of Law and Economics* 141 at 148.

[39] See generally O. Williamson, *The Economic Institutions of Capitalism* (New York 1985).

[40] Corporations receive a default governance structure from the law as a 'public good' (F. H. Easterbrook and D. R. Fischel, *The economic structure of corporate law* (Cambridge, Mass. 1991) at 34-5), and also benefit from the development of a system of precedent by publicly funded courts. In contrast, those who seek to bargain with these entities in relation to the externalities they create must bear the costs of establishing an appropriate structure on a case-by-case basis. Even if, despite the odds, they manage to coordinate their efforts, it can be seen that the absence of default structures has strong distributional effects. If Coasean bargaining is to be a realistic means of governing externalities in medium- to large-numbers scenarios, the law should arguably provide institutional support for coalitions of the affected by means of default rules.

[41] W. Farnsworth, 'Do Parties to Nuisance Cases Bargain after Judgment? A Glimpse inside the Cathedral' (1999) 66 *University of Chicago Law Review* 373 at 384. Farnsworth examined 20 nuisance actions and found that in none of them did the parties bargain around the court's order.

[42] As Vatn and Bromley put it, '... the moral dimension intrudes into the presumed clarity of economic choice. Individuals who imagine with some conviction that, say, their drinking water should be uncontaminated, will be expected to be unimpressed, if not irate, about having to pay to prevent it from being even more contaminated.' A. Vatn and D. W. Bromley, 'Choices without Prices without Apologies' (1994) 26 *Journal of Environmental Economics and Management* 129 at 141.

[43] Mishan notes that a 'cynical view' would compare the argument that the 'victim' of the externality should pay the creator with a 'protection racket', according to which both the victim who is left unbeaten and the gang who are paid for not administering a beating are better off. Regardless of the effect on aggregate social wealth, a reluctance to pay not to be beaten is to be expected. See E. J. Mishan, *The Costs of Economic Growth* Revised ed., (Westport, CT 1993) at 26.

[44] See for example R. Thaler, 'Toward a positive theory of consumer choice' (1980) 1 *Journal of Economic Behavior & Organization* 39.

[45] A. Vatn and D. W. Bromley, 'Choices without Prices without Apologies' (1994) 26 *Journal of Environmental Economics and Management* 129 at 135-6

[46] Lévêque says that 'Collective goods are just a special case of externalities... what has been said on externalities can be extended to collective goods. However, the theory of collective goods gives rise to new issues such as free-riding which are of interest in the problem of private supply of pollution abatement.' F. Lévêque, 'Externalities, Collective Goods and the Requirement of a State's Intervention in Pollution Abatement' In C. Carraro and F. Lévêque (eds.), *Voluntary Approaches in Environmental Policy* (London 1999), at 21.

[47] Unwillingness to pay for a discrete aspect of the environment may also reflect a 'composition problem'. In addition to the use and non-use values recognised by economists as relevant to valuation of environmental goods, each 'element' of the environment must be valued for its contribution to the whole, and it is impossible to put a monetary value on this because it involves putting a value on the continued existence of the environment, and with it, life. Unlike commodities, where the whole of value arises from giving the buyer control of the resources, value here is also derived from the contribution of the 'good' to the working whole of the environment. See A. Vatn and D. W. Bromley, 'Choices without Prices without Apologies' (1994) 26 *Journal of Environmental Economics and Management* 129 at 133 and 138.

[48] Sen makes a similar argument that we might 'distinguish between what a person thinks is good from the social point of view and what he regards as good from his own personal point of view.' He questions the assumption that we can only understand a person's preferences by examining his actual choices; there are non-choice sources of information on preferences, such as communication. A. Sen, 'Rational Fools: A Critique of the Behavioral Foundations of Economic Theory' (1977) 6 *Philosophy & Public Affairs* 317.

[49] As Bromley writes elsewhere, 'The mere fact that many environmental economists happen to believe that WTP [willingness to pay] is a measure of the 'value' of wetlands (or any part of nature) does not make it so.' (D. W. Bromley, 'Environmental Regulations and the Problem of Sustainability: Moving beyond "Market Failure"' (2007) 63 *Ecological Economics* 676 at 677)

[50] M. Callon, 'An Essay on Framing and Overflowing: Economic Externalities Revisited by Sociology' In M. Callon (ed.), *The Laws of the Markets* (Oxford 1998).

