CHAPTER 2

What's Wrong With Agency Theory?

Abstract This chapter begins by describing the standard model of the firm in organisational economics. It continues by providing a critique of the main premises on which the standard model is based: that shareholders own firms and directors are their agents; that agency costs arise at the level of the firm because of the different interests of shareholders and managers; that man is rational, self-interested, and rent-seeking and there is no non-pecuniary agent motivation. A case study of AstraZeneca is used to illustrate some of the points.

Keywords Theory of the firm • Agency theory • Shareholder primacy • Stakeholder theory

Introduction

Just as particle physics has a standard model of electromagnetic, strong, and weak nuclear forces and the subatomic particles which they act upon, in a similar way, organisational economics has a standard model of principal and agent relationships which helps to explain the nature of the firm. According to the standard model, firms are "legal fictions" that serve as "a

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nexus of contracts among individuals"[1] which exist primarily for three reasons; first, in order to save transaction costs in circumstances where (external) market transaction costs exceed the equivalent (internal) governance costs (while there are many references, the locus classicus is the seminal essay by leading institutional economist, Ronald Coase, published in 1937); secondly, to facilitate joint production where team surpluses could not otherwise be allocated among independent subcontractors;[2] thirdly, to provide a vehicle for defining property rights and solving contracting problems.[3] The standard model assumes that shareholders appoint professional managers to make both strategic and everyday tactical decisions on their behalf. The separation of ownership and control in this way creates agency costs as a result of information asymmetry and because self-interested managers do not necessarily act in the interests of shareholders. The agency problem is solved by monitoring (corporate governance) and by constructing high-powered incentive contracts for managers. Incentive contracts are designed to align the interests of shareholders and managers.[4] Corporate governance structures are determined by the principle of "shareholder primacy":[5] shareholders, as residuary beneficiaries, are the firm's ultimate owners; the overriding objective of company managers is to maximise shareholder value.[6]

In the same way that the sociologist Mark Granovetter has argued that neoclassical economics operates with an under-socialised conception of human action,[7] in this chapter I argue that the standard model of managerial agency is "under-institutionalised", in the sense that its assumptions about managerial behaviour, social norms, and legal institutions are over-simplified or simply wrong. I critique the standard model of agency from

[1] Jensen, M., & Meckling, W. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics,* 3 (4) p. 310.

[2] Alchian, A., & Demsetz, H. (1972). Production, information costs and economic organization. *American Economic Review,* 62 (5) pp. 777–795.

[3] Grossman, S., & Hart, O. (1983). An analysis of the principal-agent problem. *Econometrica,* 51 (1) pp. 7–45.

[4] Jensen and Meckling (1976) p. 308.

[5] Milgrom, P., & Roberts, J. (1992). *Economics, Organisation and Management* (2nd ed.). New Jersey: Prentice-Hall Inc.

[6] Friedman, M. (1970). The social responsibility of business is to increase its profits. *The New York Times Magazine, September 13, 1970.*

[7] Granovetter, M. (1985). Economic action and social structure: the problem of embeddedness. *American Journal of Sociology,* 91 (3) pp. 481–510.

an institutional economics perspective, drawing in particular on the work of legal scholars given the particular importance of corporate law when it comes to the nature of the firm.[8] I argue that standard agency theory's diagnosis of the agency problem in public corporations is essentially correct, especially as it applies to large listed companies in the US and the UK. I also argue that the deductive logic of standard agency theory is valid. However, I contend that some of the major premises on which the standard model is based are wrong and, because the major premises are wrong, the proposed solutions are wrong. Agency theory is a good example of the thesis that social science theorising is better thought of from a "model-theoretic" perspective, which recognises the contribution of scholars building on theories in a such way that knowledge accumulates, in contrast to the "law-statement" perspective which dominates the natural sciences, where empirical research supports or refutes general axioms derived from theory.[9] Accordingly, I propose to build on standard agency theory by embedding within the standard model a better understanding of relevant social norms and legal institutions, adopting a "repair" rather than "replace" strategy.[10]

A number of the arguments advanced in this chapter are consistent with earlier pronouncements by management scholars about stewardship theory.[11] Stewardship theory holds that there is no inherent, general problem

[8] Hodgson, G. (2015). *Conceptualizing Capitalism: Institutions, Evolution, Future*. Chicago, Ill: University of Chicago Press; Orts, E. (2013). *Business persons: A Legal Theory of the Firm*. Oxford: Oxford University Press.

[9] Harris, J., Johnson, S., & Souder, D. (2013). Model-theoretic knowledge: the case of agency theory and incentive alignment. *Academy of Management Review,* 38 (3) pp. 442–454. Oliver Williamson quoting Allen Newell, puts it like this: "New theories rarely appear full blown but evolve through a progression during which the theory and the evidence are interactive – 'theories cumulate. They are refined and reformulated, corrected and expanded. Thus, we are not living in the world of Popper…Theories are not shot down with a falsification bullet…Theories are more like graduate students – once admitted you try hard to avoid flunking them out…Theories are things to be nurtured and changed and built up.'" Williamson, O. (2011). Corporate governance: a contractual and organizational perspective. In L. Sacconi, M. Blair, R. Freeman, & A. Vercelli (Eds.), *Corporate Social Responsibility and Corporate Governance*. Palgrave Macmillan., p. 5.

[10] Bosse, D., & Philips, R. (2016). Agency theory and bounded self-interest. *Academy of Management Review,* 41 (2) pp. 276–297.

[11] Donaldson, L., & Davis, J. (1991). Stewardship theory or agency theory: CEO governance and shareholder returns. *Australian Journal of Management,* 16 (1) pp. 49–64. Davis, J., Schoorman, F., & Donaldson, L. (1997). Toward a stewardship theory of management. *Academy of Management Review,* 22 (1) pp. 20–47.

of executive motivation and behaviour. Managers are regarded as stewards whose motives are closely aligned with the objectives of their principals. Agency theory and stewardship theory are regarded either as opposing models or as contingent theories whose fit is dependent upon the particular organisational context. The ontological argument, which is set out in this paper, differs from stewardship theory in the way that it attempts to repair agency theory, rather than offering a competing model. By excluding factors such as identity, power, managerial philosophy, and culture from the analysis, it is also far more parsimonious than stewardship theory. My argument is that a solid base for a revised theory of managerial agency in large corporations can be constructed by replacing a number of standard agency theory's current premises with new, more realistic assumptions about the behaviour of agents and principals.

