

Theoretical Underpinnings

There are three central theories in Western corporate governance, namely the agency theory, shareholder primacy theory and the stakeholder theory. Although the term "Western" does not imply that the following theories are exclusive to Western economies, it indicates the geographical origin of modern corporate governance research.

Agency Theory

Defining agency relationship

"An **agency relationship** is defined as a contract under which one or more persons (**the principal(s)**) engage another person (**the agent**) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. If both parties to the relationship are **utility maximisers**, there is good reason to believe that ***the agent will not always act in the best interests of the principal.***" (Jensen & Meckling, 1976) ¹

In a corporate setting, this means that when the CEO (the agent) acts on behalf of shareholders (the principal), there are usually conflicting interests.

There are several conflicting areas:

Conflicting areas	Definition
Shirking	Managers may work less hard than owners would
Perks	Private jets, lavish offices (managerial consumption)
Risk preference	Managers may avoid risky but value-creating projects

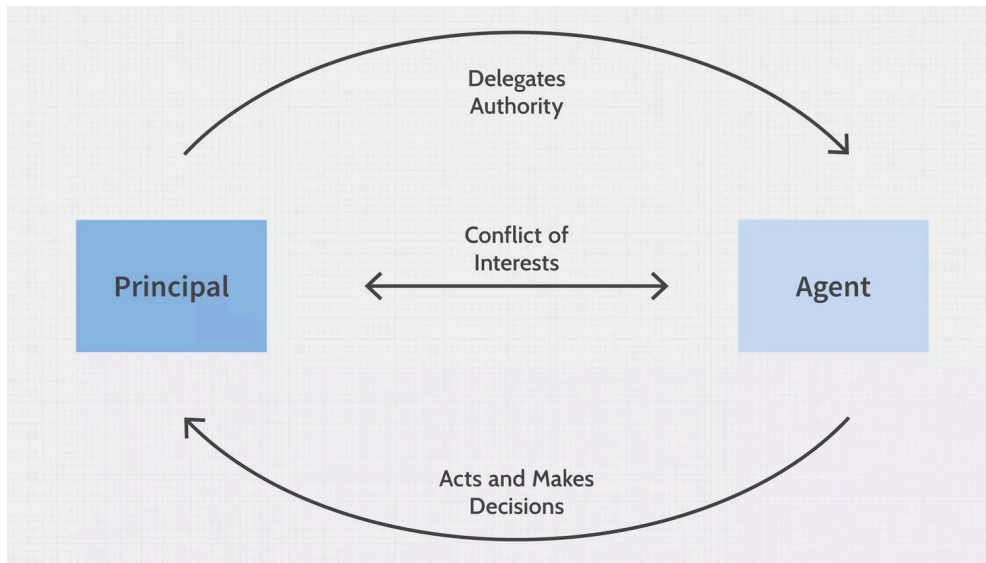


Tip

[Student activity]

Can you think of other examples of agency conflict?

Would you take on a risky project if it could lead to being fired?



Agency cost

Can the principal avoid the above conflict of interest? Maybe.

According to Jensen and Meckling (1976) (particularly chapters 1.1-1.4), the principal can limit divergencies from his interest by creating certain incentives for the agent and by monitoring designed to limit aberrant activities of the agent.

However, monitoring is not costless. **Monitoring costs** include salaries for independent directors, auditors, and hiring firms like PwC to verify financial statements. There are also **bonding costs** where CEOs promise not to misbehave by contractually limiting their own decision-making power or certain benefits. CEOs may also voluntarily tie compensation to long-term stock performance.

💡 Tip

[Student activity]

Search the internet and find out how Apple Inc. paid Steve Jobs.

Even after monitoring and bonding costs are incurred, a **residual loss** may still occur. Residual loss refers to *economic inefficiency* or value destruction that occurs when an agent's actions *deviate* from the principal's best interests. It represents the "gap" between the *ideal* outcome (perfect alignment) and the *actual* outcome due to conflicts of interest. Excessive perk is one example. Other residual losses include behaviours such as empire-building (CEOs acquiring unprofitable companies to boost their prestige) and short-termism (Managers cutting R&D to meet quarterly earnings targets, harming long-term innovation).

In summary, we can interpret agency cost as follows:

$$\text{Total Agency Cost} = \text{Monitoring} + \text{Bonding} + \text{Residual Loss}$$

💡 Tip

[Student activity]

Based on your understanding, find out cases of CEOs or corporate managers appropriating shareholders' interests. Hint: short-term profit, accounting scandal.

⚠️ Caution

Is it correct to assert that agency theory assumes all managers are selfish?

No. Agency theory is about incentive, NOT morality. Even good people could respond to misaligned rewards.

