FUNDAMENTALS OF BUSINESS ECONOMICS

Stephen Adams traces the development of theory on the principal-agent problem – an issue that companies have yet to solve satisfactorily.

The inclusion of the principal-agent problem in the CO4 syllabus can be taken as evidence of growing concerns about the nature of organisations, corporate governance and the possibility of conflict among stakeholders. But the issue is not new: Adam Smith, writing in *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), stated that he doubted the value of joint-stock companies because he felt they reduced the financial incentive for managers to perform, since the capital was provided by shareholders rather than the managers themselves.

Adam Smith.

He had this to say about the directors of such a business: "Being the managers rather of other people's money than of their own, it cannot be well expected that they should watch over it with the same anxious vigilance with which partners in a private copartnery frequently watch over their own." Perhaps Smith was still influenced by the scandal of the South Sea bubble 60 years earlier.

In the 19th century the issue lost its attraction for economists, indicating the apparently crucial role that joint-stock, limited-liability companies played in economic growth during that period. Even corporate scandals, particularly evident in the US, failed to arouse much academic enthusiasm. But interest revived in the 20th century. This reflected partly the academic discussion of organisations in other disciplines and partly the growing awareness of the increasing dominance of large companies in western economies.

In 1932 Adolf Berle and Gardiner Means coined the phrase "the separation of ownership and control" in their book *The Modern Corporation and Private Property*. Three decades later, J K Galbraith argued that a divorce of ownership from control, with managers, not shareholders, dominating decision-making had resulted from the growth of large corporations and the organisational consequences of advanced technology and mass production.

"Corporate size, the passage of time and the dispersion of stock ownership do not disenfranchise the stockholder. Rather, he can vote, but his vote is valueless," Galbraith declared in *The New Industrial State* (1967).

The principal-agent problem is now seen as a crucial element in our understanding of management and decision-making in enterprises. But it is not a purely business phenomenon. It arises in a wide range of human activities and is part of what is known as agency theory. This is concerned with the relationship between a principal and an agent who acts on behalf of that principal. Examples include:

- Shareholders delegating powers to boards of directors.
- Patients leaving decisions about their treatment to doctors.
- House-buyers employing solicitors to purchase houses on their behalf.
- Local authorities appointing private firms to perform routine council services.

Principal-agent activities are clearly common. The problematic element usually concerns the inability of principals to ensure that the agent always acts in their best interests. The relevant factors here are knowledge and power, which can be analysed in the wider context of organisational stakeholders. A stakeholder is an individual or group that has some interest in the way an organisation is structured, managed and behaves. In the case of a hospital, for instance, the stakeholders will include the medical staff, the managers, the patients and the government that funds it. In this group we can distinguish among:

- Internal stakeholders, such as managers and medical staff.
- Connected stakeholders, who have a direct link to the organisation but function outside it, such as the government.
- External stakeholders, who have an interest in the organisation but are not part of it, such as patients.

Two types of stakeholder involvement can also be identified and measured: their level of interest in the organisation and their level of influence on its behaviour. Sometimes a positive correlation between interest and influence exists. Internal stakeholders such as managers have a lot of interest and a lot of influence, whereas external stakeholders may have little of either. But this correlation does not always hold. A patient will have a high level of interest in his or her treatment, but may have far less influence on the process because they will tend to lack medical knowledge. In other cases, a lack of power

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may prevent stakeholders from influencing an organisation, despite high levels of interest.

In a principal-agent relationship, the key question is: can the principal ensure that the agent always acts in a way that's consistent with the principal's objectives? When there is a divorce of control from ownership, the question becomes: can the shareholders (principals) ensure that managers (agents) always act in their interests?

Why might shareholders lose control of an organisation that they legally own? Galbraith suggested a number of reasons for this, including:

- Lack of power. As businesses became larger, the capital requirements expanded. And, as technology became more capital-intensive, the growth in demand for capital exceeded the growth of the businesses. The need to secure economies of scale further encouraged the development of large businesses. It was argued that the capital to finance this could come only from the savings of large numbers of small investors – hence the rationale for the plc. But, if there are many investors, it implies that individual investors will have little power over the company. In Galbraith's words, the stockholder's vote is valueless.
- Lack of knowledge. With the development of modern IT, few people in high-tech firms understand every aspect of their business. Specialists are, by definition, experts in only some fields and knowledge rests more with groups of experts in the organisation – what Galbraith called the techno-structure. This now extends to the non-technological areas of the business, including finance. The challenge for investors is to acquire a minimum level of understanding of their firm. Since the flow of information from it to its shareholders is controlled by the directors, the problem is compounded.