This chapter proceeds by briefly describing the standard model of agency in firms, then by setting out a critique which draws on the work of scholars writing in the institutional economics tradition. It examines three of the major premises on which agency theory is based, explains why these assumptions are flawed, proposes revised premises, and deduces from these revised premises how agency theory can be repaired. It concludes by proposing various ways in which the standard proposed policy solutions to the agency problem should be revised.

The Standard Model of the Firm in Organisational Economics

The general principal-agent model focuses on bilateral arrangements where a principal (conventionally "her") hires an agent (conventionally "him") to carry out some activity on her behalf.[12] In its more specific application to companies, agency theory postulates, inter alia, that in order to motivate managers (agents) to carry out actions and select effort levels that are in the best interests of shareholders (principals), boards of directors, acting on behalf of shareholders, must design incentive contracts which make an agent's compensation contingent on measurable

[12] Ross, S. (1973). The economic theory of agency: the principal's problem. *American Economic Review,* 63 (2) pp. 134–139; Spence, M., & Zeckhauser, R. (1971). Insurance, information and individual action. *American Economic Review,* 61 (2) pp. 380–38.

performance outcomes.[13] The model is underpinned by two propositions generally attributed to Milton Friedman: first, that corporate executives are employed by the owners of a business, that the owners of a business are the shareholders, and that the sole responsibility of a business is to increase its profits;[14] secondly, that it does not matter how realistic or unrealistic the behavioural assumptions of a social scientific theory are as long as the theory's predictions are accurate.[15]

Criticisms of agency theory in its application to public corporations have been advanced by both empiricists and theoreticians. The first problem for agency theorists is that empirical evidence gathered over the past 35 years has failed to establish a statistically significant link between executive pay and stock price performance, as predicted by agency theory. In 1990 Michael Jensen and Kevin Murphy were unable to find a statistically significant connection between CEO pay and performance.[16] Ten years later Tosi, Werner, Katz, and Gomez concluded that incentive alignment as an explanatory agency construct for CEO pay was, at best, weakly supported by the evidence, based on their meta-analysis of over 100 empirical studies.[17] A review by Carola Frydman and Raven Saks of the US executive

[13] Jensen and Meckling (1976).

[14] Friedman (1970).

[15] Friedman, M. (1953/2008). The methodology of positive economics. In D. Hausman (Ed.), *The Philosophy of Economics – An Anthology. Third Edition* (pp. 145–178). Cambridge: Cambridge University Press. (Reprinted from: The Philosophy of Economics: An Anthology. Hausman, D. 2008).

[16] Jensen, M., & Murphy, K. (1990). Performance pay and top-management incentives. *Journal of Political Economy,* 98 (2) pp. 225–264. When Jensen and Murphy failed to find a statistically significant connection between CEO pay and performance, they argued that this was the result of political forces at the heart of the corporation and that companies should provide a greater proportion of total compensation in the form of incentive pay, thus switching from a positive to a normative line of argument. I call this the "J- twist". Paul Samuelson (1963) described Milton Friedman's thesis that the truth of the assumptions is irrelevant to the acceptability of a theory, provided that the theory's predictions succeed, as the "F-twist". Steve Keen argues that Tony Lawson provides the "L-correction" to the "F-twist" by forcing economics to consider its ontology – see Lawson (2015) postface and Chap. 3. In the same spirit, one of the aims of this book is to point out and provide a correction to Jensen's "J-twist".

[17] Tosi, H., Werner, S., Katz, J., & Gomez-Mejia, L. (2000). How much does performance matter? A meta-analysis of CEO pay studies. *Journal of Management,* 26 (2) pp. 301–339. Two subsequent meta-analytic reviews have continued to provide evidence that CEO pay and financial performance are not closely related: see van Essen, M., Otten, J., & Carberry,

compensation data covering the period 1936–2005 concluded that neither agency theory nor the managerial power hypothesis was fully consistent with the available evidence.[18] Optimal contracting theorists (mathematical economists who are the present-day descendants of mainstream agency theorists) now appear to accept that the strongest empirical correlation is between executive pay and firm size, not between executive pay and firm performance as predicted by agency theory.[19] Baker, Jensen, and Murphy have even called this: "the best documented empirical regularity regarding levels of executive compensation".[20]

The major premises of standard agency theory are as follows: first, that firms are owned by their shareholders and that directors are agents of shareholders; secondly, that all agency costs arise at the level of the firm; thirdly, that man is rational, self-interested, and rent-seeking and there is no non-pecuniary agent motivation. I address these premises, in turn, below:

First Premise: Shareholders Own Firms and Directors Are Their Agents

In 1970 Milton Friedman wrote

> A corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the

E. (2015). Assessing managerial power theory: a meta-analytic approach to understanding the determinants of CEO compensation. *Journal of Management, 26*(2), pp. 164–202, and Aguinis, H., Gomez-Mejia, L., Martin, G., & Joo, H. (2018). CEO pay is indeed decoupled from CEO performance: charting a path for the future. *Management Research, 16*(1), 117–136.

[18] Frydman, C., & Saks, R. (2010). Executive compensation: a new view from a long-term perspective, 1936–2005. *The Review of Financial Studies,* 23(5) pp. 2099–2138. The managerial power hypothesis can be found in Bebchuk, L., & Fried, J. (2004). *Pay without performance – the unfilled promise of executive compensation*. Cambridge, Mass: Harvard University Press.

[19] See Gabaix, X., & Landier, A. (2008). Why has executive pay increased so much? *Quarterly Journal of Economics,* 123 (1) pp. 49–100, and Edmans, A., & Gabaix, X. (2016). Executive compensation: a modern primer. *Journal of Economic Literature,* 54 (4) pp. 1232–1287.