Separation of ownership and control

Why does the agency problem in corporations arise in the first place? It originates from the separation of ownership and control. This is well explained by the following quote in *The Wealth of Nations* by the Scottish economist Adam Smith:

"The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

--- Smith, Adam (1776). *The Wealth of Nations*. Edited by Edwin Cannan, 1904. Reprint edition, New York, Modern Library ²

In 1932, Adolf Berle and Gardiner Means provided one of the fundamental explanations of investor and corporate relationships in their often-cited work, *The Modern Corporation and Private Property*. It highlighted that as countries industrialised and developed their markets, the ownership and control of corporations became separated. This was particularly the case in the USA and the UK, where the legal systems have fostered good protection of minority shareholders, and hence there has been encouragement for more diversified shareholder bases ³.

On the one hand, dispersed shareholders (principals), who own a small portion of the company's stock, often cannot micromanage CEOs. The cost of micromanaging incurred by an individual shareholder usually outweighs the benefit. Boards of directors, who are meant to oversee management, may be captured by executives. On the other hand, corporate insiders, such as CEOs, almost certainly have more information about operations than outside shareholders (agents), the actual owners. This allows insiders to hide inefficiencies, manipulate reports, or act opportunistically. The combination of the lack of direct control and information asymmetry leads to shareholders having little incentive or ability to coordinate and monitor management effectively --- this is the **collective action problem**.

Tip

Imagine you own stocks in Apple Inc. Can you realistically challenge the CEO's decision, even if they are suboptimal?

In fact, as an individual shareholder, one may prefer to avoid the costs of monitoring, hoping others will do so -- this is the **free-rider problem**.

Shareholder Primacy Theory

"There is one and only one social responsibility of business - to...increase its profits."

--- Milton Friedman, Nobel Laureate in Economics

The origin

Milton Friedman is widely regarded as one of the most influential economists in history, second only to John Maynard Keynes. His economic counsel shaped the policies of leaders such as Richard Nixon, Ronald Reagan, and Margaret Thatcher. In 1976, he was awarded the Nobel Prize in Economics, largely for his groundbreaking work on monetary theory, which continues to guide central banks today. However, his most frequently referenced work is not an academic study on monetary policy, but rather a 1970 New York Times Magazine essay titled "*The Social Responsibility of Business Is to Increase Its Profits.*" ⁴ This article has been cited over 23,000 times—far more than any of his scholarly papers—yet many of these references are critical, using Friedman’s argument as a symbol of outdated capitalist thinking. Today, openly rejecting Friedman’s stance has become almost a rite of passage in progressive intellectual circles (Edmans 2021) ⁵.

 **Tip**

[Student activity]

Read the 1970 New York Times Magazine essay *The Social Responsibility of Business Is to Increase Its Profits.*

Key arguments	
Agency problem	Executives are agents of shareholders; spending company resources on social responsibilities (e.g., environmental or social causes) is akin to " taxation without representation ", as it diverts profits without owners’ consent.
Incompetence	Managers often lack the expertise to address social issues (e.g., poverty, pollution) and struggle to determine the most effective way to allocate others' resources.
Market Discipline	In competitive markets, social responsibility initiatives that raise costs will be punished by shareholders, customers, or competitors.
Window-dressing	Most social responsibility activities are self-interested (e.g., PR, tax deductions) rather than altruistic.

The theory

A corporation’s primary duty is to shareholders (owners), not other stakeholders (employees, communities, etc.). Corporate managers are agents. They must act as **fiduciaries** for shareholders (principals). Any diversion of resources to social responsibility activities violates this duty. Competitive markets punish firms that prioritise CSR over profits (e.g., via shareholder revolts or customer backlash).

Does shareholder primacy theory assume investors only care about profit? Not really.

"The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so."

The theory does not assume that investors only care about profits. Consider two investors, Sarah and James, who both own shares in Huawei. Sarah prioritises gender equality, while James focuses on climate action. If Huawei were to donate a significant sum to a women’s empowerment organisation, Sarah would approve, but James might not. Instead, Huawei could focus on **maximising profits** and **distributing higher dividends** to shareholders. This way, Sarah could allocate a portion of her dividends to causes she supports, such as gender

equity initiatives, while James could direct his toward environmental groups like The National Trust. Alternatively, both might choose to use their dividends for other socially beneficial purposes, such as supporting their families or funding education.

Friedman does recognise that individuals have social responsibilities beyond profits. He argued that the social responsibility of business is to increase profits because doing so gives individuals – Sarah and James – maximum flexibility to choose which social responsibilities they wish to fulfil. It's not the CEO's special privilege to take this decision away from them:

"If he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other."

