

CHAPTER 7

What is the Purpose of the Firm?: Shareholder and Stakeholder Theories

by Michael D. Pfarrer



There are two competing theories about the purpose of the modern business firm. Each provides a framework for evaluating executive compensation policies, corporate governance procedures, and the economic and social performance of business. The first, shareholder theory, emanates from an economic perspective, focusing on the firm's purpose of creating wealth for its owners while minimizing both the importance of the firm's interaction with its other constituencies and its role in society. The second, stakeholder theory, broadens the first perspective, recognizing the importance of wealth creation as well as the firm's relationships with its multiple constituent groups—shareholders, creditors, employees, customers, suppliers, regulators, and local communities—and impact on society at large. Below, I discuss the foundations of these two theories, provide an overview of some recent developments within each theory, and conclude with some suggestions about how shareholder and stakeholder principles might be used to construct more effective frameworks for thinking about the role of the modern business firm.

Shareholder Theory

The origins of the ideas shaping shareholder theory are more than 200 years old, with roots in Adam Smith's (1776) *The Wealth of Nations*. In general, shareholder theory encompasses the idea that the main purpose of business lies in generating profits and increasing shareholder wealth. Modern proponents of shareholder theory espouse three tenets from Smith,

1. the importance of “free” markets;
2. the “invisible hand of self-regulation;” and
3. the importance of “enlightened self-interest.”

Shareholder theorists call for limited government and regulatory intervention in business, believing markets are best regulated through the mechanism of the invisible hand—that is, if all firms work in their own self-interest by attempting to maximize profits, society at large will benefit. Some proponents of the shareholder view even believe that the invisible hand checks illegal activity, arguing that the market will punish, or weed out, firms that engage in illegal or unethical behavior. Therefore, they conclude that, in general, excessive oversight and regulation of industry is unnecessary.

Members of the “Austrian School” of economics were early proponents of the shareholder perspective. Such economists such as Friedrich von Hayek, Israel Kirzner, Joseph Knight, and Joseph Schumpeter advocated the idea of “laissez-faire” (literally, to “leave alone”) capitalism, which focuses on the importance of self-regulation among firms, with limited government intervention.

Shareholder theory in its current form is linked most directly to the “Chicago School” of economics, most notably to Milton Friedman and his colleagues, who have argued for nearly four decades that the overriding purpose of the firm is to maximize shareholder wealth. They believe solving social problems is the responsibility of the state. Corporate philanthropy and other activities not directly related to generating shareholder wealth are both a waste of shareholders’ money and, potentially, immoral because they amount to stealing from owners.

Although this last statement seems strong, Friedman believed, in short, that the business *of business is business*. Firms are created to make money, not oversee the social or moral development of society. Social and moral development, according to Friedman, is best handled by the government or (preferably) through voluntary organizations (NGOs). When firms become involved in social or public policy issues, wealth is diverted to issues outside the core expertise of their managers. This inefficient use of wealth will negatively affect society in the long run. Friedman’s negative view of socially involved companies went so far as to proclaim that such actions usurped the role of democratically elected officials.

It is important to note that Friedman never espoused firms acting unethically, immorally, or illegally. In fact, while promoting the corporate goal of “maximizing shareholder wealth,” he argued that this must be done within the moral, ethical, and legal boundaries of society. He asked only that government and the citizenry assume their rightful roles in creating those boundaries.

Shareholder theories today. Two influential and recent schools of thought fall under the broad umbrella of shareholder-based theories: “transaction cost economics” (TCE) and “agency theory.” Like shareholder theory, each focuses on behaviors that can maximize firm efficiency: TCE focuses on the importance of corporate hierarchies and monitoring employee behavior to minimize

self-interested behavior; agency theory focuses primarily on the principal vs. agent (shareowner vs. manager) relationship in publicly traded firms, and how to best align the competing interests of the two parties to maximize firm value. Both TCE and agency theory have a “gloomy vision” of human self-interest. Both assume that human beings are opportunistic, and, thus, will put their own interests before the firm’s.