[20] Baker, G., Jensen, M., & Murphy, K. (1988). Compensation and incentives: practice vs theory. *Journal of Finance,* 43 (3) p. 609.

> business in accordance with their desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.[21]

Here, as elsewhere, Friedman makes the tacit assumption that the "owners of the business" are its shareholders, following standard economic thinking that ownership of corporations is linked to the provision of capital. Other scholars have pointed out that property rights within a firm are not unitary and can be easily disaggregated.[22] Shareholders hold property rights in company shares, entitling them to residual cash flows, including dividends and proceeds from stock buybacks;[23] they also have representation rights, for example, to vote in certain narrowly prescribed circumstances; however, this does not make them a public corporation's "owners"—they do not have a complete bundle of rights which would make them owners in any conventional sense.

One of the main theoretical challenges to the standard model has come from the stakeholder theory of the firm.[24] Stakeholder theory questions agency's theory's central concept of shareholder primacy, arguing instead that shareholders are only one of a number of important interest groups; other stakeholders include employees, customers, suppliers, and local communities. Joseph Heath provides a typology, proposing that there are many different types of stakeholder theory, including ontological stakeholder theory (a theory about the fundamental nature and purpose of the corporation), strategic stakeholder theory (which argues that devoting sufficient resources and managerial attention to stakeholders generally will tend to have positive performance outcomes in terms of profitability, revenue, and share price growth), and corporate law stakeholder theory (which proposes that stakeholder theory more accurately describes the legal nature of corporations than the standard model, and provides insights into how corporate law should be developed to better reflect ontological,

[21] Friedman, M. (1970). The social responsibility of business is to increase its profits. *The New York Times Magazine, September 13, 1970.*

[22] Heath, J. (2014). *Morality, Competition, and the Firm*. NY, USA: Oxford University Press.

[23] Ghoshal, S. (2005). Bad management theories are destroying good management practices. *Academy of Management – Learning & Education,* 4 (1) pp. 75–9.

[24] The landmark text is Freeman, R. (1984/2010). *Strategic Management: A Stakeholder Approach*. Cambridge, UK: Cambridge University Press.

Table 2.1 Heath's typology of stakeholder theories

Type of theory	*Description*
Ontological stakeholder theory	A theory about the fundamental nature and purpose of the corporation
Explanatory stakeholder theory	A positive theory that purports to describe and explain how corporations and managers actually behave in practice
Strategic stakeholder theory	Argues that devoting sufficient resources and managerial attention to stakeholders generally will tend to have positive performance outcomes in terms of profitability, revenue, and share price growth
Branding and culture stakeholder theory	A theory about how a commitment to pay extraordinary attention to the interests of particular stakeholder groups (e.g., customers and employees) can become a fundamental aspect of a firm's branding and corporate culture
Deontic stakeholder theory	An approach which proposes that stakeholder theory helps to determine the rights and duties of stakeholders and managers from an ethical perspective
Managerial stakeholder theory	A catch-all theory of management that helps leaders and managers realise the strategic benefits of stakeholder theory
Governance stakeholder theory	An approach which proposes that stakeholder theory explains how different stakeholder groups should exercise oversight and control over managers
Regulatory stakeholder theory	A theory that defines which interests and rights of specific stakeholder groups ought to be protected by government regulation
Corporate law stakeholder theory	Argues that stakeholder theory more accurately describes the legal nature of corporations than the standard model, and provides insights into how corporate law should be developed to better reflect ontological, deontic, and governance approaches to corporations

deontic, and governance approaches to corporations).[25] Heath's full typology is set out in Table 2.1.

Perhaps the most notable example of corporate law stakeholder theory[26] is the "team production theory of corporate law" advanced by

[25] Heath, J. (2014).

[26] Heath (2014) points out that corporate law varies significantly from country to country and between states in the United States. This presents certain difficulties when attempting to generalise principles drawn from close legal analysis. The implications of this are examined further in Chap. 4.

Margaret Blair (an economist) and Lynn Stout (a legal scholar).[27] They argue that, while agency theory may be important in understanding the private business firm, it does not necessarily provide the same insights into our understanding of public corporations. In a closely held private company stock ownership is often concentrated in the hands of a small number of investors (principals) who select, appoint, and exercise tight control over the board of directors (agents). However, in the case of public corporations, corporate law does not treat directors as the agents of shareholders but as something quite different. They are not charged with serving shareholders' interests alone but with serving the interests of the company. In the eyes of the law, corporate directors are a unique form of fiduciary who more closely resemble trustees than agents. They owe fiduciary duties of loyalty and care to the company, not to shareholders. In the US, legal scholars who subscribe to the standard model rely on the decision in the famous case of Dodge versus Ford Motor Company (Michigan 1919) when the court sided with the Dodge brothers, shareholders who wanted dividends to be maximised, and against Henry Ford, who believed that the company's prosperity should be shared with other stakeholders, including assembly line workers and the local community. That case also affirmed the business judgement rule, which gives corporate executives in the United States wide latitude in how to run a company. However, the primary job of the directors of a public corporation is to act, in effect, as trustees for the corporation itself. They are thus not merely the agents of shareholders, pursuing shareholders' interests at the expense of employees, creditors, and other team members.

Blair and Stout propose that public corporations comprise teams of people making specific investments in the form of both financial and human capital who enter into a complex agreement to work together for mutual gain under a "mediating hierarchy". However, they are careful to distance themselves from other stakeholder theorists who believe that corporate law ought to require directors to serve consumers, creditors, and the public as a whole as well as shareholders and employees. Michael

[27] There are many references, most notably Blair and Stout (1999) A team production theory of corporate law. *Virginia Law Review,* 85 (2) pp. 247–328, but also including: Blair (1995, 1996) and Stout (2012). "Team production" is a reference to the economic theory of the firm advanced by Alchian & Demsetz (1972). Blair & Stout also make reference to the conventional theory of corporate agency relationships, described in this book as "the standard model", which they refer to as the "grand-design principal-agency model".