[51] A. Johnston, 'Facing up to Social Cost: the Real Meaning of Corporate Social Responsibility' (2011) 20 *Griffith Law Review* 221.

[52] An apparently small externality may even result in catastrophic consequences where a particular species or other aspect of the environment is 'functionally transparent' in the sense that its contribution is to the complex system as a whole is not known until it is removed. A. Vatn and D. W. Bromley, 'Choices without Prices without Apologies' (1994) 26 *Journal of Environmental Economics and Management* 129.

[53] See for example M. Brueckner and D. Ross, *Under Corporate Skies: A Struggle between People, Place and Profits* (Fremantle, WA 2010) at 44, 118, 132; G. Parchomovsky and P. Siegelman, 'Selling Mayberry: Communities and Individuals in Law and Economics' (2004) 92 *California Law Review* 75 at 110-12.

[54] Buchanan and Stubblebine emphasise that externalities do not necessarily have to be corrected for pareto efficiency to exist. They define an externality as 'Pareto-relevant when the extent of the activity may be modified in such a way that the externally affected party, A, can be made better off without the acting party, B, being made worse off.' (J. M. Buchanan and W. C. Stubblebine, 'Externality' (1962) 29 *Economica* 371 at 376) They note at 380-1that 'externalities... may remain even in full Pareto equilibrium. That is to say, a position may be classified as Pareto-optimal or efficient despite the fact that, at the margin, the activity of one individual externally affects the utility of another individual... The internal benefits from carrying out the activity, net of costs, may be greater than the external damage that is imposed on other parties.'

[55] R. Coase, *The Firm, the Market and the Law* (Chicago 1988) at 26.

[56] K. W. Kapp, 'On the Nature and Significance of Social Costs' (1969) 22 *Kyklos* 334 at 334. See also A. H. Barnett and Bruce Yandle, *The End of the Externality Revolution* at 3 ('unintended (uncontracted) effects are pervasive. We find them in virtually every sphere of human activity')

[57] R. Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386 reprinted in R. Coase, *The Firm, the Market and the Law* (Chicago 1988) . The only discussion of using the firm to govern social cost in the economic literature is in J. Meade, *The Theory of Economic Externalities* (Leiden 1973) . Meade notes at 45 that 'A first obvious way to improve matters [where there is an externality] is to rearrange the institutions of society in such a way that the affected person does become a party in reaching any decision which affects his interests seriously'. Meade suggests that one form this 'joint internalised decision-making' can take is that of 'a business corporation'. However, the examples he gives suggest he envisaged all those concerned with a particular activity becoming shareholders in a corporation, as in the case of an oil deposit lying under various landowners' property, rather than, as is being suggested here, a corporation taking into account the interests of all those affected by its activities, whether they are shareholders or not.

[58] Milton Friedman was strongly opposed to corporations 'spending someone else's money for a general social interest' such as 'improving the environment'. However, he accepted that social responsibility would 'frequently' be 'a cloak for actions' that that 'are entirely justified in its own self-interest'. While he termed these actions 'hypocritical window-dressing' and argued that they threatened the 'foundations of a free society', he also recognised that this cloaking of self-interest was necessary because of 'the attitudes of the public'. See M. Friedman, 'The Social Responsibility of Business is to Increase its Profits' (September 13, 1970) *The New York Times Magazine* . Vogel offers a slightly different interpretation of the driving force behind the explosion in corporate philanthropy. The 'business case' for CSR allows corporate managers to reconcile their desires to make money and make the world a better place. It allows shareholder value corporate governance and social values to be aligned. See D. Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* (Washington, DC 2005) at 27.

[59] See D. Millon, 'Two Models of Corporate Social Responsibility' (2011) 46 *Wake Forest Law Review* 523 at 530.