TCE and agency theory grew out of scholarship in the early 1970s, and both form the foundations for much of the corporate governance behavior we see today. Since both theories assume that humans are self-interested, both focus on mechanisms to 1) monitor manager behavior, and 2) provide incentives to align manager interests with those of the firm’s owners (primarily, to maximize shareholder wealth). Those mechanisms constitute the primary incentive systems currently in use today in most large corporations: Because opportunism, self-interest, and shirking are assumed, public corporations have instituted boards to both monitor managers and to incentivize them. Boards hire and fire executives and set their compensation; they evaluate executive behavior and use ownership plans (the granting of stock, stock options, and bonuses) to incentivize executives to work more toward the overall interests of the firm than to increase their own personal wealth. Although these incentive systems have come under increasing fire recently, it is difficult to argue against aligning owner and manager interests through monitoring and incentive systems.

Stakeholder Theory

The idea that a company should have an expanded role and responsibilities to other stakeholders besides its owners is much newer than shareholder theory. Although tenets of shareholder and stakeholder theories differ, both are concerned with the purpose of the firm and strategies to improve its competitive position. Thus, the two theories are *not* diametrically opposed, as it sometimes appears. Each is concerned with the firm’s best interests—one may say self-interest—but each differs on the most effective approach to realize those interests. For example, stakeholder theory does not view maximization of shareholder wealth as the most efficient way to generate competitive advantage for the firm. The theory holds that firms can best generate competitive advantage and wealth by taking more than just their shareholders into account.

Starting in earnest in the late 1970s and early 1980s, researchers with backgrounds in philosophy, psychology, sociology, and management began putting forth a new theory of the firm that challenged some of the basic assumptions of classic economics and shareholder theory (the term “stakeholder” is derived, perhaps irreverently, from “shareholder”). In particular, Archie Carroll and Ed Freeman theorized that by taking the interests of all the firm’s stakeholders into account, the firm could do “better” (achieve greater performance) than by simply focusing on shareholder interests.

Carroll noted that corporations have four major responsibilities: economic (to generate shareholder wealth), legal (to obey laws and regulations), ethical (to recognize that the firm is part of a community, and thus has obligations to, and an impact on, others), and discretionary (to engage in philanthropy). Nonetheless, economic responsibility is still primary—that is, “the business of business is business.” Similarly, Freeman espouses that profit generation should be the outcome of a well-managed company (much like Carroll and Friedman). Unlike Friedman, however, both Carroll and Freeman believe that if a firm creates value for its stakeholders, it will create value for its shareholders, as well. Thus, unlike the assumptions of classical economics and shareholder theory (that a firm can only maximize value on one dimension), stakeholder theorists believe that taking all constituent groups into account is the better way to maximize overall firm performance.

Stakeholder theories today. A firm’s stakeholders are all those diverse individuals and groups who affect or are affected by a firm’s actions—including competitors, consumers, employees, investors, communities, regulators, suppliers, and governments, to name the most prominent. Stakeholders can be assigned to three categories: capital market stakeholders (e.g., financiers and shareholders); product market stakeholders (e.g., customers, suppliers, communities); and organizational stakeholders (e.g., employees). They also can also be grouped by importance, or salience. Indeed, as stakeholder theory has evolved in this century scholars are recognizing the importance for firms to understand “who counts” under what particular circumstances, as well as how this “hierarchy of salience” can change depending on the relative power of stakeholders, the legitimacy of their claims, and the urgency of their claims on the company. Hence, a firm must learn to deal with trade-offs among its stakeholders, since those groups inevitably will make competing claims in which it is likely that the firm will prefer the interests of one group over another. For example, in the wake of child labor and sweatshop allegations against its factories in Asia, Nike considered the claims of NGO, regulatory, and activist stakeholders to be most salient. During other non-crisis periods, however, shareholders, employees, and customers most likely will be treated as higher in Nike’s stakeholder hierarchy. (see chapter 8)