Jensen has in any case identified a fundamental difficulty with these kind of multi-stakeholder theories, pointing out the logical impossibility of maximising in many dimensions at the same time except in unusual circumstances in which all the dimensions are monotonic transformations of one another.[28] For example, if a company's directors have to choose, in the teeth of a recession, between protecting employment, maintaining the company's presence in all the communities in which it currently operates, and paying a dividend, then they are expressing a preference between the utility of employees, the utility of other residents in local communities, and the utility of shareholders. This has been described as the "multi-principal problem" of which it has been said: "a manager told to serve two masters has been freed from both and is answerable to neither".[29] Edward Freeman has suggested that managers must "act like King Solomon" in adjudicating among the claims of various stakeholder groups;[30] the risk is that giving managers such freedom to balance rival claims would create extraordinary agency risks.

Stephen Bainbridge, another legal theorist, has also questioned the idea that shareholders are owners of companies.[31] Shareholders hold property in the form of shares which provide various (limited) rights: to receive dividends (but only if declared by directors); to vote on certain matters of importance, including the appointment and reappointment of directors (but only from a slate of candidates proposed by the board); and to veto major transactions (but only if a coalition of shareholders representing the necessary proportion of total votes prescribed by law can be assembled). They also have the right to receive residual assets in a winding-up, but this rule rarely operates in practice: public companies tend to be wound-up only when bankrupt, when there are often no residual assets. Shareholders are not automatically entitled to enter company premises, to use company assets, or to arrange transactions on the company's behalf; they surely would be if they were genuinely a firm's "owners". According to Antony Honoré, "full ownership" is characterised by 11 "incidents" or indicators:

[28] Jensen, M. (2001). Value maximization, stakeholder theory, and the corporate objective function. *Journal of Applied Corporate Finance,* 14 (3) pp. 8–22.

[29] Heath, J. (2014) p. 62; Easterbrook, F., & Fischel, D. (1991). *The Economic Structure of Corporate Law*. Cambridge, Mass: Harvard University Press, p. 38.

[30] Freeman, R. (1984/2010).

[31] Bainbridge, S. (2003). Director primacy: the means and ends of corporate governance. *Northwestern University Law Review,* 97 (2) pp. 547–606.

the right to possess, the right to use, the right to manage, the right to income, the right to capital, the right to security, the rights of transmissibility and absence of term, the prohibition of harmful use, liability to execution, and incidence of residuarity.[32] Of these indicators, only three (income, capital, and residuarity) appear with any certainty to be met when it comes to shareholders "ownership" of a firm, as opposed to their ownership of shares which convey an interest in the firm.[33]

As an alternative to shareholder primacy and stakeholder theory, Bainbridge proposes "director primacy" which treats the corporation as a vehicle for the board of directors to hire various factors of production. In his model the board is: "a sort of Platonic guardian serving as a nexus for the various contracts comprising the corporation".[34] This approach is consistent with Blair and Stout's analysis that the duties of directors of public corporations more closely resemble those of trustees rather than agents, although Bainbridge departs from Blair and Stout in various other ways, including the question of who directors are trustees for, and especially when it comes to the notion of the board as a mediating hierarchy. Both approaches are broadly consistent with an alternative construction of the overriding responsibility of directors, latterly proposed by Michael Jensen, which he calls "enlightened stakeholder theory" and "total firm value maximization" (TFVM).[35] This postulates that long-term value maximisation of the whole firm (i.e., as distinct from its shareholders) should be the primary objective of company managers. Jensen says: "maxi-

[32] Honoré, A. (1961). Ownership. In A. Guest (Ed.), *Oxford Essays in Jurisprudence* (pp. 107–147). Oxford, UK: Oxford University Press.

[33] Also relevant are the five different types of property rights that have been identified (by their presence or absence) in empirical studies of common pool resources systems. These are: *access*, the right to enter a defined physical property; *withdrawal*, the right to draw an income from a common pool resource; *management,* the right to regulate the patterns of use of common pool resources and to transform a resource system by making investments and improvements; *exclusion,* the right to determine who has access and withdrawal rights; and *alienation,* the right to sell or lease any of the other rights – see Poteete, A., Janssen, M., & Olstrom, E. (2010). *Working Together – Collective Action, the Commons, and Multiple Methods in Practice*. Princeton & Oxford: Princeton University Press, p. 95. Shareholders have some (i.e., access, withdrawal, and alienation rights) but not all of these. For more on the relevance of the literature on common pool resources to public corporations, see Chap. 4.

[34] Bainbridge (2003) pp. 550–51.

[35] Jensen (2001).

mising the total market value of the firm – that is the sum of the market values of the equity, debt and any other contingent claims outstanding on the firm – is the objective function that will guide managers in making the optimal trade-offs among multiple constituencies".[36] He continues: "It is a basic principle of enlightened value maximisation that we cannot maximise the long-term market value of an organisation if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators, and communities". Andrew Keay, an English law scholar, has demonstrated how a watered-down version of enlightened stakeholder theory, which he calls "the enlightened shareholder value principle", applies in UK company law as a result of work undertaken by the Company Law Review Steering Group, which published several reports between 1998 and 2001.[37] After much debate about stakeholder theory and shareholder primacy, the provisions which were eventually incorporated into section 172 of the UK Companies Act 2006 in effect confirmed the prevailing view that companies are run for the benefit of their members (i.e., shareholder primacy) but require directors to have regard to the interests of employees, relationships with suppliers and customers, the impact of a company's operations on communities and the environment, and the desirability of maintaining a reputation for high standards of business conduct. They also require directors to consider the long-term consequence of their decisions and the need to act fairly between the members of the company.

Keay has separately argued that a version of TFVM, which he calls the "entity maximisation and sustainability model" (EMS), should become the corporate objective of British public companies. Two important elements of both the TFVM and EMS ways of answering the question "what is a company for?" should be specifically noted. First, value is to be maximised in the long run, not the short run; it is thus aligned with demands that economic policy and regulation should emphasise the benefits of long-term corporate investment.[38] Secondly, it is firm value, not shareholder value, which is to be maximised. This admits the legitimate interest

[36] Jensen (2001) p. 16.