[60] Fisman, Heal and Nair argue that CSR expenditures like corporate philanthropy 'which are visible to the consumer but unrelated to the firm's products, are useful in signaling the firm's trustworthiness in providing (unobservable) quality'. R. Fisman, Heal, G and Nair, 'A Model of Corporate Philanthropy' (2006) *Wharton Working Paper* at 2-3. The argument is that firms that care about both profits and externalities cut fewer corners and produce higher quality goods than those which focus purely on profits, and so sending a signal about this through philanthropy serves to signal quality. It seems clear that their argument could be extended beyond highly visible philanthropy to cover less visible voluntary internalisation ('the complementarities between a firm's production and its socially oriented activities are not always so clear'), provided consumers of products are sufficiently aware of the 'sacrifices' made by the firm in relation to its production and distribution decisions. Where companies donate to charity, this is termed 'delegated philanthropy' because consumers pick up the tab in the form of higher prices. Shapira asks 'why consumers would want to delegate charity' when they could pay a lower price for a product and donate the surplus to a charity of their own – rather than the firm's – choosing. He suggests that a benefit for consumers may arise 'where the production process or distribution channels generate complementarities with the good deeds that are important for stakeholders'. R. Shapira, 'Corporate Philanthropy as Signaling and Co-optation' (2012) 80 *Fordham Law Review* 1889 at 1902. Arguably, internalising externalities achieves something which would not otherwise happen, because, unlike charitable giving, which could be carried out either by the consumer or the company, changes to production and distribution can only be effected by the company. In terms of the business case, however, the question remains whether consumers are willing to pay the higher costs, or whether a firm which voluntarily moves first to internalise its externalities will – as seems more plausible – suffer a competitive disadvantage.

[61] Most common law jurisdictions do not consider something to be in the interests of the company or its shareholders unless it is capable of producing a return for them. If an externality is not attracting public attention, and those affected cannot themselves affect the corporation's bottom line, the law would be unlikely to consider internalising that externality to be in the interests of the shareholders.

[62] A. Febbrajo, 'The Autopoietic Approach and its Form' In G. Teubner and A. Febbrajo (eds.), *State, Law and Economy as Autopoietic Systems* (Milan 1992), at 30.

[63] G. Teubner, *Law as an Autopoietic System* (Oxford 1993) at 88-9; G. Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences' (1998) 61 *Modern Law Review* 11.

[64] G. Teubner, 'Enterprise Corporatism - New Industrial-Policy and the Essence of the Legal Person' (1988) 36 *American Journal of Comparative Law* 130 at 137-40.

[65] J. Achterbergh and D. Vriens, *Organizations: Social Systems Conducting Experiments* (Heidelberg 2010) at 157

[66] M. Callon, 'An Essay on Framing and Overflowing: Economic Externalities Revisited by Sociology' In M. Callon (ed.), *The Laws of the Markets* (Oxford 1998 at 249.

[67] Ibid at 260-3.

[68] M. Callon and A. Rip, 'Humains, non-humains: morale d'une coéxistence' In B. Kalaora (ed.), *La Terre Outragée. Les Experts sont Formel!* (Paris 1992) at 148.

[69] M. Callon, P. Lascoumes and Y. Barthe, *Acting in an Uncertain World* (Cambridge, MA 2009).

[70] M. Callon and A. Rip, 'Humains, non-humains: morale d'une coéxistence' In B. Kalaora (ed.), *La Terre Outragée. Les Experts sont Formel!* (Paris 1992), at 153, author's own translation.

[71] Ibid at 154.

[72] J. Lenoble and M. Maesschalck, 'Beyond Neo-institutionalist and Pragmatist Approaches to Governance' (2006) *Reflexive Governance in the Public Interest Working Paper Series REFGOV-SGI/TNU-1* describes this as a 'pragmatic' approach to reflexive governance. It extends beyond the development of 'shared understandings' and appropriate solutions to give stakeholders 'choice as to how to choose', thereby allowing them to improve and develop the very mechanisms of their participation over time.

[73] See for example J. Sarra, 'New Governance, Old Norms, and the Potential for Corporate Governance Reform' (2011) 33 *Law & Policy* 576 at 587.

[74] Easterbrook and Fischel prefer Pigovian taxes on pollution to interference with the corporate governance structure on the basis that taxes 'induce the firm to emit less' and to 'behave as if it had the interests of others at heart'. Changing the prices confronting the firm through taxes leaves intact its wealth-maximizing structure, and so yields more social wealth and less pollution than interference with corporate governance, which 'yield[s] less of both good ends', they argue. However, over both these options they prefer the Coasean solution of establishing 'property rights so that the firm treats the social costs as private ones, and so that its reactions, as managers try to maximize profits given these new costs, duplicate what all of the parties... would have agreed to were bargaining among all possible without cost.' F. H. Easterbrook and D. R. Fischel, *The economic structure of corporate law* (Cambridge, Mass. 1991) at 37-8. This latter statement is an example of the 'normative Hobbes theorem' which states that, where transaction costs are high, 'the law should allocate property rights to the party who values them the most.' See R. Cooter and T. Ulen, *Law & Economics* 5th, International ed., (Boston 2008) at 97-8.