However, Friedman's theory assumes that a pound Huawei takes from shareholders creates only a pound of value to society. If it is true, then it does not matter who spends the money. But the assumption isn't true for most actions that directly affect society. If Huawei invests a pound in reducing its plastic packaging, it helps the environment much more than if it paid out that pound as dividends and James donated it to the National Trust to lobby for a tax on plastic bags.

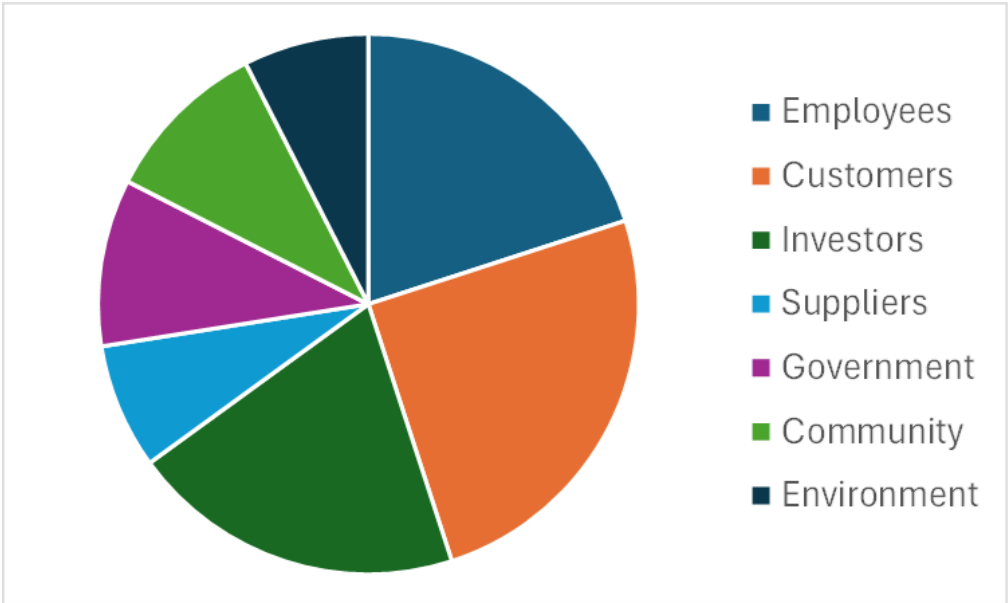
📢 Important

So Friedman's claim that companies serve society by maximising profits isn't always true. This is because his assumption that they have no comparative advantage in serving society is sometimes invalid.

Stakeholder Theory

Question: If a company fires 1,000 workers to boost profits, who is affected beyond shareholders?

Edward Freeman referred to all the affected parties as *stakeholders*. According to Freeman (1984), stakeholders are *any group/individual affected by or affecting a firm's goals* (not just shareholders/investors) ⁶.



Stakeholders	What they value	Meaning
Shareholders	Profits	Returns above the investment

Stakeholders	What they value	Meaning
Employees	Livelihoods	Pay, work-life balance, impact, etc.
Customers	Surplus	Value received above price paid
Suppliers	Funding	Stable source of revenue
Environment	Renewal	Not simply maintaining the status quo
Communities	Vibrancy	Employment opportunities, the spread of knowledge, and living standards, etc.
Government	Tax revenues	Sufficient financial resources

A company serves not only investors but also all the other stakeholders. **But why do stakeholders matter?**

Tip

[Student activity]

Investigate two cases: (1) the price hike of Daraprim in 2014; (2) the Mectizan Donation Programme (MDP) in 1987

The two cases are related to the fall of Turing Pharmaceuticals and the rise of Merck, respectively. In your investigation, consider two questions:

- How shareholder primacy theory and stakeholder theory disagree with each other.
- Whether the interests of shareholders are always misaligned with those of the stakeholders.

Are there other cases where companies achieve financial success through caring for stakeholders' interests?

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1. Meckling, W. H., & Jensen, M. C. (1976). Theory of the Firm. *Managerial behavior, agency costs and ownership structure*, 3(4), 305-360. [↗](#)
 2. Smith, A. (1776). *The Wealth of Nations*. Edited by Edwin Cannan, 1904. Reprint edition, New York, Modern Library [↗](#)
 3. Means, G. (2017). *The modern corporation and private property*. Routledge. [↗](#)
 4. Friedman, M. (1970). The Social Responsibility of Business is to Increase its Profits. *New York Times Magazine*, September, 13, 122-126. [↗](#)
 5. Edmans, A. (2021). *Grow the pie: How great companies deliver both purpose and profit-updated and revised*. Cambridge University Press. [↗](#)
 6. Freeman, R. E. (2010). *Strategic management: A stakeholder approach*. Cambridge University Press. [↗](#)