[37] Keay, A. (2013). *The Enlightened Shareholder Value Principle and Corporate Governance*. Abingdon, UK: Routledge.

[38] Kay (2012); Mayer (2013).

in value creation of at least some other stakeholders, including managers and other employees who make long-term personal investments in the company. Just as shareholders contribute financial capital to a firm, so it is alleged that managers and employees contribute human capital, being the sum total of their knowledge, skill, experience, and intelligence; therefore, it is argued that they also have contingent claims outstanding on the firm. Blair and Stout describe these kinds of investments as "specific assets", in much the same way as Oliver Williamson talks about "asset specificity".[39] The TFVM principle can itself be derived from one of the fundamental principles of social welfare; that society's object is to maximise total utility, to create the greatest good for the greatest number, to maximise the efficiency with which society uses resources to create wealth and minimise waste. To quote Jensen again, "moreover, we can be sure…apart from the possibilities of externalities and monopoly power – that using this value criterion will result in making society as well off as it can be".[40]

Second Premise: Agency Costs Arise at the Level of the Firm Because of the Different Interests of Shareholders and Managers

A further issue for the standard model is that the upper echelons of a public corporation involve a number of different principal-agent and fiduciary relationships. In the language of agency theory, shareholders (principals) appoint directors (agents); the directors in turn (now acting in the role of principals) appoint managers as their agents. Agency costs can arise at both levels. Some directors are also managers and therefore wear two hats, sometimes acting as agents (on behalf of shareholders) and sometimes as principals (as members of the board of directors when instructing other managers). This creates the potential for role confusion, although the implications of dual-role conflicts of interest are not examined further here.

To complicate matters, once appointed, directors become fiduciaries, owing their primary duty to the company rather than to its shareholders. They take on an open-ended set of responsibilities to the corporation,

[39] Blair and Stout (1999); Williamson, O. (1975). *Markets and Hierarchies*. New York: The Free Press.

[40] Jensen (2001) p. 16.

empowering them to manage the corporation's business and affairs, and imposing upon them a duty of care in exercising those powers. They are expected to exercise a high degree of care, skill, and diligence in carrying out their duties. They are required to show loyalty to the company. They are not in any strict legal sense agents of stockholders.[41] To complicate matters further, many shareholders in public corporations are in fact pooled investment funds, run by investment managers (agents) who invest money on behalf of individuals, firms, and other funds (principals). This creates a further set of agency and fiduciary relationships, and hence further agency costs. Thus, rather than a simple conflated agency relationship between shareholders and managers, as posited by many subscribers to the standard model, it must be recognised that public company governance structures involve a complex web of fiduciary and agency relationships requiring a more sophisticated institutional analysis than allowed for by the mathematical models of many modern agency theorists.

To illustrate these points, consider the case of AstraZeneca plc., a large pharmaceutical company listed on the London Stock Exchange. At the time of writing, AstraZeneca's board comprised two executive directors (the CEO and CFO) and ten non-executive directors, including the chairman and senior independent non-executive director. The company also had a non-statutory management board, known as the "senior executive team", comprising the two executive directors and ten other senior managers. While the main board was said to be responsible for strategy, policy, corporate governance, and monitoring the performance of management, the senior executive team was responsible for management, development, and performance of the business, and for developing a strategy for review by the main board. Both the board and senior executive team were described as being "accountable to shareholders for the responsible conduct of the business and its long-term success". This type of structure, with the management board referred to variously in different companies as the "executive board", "executive committee", "management committee", and so on, has become commonplace in the FTSE 100. One

[41] Clark, R. (1985). Agency costs versus fiduciary duties. In J. Pratt & R. Zeckhauser (Eds.), *Principals and Agents: The Structure of Business*. Boston, MA: Harvard Business School Press.

consequence is that there is no requirement to disclose the pay of senior executives on the management board unless they are also members of the main board.

AstraZeneca's top 100 shareholders controlled nearly 64% of the company's ordinary share capital. Seventy-five of these were institutional investors, managing funds on behalf of individuals and pension funds. The largest investors were Blackrock, with an 8% shareholding, followed by Wellington Management and Capital Group, both owning more than 3%. While Wellington and Capital Group are privately owned investment management companies, Blackrock is itself a public company, listed on the New York Stock Exchange. Its major shareholders included PNC Financial Services Group (a listed investment management company owning 21% of Blackrock), Wellington, Vanguard (another privately owned investment management company), and Norway's sovereign wealth fund. In turn, PNC's major shareholders were Vanguard, Old Mutual, State Street, and Capital Group. Blackrock also owned 4.8% of PNC.

Figure 2.1 maps shareholders owning more than 3% of the share capital of AstraZeneca in December 2015, that is, Capital Group, Wellington (both private investment companies), and Blackrock (a listed investment management company). Major shareholders in Blackrock are also mapped, as, in turn, are the shareholders of its major listed shareholders. The diagram stops at this third level of analysis.

In all this we see a complex web of holdings and cross-holdings, and of agency and fiduciary relationships. Retail investors (principals) make investments in pooled funds. The directors of these funds appoint investment managers as agents to manage investments on their behalf. Both fund directors and investment managers have fiduciary responsibilities. The funds, along with other shareholders (principals), appoint the board of directors of AstraZeneca. The board of directors (acting as agents of shareholders) appoint the CEO. The CEO (now acting as principal) in turn appoints other senior managers (agents of the company). Executive and non-executive directors owe fiduciary responsibilities to the company (but not, strictly speaking, to the company's shareholders).