Stakeholder theory also is influencing scholars from the communications and public relations domains who are interested in how firms interact with their environments. For example, a new theory of “symmetric” communications emphasizes the interdependence of organizations with their customers, clients, suppliers, competitors, the media, and even activists. As a result, firms are encouraged to be two-way communicators, balancing their self-interest with altruism, advocacy with accommodation, and by creating symmetry between their own interests and those of their stakeholders, even if those interests are opposed. This symmetric approach calls for compromise from both sides in order to reach a win-win zone in which the firm and its stakeholders both can benefit. Significantly, the symmetric communications perspective

does not call for an end to enlightened self-interest from any side; instead, the perspective looks for a process in which firms and their stakeholders both seek their own advantage while, at the same time, respecting the needs of others.

Two other recent theories that reinforce and relate to stakeholder theory are “stewardship theory” and “social capital theory.” Stewardship theory, an alternative to agency theory, assumes that human beings, in fact, may put the interests of others, including the organization, above their own self-interest. Scholars such as Lex Donaldson and Jim Davis have promoted stewardship theory as a positive approach to organizational dynamics and corporate governance, in contrast to the traditional gloomy vision of agency theory and similar economics-based perspectives.

Perhaps the most vocal critics of the shareholder model who can be viewed as members of the stakeholder (and positivist) camp are the late Sumantra Ghoshal and other proponents of social capital theory. In direct opposition to the Chicago School’s emphasis on “neat mathematical models that only work when multiple assumptions are in place,” and in stark contrast to the ideas of human opportunism and self-interest espoused in traditional economic views, social capital theory assumes that organizational actors also have a proclivity for goodness and self-enlightened behavior that can add value to the firm. Whereas agency theory assumes the potential for conflict between managers and owners, social capital theory assumes the potential for cooperation among employees and shareholders for the overall betterment of both the individual and the firm. Ghoshal focuses on the roles of trust, goodwill, and even good karma, in positively contributing to the firm’s bottom line. Ghoshal and his followers thus challenge the economists’ traditional, pessimistic vision of human nature, arguing that the assumptions of self-interest and opportunism only lead to a self-fulfilling, vicious cycle in which employees, feeling distrusted, will engage in the very opportunistic behaviors that the monitoring and governance mechanisms prescribed by traditional theories are supposed to curtail.

In contrast, social capital theory attempts to create a virtuous cycle in which organizational actors are assumed to be willing to work not for their own benefit but for the benefit of the organization as a whole. They know by doing so they will reap greater personal rewards—what economists call “psychic benefits”—in addition to monetary ones. Social capital theorists recognize that people can be self-interested and opportunistic, but they fear that the widespread use of those negative assumptions has tainted how firms run their businesses and manage their stakeholders. Instead, Ghoshal asks, “Why not assume that humans are good *and* bad?” This positivistic approach to firm-stakeholder interaction has gained great traction of late among management researchers and business leaders. The University of Michigan’s Ross School of Business runs the Center for Positive Organizational Scholarship, focusing on compassion, positive identity, positive leadership, and positive social capital within the firm. Companies implementing a positivistic approach to their business decisions include Burt’s Bees, Google, and Reuters. However,

time will tell if this perspective makes the same impact shareholder theory has made, or stakeholder theory is beginning to make.

A final branch of stakeholder-related theory is the now near-ubiquitous field known as corporate social responsibility (CSR). As befitting a stakeholder view of the role of business in society, the study of CSR includes the actions a firm takes as it relates to other institutions and constituencies. For example, CSR can mean promoting environmental integrity, economic development, and social justice as part of the firm's overall strategy to gain competitive advantage.