[75]Lynn Stout argues that 'the best argument for shareholder primacy does not rest on its benefits for shareholders alone. Rather, it rests on the notion that shareholder primacy is a second-best solution that is good for *all* the stakeholders in the firm, because it limits what might otherwise be the runaway agency costs that might be incurred by all if directors were not held to a clear and easily observed metric of good corporate governance.' However, she adds that 'Before we know whether social wealth is best promoted by a rule of shareholder primacy or a rule that allows directors discretion to consider other stakeholders, we must actually know the costs and the benefits that flow from each rule. ' L. A. Stout, 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2001) 75 *S. Cal. L. Rev.* 1189 at 1200-1. Since many externalities currently go unidentified, it can be seen that we are a long way from this knowledge.

[76] In his discussion of the reasons why externalities have not been brought more forcibly to the attention of the public, Mishan argues that 'the kinds of damage that are suffered by the public at large... are difficult to measure and to allocate among the different sources'. (E. J. Mishan, 'The Postwar Literature on Externalities: An Interpretative Essay' (1971) 9 *Journal of Economic Literature* 1 at 26) The lack of empirical data means that these costs cannot appear in the relevant accounts and be set off against the clearly signified benefits of corporate activity.

[77] D. Campbell and D. Harris, 'Flexibility in Long-Term Contractual Relationships: The Role of Co-Operation' (1993) 20 *Journal of Law and Society* 166 at 178.

[78] R. Coase, *The Firm, the Market and the Law* (Chicago 1988) at 15.

[79] A. Vatn and D. W. Bromley, 'Externalities - A Market Model Failure' (1997) 9 *Environmental and Resource Economics* 135 at 146

[80] Ibid.

[81] Ibid. This, Vatn and Bromley emphasise, is not 'market failure' because externalities flow inexorably from the structure and operation of the market. It is instead 'model failure' because externalities are not somehow 'external' to the 'internal' of consensual transactions; the 'internal' and the 'external' are interdependent domains because they emerge from and are constituted by the model which forms the basis for the organization of the economy. A consensual transaction which increases social wealth when only its 'internal' consequences are taken into account may no longer do so when its 'external' consequences are also considered.

[82]The assumption that the market will produce social harmony is based, as sociologist Gabriel Tarde argued so forcefully more than a century ago, on a belief in providence or the guidance of the divine rather than empirical evidence. See B. Latour and V. Lépinay, *L'économie science des intérêts passionnés* (Paris 2008) , translated into English: B. Latour and V. Lépinay, *The Science of Passionate Interests* (Chicago 2009) at 71-4.

[83] A. Vatn and D. W. Bromley, 'Externalities - A Market Model Failure' (1997) 9 *Environmental and Resource Economics* 135 at 147. Elsewhere, Bromley uses the Hohfeldian notion of privilege to describe the situation where 'Alpha may undertake actions that may be detrimental to Beta, but Alpha need hold no particular concern for the interests of Beta and can only be stopped if Beta agrees to buy off Beta'. See D. W. Bromley, *Sufficient Reason - Volitional Pragmatism and the Meaning of Economic Institutions* (Princeton, NJ 2006) at 60.

[84] A. Vatn and D. W. Bromley, 'Externalities - A Market Model Failure' (1997) 9 *Environmental and Resource Economics* 135 at 147.

[85]Ibid. at 147.

[86] Rather than face this question, most economists proceed on the basis that, rather than eliminate externalities, the aim should be to eliminate transaction costs. Transaction costs are viewed as the source of externalities (making externalities a mere ‘symptom’ of the imperfect world per C. Dahlman, ‘The Problem of Externality’ (1979) 22 *Journal of Law and Economics* 141), because the Coase Theorem tells us that without them we would have an optimal system of resource allocation. If, as Vatn and Bromley argue, transaction costs are inherent in the atomistic world of market governance, the only way to eliminate them is to allocate property rights to their highest valued use. How this is done appears to be of little or no concern to economists, who assume that judges can work out a solution which is efficient not only for the dispute in front of them, but also for all other analogous relationships governed by the precedents these decisions establish.

[87] D. W. Bromley, ‘Reconsidering Environmental Policy: Prescriptive Consequentialism and Volitional Pragmatism’ (2004) 28 *Environmental and Resource Economics* 73 at 85.

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