Agency costs arise at many levels. Because investment firms are sometimes privately held (i.e., private companies or partnerships), transparency (e.g., of compensation costs) is less than for public corporations. Listed investment management companies employ investment executives below

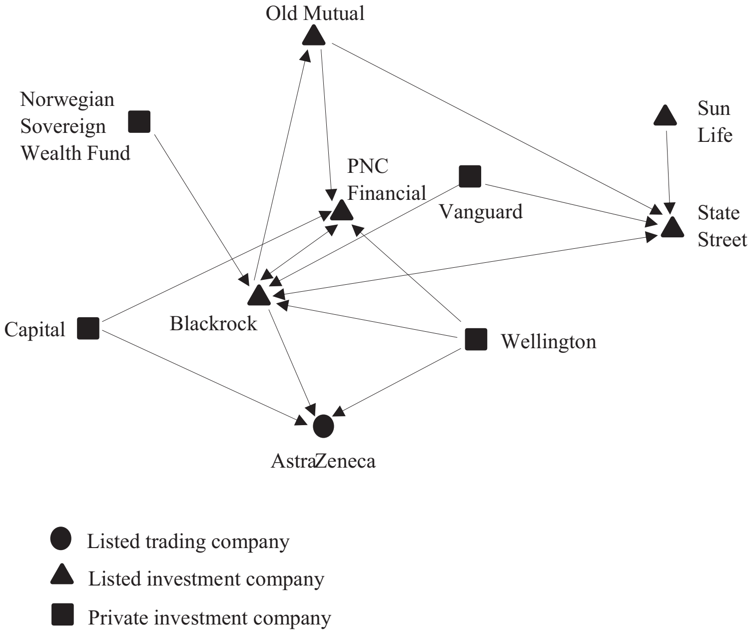

Fig. 2.1 Major shareholders in AstraZeneca – December 2015

board level whose pay is not separately disclosed. It is highly probable that agency costs will arise in pooled investment funds because of the collective action problems which are likely to be extant among widely dispersed retail investors.[42] (I expand on the nature of collective action problems in the next chapter). This is over and above the agency costs which arise in the trading company.

[42] This is consistent with the findings of the review carried out by John Kay on behalf of the UK Government's Department of Business, Innovation and Skills in 2012 (Kay 2012).

Third Premise: Man Is Rational, Self-interested, and Rent-seeking, and There Is No Non-pecuniary Agent Motivation

An underlying assumption of the standard model is that companies are profit-making, that principals and agents are both rational and rent-seeking, and there is no non-pecuniary agent motivation. Economists recognise that these assumptions are an oversimplification but argue that the most efficient way to construct theory is to adopt a reductive approach. David Hume took a similar line when he wrote in his essay "Of the Independency of Parliament":

> Political writers have established it as a maxim, that, in contriving any system of government, and fixing the several checks and controls of the constitution, every man ought to be considered a *knave*, and to have no other end, in all his actions, than private interest. By this interest we must govern him, and, by means of it, make him, notwithstanding his insatiable avarice and ambition, co-operate to public good…It is, therefore, a just *political* maxim, *that every man must be supposed a knave:* Though, at the same time, it appears somewhat strange, that a maxim should be true in *politics*, which is false in *fact*. But to satisfy us on this head, we may consider, that men are generally more honest in their private than in their public capacity…Honour is a great check upon mankind.[43]

Many scholars now dispute Hume's approach. Julian Le Grand of the London School of Economics has examined the motivation of agents in the public sector in the light of David Hume's famous dictum. Le Grand argues that, both as a matter of fact (i.e., as a positive theory of what is) and in terms of what should be the case (i.e., as a normative theory), the public sector is populated by "knights" as well as "knaves". In Le Grand's terminology, while knaves are "self-interested individuals who are motivated to help others only if by doing so they will serve their private interests", knights are "individuals who are motivated to help others for no private reward, and indeed who may undertake such activities to the

[43] Hume, D. (1804). Of the Independency of Parliament *Essays, Moral, Political, and Literary*. Edinburgh: Bell & Bradfute.

detriment of their own private interests".[44] Hume refers to the latter as a "man of honour", and an "honest man". (In Hume's day there was less concern about using terminology that was gender neutral.) To put it another way, the distinction is between, on the one hand, those who are motivated to perform only those activities that are of direct benefit to their own material welfare, such as their own personal consumption of material goods, and, on the other hand, those that are motivated to engage in other directed activities, that is, activities which benefit others and which do not positively affect their own material welfare. Le Grand's argument is that, while both types are found in public service, knightly behaviour is needed if the public sector is to operate efficiently. He also argues, drawing on the work of the Swiss economist Bruno Frey, that increasing in monetary incentives can "crowd-out" intrinsic motivation. Besley and Ghatak have argued that "motivated agents" can be found in public and non-profit organisations, where activities coalesce around a "mission", whose economic behaviour is affected by intrinsic motivation.[45] The economist Samuel Bowles has advanced the same thesis in his book entitled *The Moral Economy – Why Good Incentives are No Substitute for Good Citizens*.[46] If further evidence is needed, Martin Nowak, a mathematical biologist based at Harvard, has published an extensive body of research on human behaviour and evolution. He argues that man should be thought of as a complicated hybrid species ruled as much by emotion and altruism as by reason and selfishness. He demonstrates that human evolution would not have been possible if humans really were relentlessly bent on maximising purely selfish rewards.[47]

Reverting to corporations, corporate governance, and the standard model of principal and agent relationships in firms, the Australian

[44] Le Grand, J. (2003). *Motivation, Agency and Public Policy*. Oxford: Oxford University Press.

[45] Besley, T., & Ghatak, M. (2005). Competition and incentives with motivated agents. *American Economic Review,* 95 (3) pp. 616–636.

[46] Bowles, S. (2016). *The Moral Economy – Why Good Incentives are no Substitute for Good Citizens*. New Haven, CT: Yale University Press.