CSR advocates have been trying fervently to show that a positive link exists between more inclusive stakeholder management and increased financial performance (CFP). Unfortunately, only limited progress has been made in this regard because of the intrinsic difficulty of measuring the impact of corporate actions on stakeholders other than shareholders. One clear advantage of shareholder theory is its emphasis on metrics (stock price and the bottom line) that are readily available and easily quantified. Measuring a firm's effectiveness in its interactions with stakeholders outside the capital markets is far more difficult. Indeed, several meta-analyses of the link between CSR and CFP have proved inconclusive. Some studies show a positive relationship, some negative, and some show none at all (see chapter 11).

Nevertheless, perhaps the best proof is in the pudding: that is, the ever-increasing number of companies recognizing the importance of bringing more stakeholder groups to the table, and believing that doing so can benefit their bottom line. For example, the 2009 release of the Global 100 Most Sustainable Corporations reads like a Who's Who of the world's most recognizable and profitable companies, and includes Adidas, Coca-Cola, Ericsson, Danone, and Honda. This demonstrates that stakeholder theory, and the theories like CSR that draw on it, are *management* theories intrinsically concerned with the performance of the firm.

Bridging the Shareholder-Stakeholder Gap?

A key tenet of stakeholder theory unfortunately often gets lost in the debates about its merits: taking all a firm's constituencies into account (on some level) in the process of strategy formulation can be *financially* beneficial for the firm. Too often, however, advocates of stakeholder theory have gotten away from this core intention, focusing instead on the importance of non-financial market stakeholders (employees, NGOs, local communities, and environmentalists) at the expense of the firm's owners. We must remember that both shareholder and stakeholder theories recognize the importance of the firm's financial success—they just advocate different approaches to that end. Both are theories of value creation, and both are predicated on the assumption that firms should create as much value as possible within the boundaries of the law. Stakeholder theories differ from shareholder theories, however, in recognizing that a firm

can maximize value by understanding how it affects, and is affected by, all its numerous constituencies.

Shareholder theory is seemingly hostile toward actions not directly impacting the firm's bottom line, whereas stakeholder theory revolves around human decision-making and, thus, ethics. Advocates of stakeholder theory believe that it does not make sense to talk about business without ethics, and vice-versa, and it doesn't make sense to talk about either without talking about humans making choices. They thus reject the commonly held separation thesis (that economic and ethical matters in business are distinct), and provide justification for using more inclusive frameworks to think about the role of business in society. Key questions stakeholder theorists encourage managers to ask are: *For whom is value created or destroyed if this decision is made? Whose rights will be enabled or not? What kind of person will I be if I make this decision?*

None of this should be seen as anti-Friedman. After all, Milton Friedman wanted firms to maximize profits within the rules—and that *may*, or may not, include CSR-type activities—depending on the outcomes generated. The trick here is that economists traditionally have had trouble measuring value outside of the bottom-line; hence they tend to ignore what they can't (precisely) measure. In the end, they are unable to create tight mathematical models that represent the loose, real world we live in.

Generating stable and growing profits should be the outcome of a well-managed company, and stakeholder theory can help the firm get there—perhaps more effectively than shareholder theory—by measuring such soft variables as firm reputation, the quality of products and services, trustworthy suppliers, good employees, supportive communities, and cooperative financiers. In short, stakeholder theory recognizes the firm has a potential for profit in generating a strong, lasting reputation among stakeholders and through addressing real needs and interests of such groups.

Dare we then say that stakeholder theory is an extension of shareholder theory, and that its broader framework and understanding of the firm's interaction with society can actually generate better performance for the firm and thus, create more benefits for society-at-large? That is a bold assertion to be sure, but it seems to make sense in the 21st century, when greater numbers of firms are accepting the legitimacy of notions such as the triple bottom line (economic, social, and ecological), sustainability, accountability, transparency, and other soft measures of performance. It also seems sensible to assume that people can be both self-interested and self-enlightened, thus creating potential for the melding of shareholder and stakeholder approaches into one useful theory.

Resources:

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