Since the objectives of an organisation will reflect the objectives of those who control it, this conclusion has important implications.

Conventional economic theory assumes that shareholders are solely interested in maximising their wealth, so the aim of the business is assumed to be profit maximisation. But this assumption is weakened if the management team is, in effect, controlling the business. If the enterprise reflects the aims of its managers, can we still apply the profit-maximising theory to the organisation? The argument here is that managers have no reason to be motivated to maximise the wealth of remote shareholders who have no real influence over them. Instead, they will pursue their own objectives, which, it's suggested, concern financial reward, power, prestige, status and independence of action. The problem is how to translate this mix of objectives into an assumption about business motivation.

William Baumol (*Business Behaviour, Value and Growth*, 1959) argued that these objectives were a function of the scale of the enterprise. For example, financial rewards for directors tend to correlate to business size. Baumol's model assumed that businesses were sales growth maximisers, albeit with a profit constraint – the level of profit sufficient to keep shareholders happy (and quiet) – but profit was not an objective in itself for the managers. Robin Marris (*The Economics of Managerial Capitalism*, 1969) abandoned the idea of maximisation itself, suggesting that we should regard organisations as satisficers rather than maximisers, and that managers would aim at satisfactory levels of growth, profitability and share price value.

The theory, therefore, was that companies' owners had lost effective control of their businesses. But is this really the case? Two arguments suggest otherwise. First, shareholders may have more power and knowledge than the model assumes. Most shares traded on the London Stock Exchange are owned not by individuals, but by institutions such as pension funds. These organisations may own considerable blocks of shares in companies and can be expected to have extensive knowledge about these businesses. In some countries – notably, France, Germany, Italy and Japan – shareholding is even more concentrated in these institutions than it is in the UK or the US. But a shareholder will incur considerable costs guarding its interests by monitoring the performance of firms in which it owns stock, and it will reap only a proportion (depending on the size of its holding) of the benefits of improved business performance. So there's an incentive to sit back and let other shareholders bear these costs, which creates a risk that all shareholders will try to take a "free ride" and none of them will do the monitoring.

J K Galbraith.

The second counter-argument is that shareholders may be able to create reward systems in which the management team has powerful financial incentives to act entirely in their interests. The problem here lies in determining these packages. If shareholders could directly observe the effectiveness of the management team, they could devise reward schemes that oblige the directors to put in the level and direction of effort that maximises shareholder wealth. But shareholders don't have perfect information of this kind. If they have limited knowledge and don't know whether the company's performance outcomes have resulted from directors' actions or from other factors,

designing effective incentive packages becomes an extremely difficult task.

Shareholders don't normally design directors' remuneration packages anyway; they are required only to approve them. These are normally devised by remuneration committees – consisting primarily of directors. Even when these are non-executive directors with some independence from the management team, it might be natural to make the packages generous, with targets that are either easy to achieve or too flexible to act as a real control on performance. Perhaps these non-execs, who are often senior managers in other companies, are generous given that they also have such packages devised for them. Directors' remuneration systems are often complicated, too. Most FTSE-100 companies hire specialist consultants to devise executive pay schemes, which are not easily understood by private shareholders.

Despite all of this, there is a lot of pressure on directors to perform for shareholders. A low share price arising from poor management may invite takeover bids from rivals who intend to replace the management team and thereby improve performance. Furthermore, this concern for the position of shareholders has been reflected in various proposals concerning corporate governance. Although these have addressed many issues, a main theme has been the strengthening of shareholder control and reinforcement of directors' responsibilities to shareholders.

The principal-agent problem is alive, well and directly relevant to our understanding of the relationship between shareholders and managers. As long as executive reward schemes continue to involve large sums of money, the issue will have topical value. Last year, for example, the US firm Home Depot parted company with its chief executive and his pay-off was reported to be £105m. And, as long as company failures come as a surprise to investors, the issue will retain its shock value. Given what happened to Northern Rock's share price recently, its shareholders may well be feeling the force of Adam Smith's comment that when directors are managing someone else's money, they might take less care with it than when managing their own.

Stephen Adams is a former CIMA examiner for economics papers.

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