[47] Nowak, M., & Highfield, R. (2011). *Super Cooperators – Evolution, Altrusim and Human Behaviour*. Edinburgh: Canongate. See also Nowak, M., Page, K., & Sigmund, K. (2000). Fairness versus reason in the ultimatum game. *Science,* 289 (5485), pp. 1773–1775, and Sigmund, K., Fehr, E., & Nowak, M. (2001). The economics of fair play. *Scientific American,* 286(1), pp. 82–87.

management scholar Lex Donaldson has pointed out that the characterisation of managers in the standard model is almost entirely negative, and argues that this is deeply unhelpful. If organisational economists regard managers as self-interested, opportunistic agents requiring close monitoring by their principals, as well as needing extrinsic incentives to motivate their every action, this will inevitably influence their policy recommendations.[48] There is even a risk that managers might become what the policy recommendations assume them to be. In a famous essay entitled "Bad management theories are destroying good management practices", Samantra Ghoshal argued that reductive theories such like agency theory cause great damage.[49] No matter how cleverly designed to harness managers' self-interest, incentives alone cannot provide the foundations of good corporate governance. The erosion of ethical, social, and intrinsic motivations essential to good governance could be the unintended consequence of policies, including the excessive use of monetary incentives to guide individual behaviour, which agency theorists favour. The reliance on high-powered incentives to align the interests of shareholders and managers has become another example of what the sociologist Donald Mackenzie describes as "performativity", that economics creates the phenomena it describes.[50] Because economists advocate the use of high-powered incentives to motivate executives and to align their interests with those of shareholders, such incentives have become the norm, even though they have not typically achieved their ultimate objective of improving corporate performance.

A central thesis of this book is that, in corporate governance as in public government, we should recognise the need for ethical behaviour, for honest and honourable men and women who are motivated by mission and regard for others and not just by self-interest. There is a powerful argument that says one part of the logic of the standard model should be reversed, and managers seen not as opportunistic self-regarding agents, but as autonomous intrinsically motivated principals who are central to the enduring mission of the firm.[51] The board of directors and executive

[48] Donaldson, L. (1995).

[49] Ghoshal, S. (2005).

[50] Mackenzie, D. (2007). Is economics performative? In D. Mackenzie, F. Muniesa, & S. L (Eds.), *Do Economists Make Markets?* Princeton, New Jersey: Princeton University Press; see also Hodgson 2015: 61 n5.

[51] Donaldson (1995).

management team are what gives life to the corporation as a stable, enduring entity, which is capable of making long-term commitments.[52] One implication is that directors should do their best to ensure that key managers are well entrenched and that their wealth is tied up on a long-term basis in the companies in which they are employed. Homo economicus is not the only model of man available to agency theorists. Pepper and Gore have proposed "behavioural economic man" in their article entitled "Behavioural agency theory", arguing that agents should be modelled as "boundedly rational" (i.e., that there are neuro-physiological rate and storage limits on the ability of agents to receive, store, retrieve, and process information without error). They postulate that agents are intrinsically as well as extrinsically motivated, in such a way that in some circumstances there is a trade-off between these two types of motivation. Agents are also loss averse rather than risk averse, and hyperbolic rather than exponential time discounters, thus over-emphasising the importance of the present at the expense of the future.[53] Bosse and Phillips argue that agency theory should be developed by assuming that principals and agents exhibit "bounded self-interest"—self-interest bounded by norms of reciprocity and fairness so that agency relationships are mediated through positively and negatively reciprocal behaviours.[54] Samuel Bowles argues for "homo socialis", postulating that humans have social preferences which are affected by "altruism, reciprocity, intrinsic pleasure in helping others, aversion to inequity, ethical commitments, and other motives that induce people to help others more than is consistent with maximising their own wealth or material payoff".[55] Sigmund, Fehr, and Nowak refer to "homo emoticus", arguing, like the political scientist Jon Elster, that economic theory must take into account human emotions as well as reason.[56] Alger and Weibull propose "homo moralis", contending that a combination of selfishness and morality stands out as being evolutionarily stable.[57]

[52] Mayer (2013).

[53] Pepper and Gore (2015).

[54] Bosse and Philips (2016).

[55] Bowles (2016).

[56] Sigmund et al. (2001); Elster (1998). Emotions and economic theory. *Journal of Economic Literature,* 36 (1) pp. 47–74.

[57] Alger & Weibull (2013). Homo moralis – preference evolution under incomplete information and assortative matching. *Econometrica,* 81 (6) pp. 2269–2302.

There will be those who criticise this line of argument, contending that I am introducing normative considerations (of what ought to be the case) into a positive theory (of what is the case). I offer two arguments in defence. First, for all that it is often described as a positive theory,[58] agency theory has become laden with normative considerations. When Michael Jensen and Kevin Murphy calculated that the pay-performance relationship for CEOs was a $3.25 change in CEO wealth for every $1000 in shareholder wealth, their conclusion was not that the empirical evidence refuted agency theory, but that political forces operating in public markets and inside public corporations were placing constraints on pay for performance.[59] Agency theorists, therefore, recommended increasing the amount of leverage in CEO pay arrangements, an essentially normative conclusion. In Chap. 1 of *The Economics of Welfare*, A.C. Pigou argues that the distinction between positive and normative theories is often blurred in economics.[60] Kenneth Boulding maintains that the object of social science is to find out what is possible, not what merely is the case.[61]

Second, and more subtly, there is substantial evidence that some combination of "homo socialis", "homo emoticus", and "homo moralis" is much closer to the truth than "homo economicus". A number of behavioural scientists have demonstrated empirically that people are not wholly self-interested and motivated only by money—I expand on this point in Chap. 5. To model executive behaviour on the basis of a misleading set of assumptions about human behaviour risks building theory leading to flawed conclusions—the problem that Professor Tony Lawson of Cambridge University identified with the assumptions made by Milton Friedman.[62] In other words, a positive theory of agency constructed on the premise that our "model of man" should assume a combination of both knightly and knavish behaviour (i.e., that we are "boundedly self-interested" as well as "boundedly-rational") is better social science.

My objective in this book is to provide an empirically grounded and realistic theory about the relationship between company managers, shareholders, and other key corporate stakeholders which will help to guide

[58] Eisenhardt (1989).
[59] Jensen and Murphy (1990).
[60] Pigou, A. (1920/1932). *The Economics of Welfare*. London: Macmillan.
[61] Boulding, K. (1953). *The Organizational Revolution*. New York: Harper & Brothers.
[62] See note 16 above.

corporate action. I aim to do this by (1) starting from a realistic set of premises; (2) establishing a universally desirable objective function; and (3) proceeding logically from (1) to (2). I also aim to comply with critical realism's criteria for good scientific theorising[63]—for more on this, see Chap. 3.

Conclusion

To summarise the argument to this point: standard agency theory consistently confuses the positions, responsibilities and rights of shareholders, directors, and managers in public corporations.[64] Property rights within the firm are not unitary and can be easily disaggregated. Shareholders do not have a complete bundle of rights which would make them owners in any conventional sense, nor are they owners in a way which clearly distinguishes their contribution from those of certain other stakeholders who also make substantial commitments to the firm.[65] Managers and employees often dedicate large parts of their careers to a single company, developing company-specific skills that are not readily transferable—specific assets, in the words of Blair and Stout[66]—which give them a legitimate interest in the firm. Company directors are not agents of shareholders in a technical sense, but are in fact a special kind of fiduciary more akin to trustees than agents, with specific duties of care and loyalty to the firm, rather than to stockholders—the doctrine of "director primacy".[67] It is not only between shareholders, directors, executives, and other employees that chains of agency and fiduciary relationships exist. Many stockholders are themselves agents or fiduciaries, holding shares in pooled funds, and acting on behalf of retail investors, giving rise to a separate set of agency costs and risks which are too often overlooked by scholars. Finally, good corporate governance, practices, and incentive designs cannot be constructed on the basis of entirely negative assumptions about people's nature, preferences, and behaviours. Some kind of virtue ethic for agents and fiduciaries is needed to underpin the current assumptions about economic man.

[63] Bhaskar, R. (1975). *A Realist Theory of Science*. Leeds, UK: Leeds Books Ltd.

[64] Clark (1985).

[65] Heath (2014).

[66] Blair and Stout (1999).

[67] Bainbridge (2003).

This analysis is, in Heath's typology, an ontological theory about the fundamental nature and purpose of companies, and their managers, combining elements of deontic, governance, and corporate law stakeholder theories. It is submitted that a more complete agency model for public corporations in which institutions are properly embedded should take account of all these factors. Agency theorists have focused much attention on the use of high-powered incentives as a mechanism for overcoming agency problems within firms. In so doing, they have dramatically underestimated the role that institutions play in determining organisational behaviour. Subscribers to the standard model have spent considerable amounts of time devising highly complex incentive plans while ignoring the fiduciary responsibilities and professional ethics of directors and managers.[68]

The centrality of fiduciary relationships in this analysis illustrates the underlying paradox in standard agency theory—it relies on the ethical motives of the chairman and other non-executive directors to solve agency problems, when the conventional model of man in neoclassical economics assumes uni-dimensional self-interested utility-maximising behaviour.[69] This paradox reinforces the need to devise a more sophisticated model of economic man, one that recognises the significance of moral sentiments as well as economic impulses. It also gives force to the importance of developing normative models of executive and director behaviour that incorporate higher deontic expectations of company directors and senior executives—how can society ensure that high-performing individuals of high moral stature are recruited into these roles and given the tools they need to carry out their duties to maximum effect? These various conclusions about the standard model and the revisions that are necessary in a revised agency theory are summarised in Table 2.2.

Another element of the standard model is the assertion that firms are "legal fictions" serving as a "nexus for a set of contracting relationships among individuals".[70] As such, according to Jensen and Meckling, it makes no sense to talk about a firm's behaviour, social responsibility, or objective function. As they say: "there is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction

[68] Heath (2014).
[69] Hodgson (2015).
[70] Jensen and Meckling (1976) pp. 310.

Table 2.2 Assumptions underpinning the standard and revised models of agency

Assumption	*Standard model*	*Revised model*
Model of man	Economic man (or homo economicus): man is rational, rent-seeking, self-interested, and there is no non-pecuniary agent motivation	Behavioural economic man: man is boundedly rational, boundedly self-interested, and intrinsically as well as extrinsically motivated
Ownership and property rights—who owns the firm?	The doctrine of shareholder primacy: shareholders are the owners of a firm	The doctrine of director primacy: shareholders hold property rights in a company's shares entitling them to dividends and certain other residual cash flows, plus representation rights
Firm's primary objective—what is a company for?	The doctrine of shareholder value maximisation: the overriding objective of a corporation's directors and managers is to maximise shareholder value	The doctrine of total firm value maximisation
Role of directors and managers	Directors and managers are agents of shareholders	Directors are a unique form of fiduciary more closely resembling trustees than agents. Managers are strictly the agents of directors
Where do agency costs arise?	Agency costs arise because of the different interests of shareholders and managers	Agency costs arise because of the different interests of retail investors and funds, shareholders and directors, directors and managers, and managers and other employees
Mechanism for allocating residual profits	Shareholders are entitled to residual profits, which they receive by way of dividends and capital gains	Residual profits should be shared by all stakeholders who make specific personal investments in the firm

(the firm) and the owners of labor, material and capital inputs and the consumers of output".[71] This a strange way of putting it, if you think about it, as a *fiction* surely cannot enter into a contract; what I think they really mean is that the contracts are all between natural persons (i.e., directors, executives, employees, shareholders, suppliers, customers, etc.,) which we conceptualise as "a firm" much as the philosopher Gilbert Ryle conceptualises the mind as a "ghost" in the "machine" of the body;[72] in other words the firm, like the mind according to Ryle, does not really exist. Jensen and Meckling advance no arguments in support of this claim, thus ignoring nearly 200 years of philosophical argument about the nature of companies. That assertion requires further investigation; therefore, I turn next to the question of "what a public corporation really is" in Chap. 3.

Further Reading
The key readings on the standard model can be found in: Kroszner, R., & Putterman, L. (2009) *The Economic Nature of the Firm – A Reader. Third Edition*. Cambridge University Press. A valuable collection of accessible essays on agency theory is: J. Pratt & R. Zeckhauser (Eds.), *Principals and Agents: the Structure of Business*. Harvard Business School Press. Margaret Blair's and Lynn Stout's work on the "team production theory of company law" is summarised in: Stout, L. (2012). *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, & the Public*. Berrett-Koechler Publishers, Inc.

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[71] Jensen and Meckling (1976) pp. 311.

[72] Ryle, G. (1949/2000). *The Concept of Mind*. London: Penguin Books.

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