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Understanding the firm: description, theory and normativity

Hervé Dumez
CNRS / École polytechnique

To A.

Understanding the corporation, its functioning and its place in society, requires three analytic dimensions: description, theory, and normativity[1]. A crucial question is that of their interrelations. We cannot understand the corporation or the firm without a good description, without relevant theories, and in the absence of value judgments – but neither without a conception of how these dimensions interact with each other. There is no shortage of theories of the firm, and they will keep multiplying. At the same time, the dominant theory has remained remarkably stable since it was first elaborated by Jensen and Meckling (1976), who themselves reformulated previous theories. This dominant view states that firms maximizes their shareholders' income. In practice, there is a risk that the firm does not always do that, because of agency costs. Thus, at the heart of the theory lies the agency relationship between the firm's owners, i.e. the shareholders, and its managers, with corporate governance aimed at ensuring that managers run the company in the shareholders' interest.

It is immediately obvious that the theory raises the question of value. Agency theory analyzes the relationship between shareholders and managers (what is), but it also has an inherently normative component (what ought to be), since in principle the interests of both parties should be aligned. Yet the need for a description of the firm is not as well recognized as the need for a theory. Indeed, description does not have a good press. The questions nevertheless arise, whether theories of the firm are based on good descriptions, and whether they are able to provide one. Moreover, what counts as a good description, and how can it be distinguished from theory? A description is a "seeing as" (a term borrowed from Wittgenstein), and its link to theory is complex (Dumez, 2013). Finally, a tradition inherited from positivism and the Vienna Circle wants scientific explanation to be free from value judgment. It has been strongly challenged by what Hilary Putnam characterized as one of the most profound changes in moral philosophy: the idea that the opposition between facts and values is not as clear-cut as generally believed, and that there exist normative/descriptive or "entangled" concepts (Murdoch, 1970; Williams, 1985; Putnam, 2002). To address the issue of the interconnections between description, theory and value judgment regarding the firm, let us begin with an outstanding description.

1. This paper was presented in french on 26 May 2013 during a Colloque de Cerisy "*À qui appartiennent les entreprises ? Vers de nouveaux référentiels de l'engagement collectif*". I thank Baudoin Roger, Blanche Segrestin and Stéphane Vernac for their authorization to publish it in english in *Le Libellio*.

2. One could evoke Chandler (1962 & 1977) for a description from a historical perspective or Drucker (1946), whose book *Concept of the Corporation* is, in spite of its title, a form of description.

The fascinating enigma of Galbraith's description of the firm

In *The New Industrial State*, Galbraith (1967a) provided an ambitious description of the firm – one of the few, and perhaps the last one, to deal with the firm at such an extensive scale (the question remains open on this point[2]).

To begin with, Galbraith focused on the big corporation, which he saw as the center of an economy, even though it did not represent it entirely, since small firms still played an important role. Given that he was concerned with one particular type of firm, the question arises whether it is possible at all to provide *a* description of *the* firm?

For Galbraith, the firm's large size resulted from its seeking to plan and stabilize its environment so as to minimize risk. Big corporations controlled consumer behavior through advertising, they controlled the markets by setting prices rather than following market price, and they controlled the state. Their aim, however, was not profit maximization. Rather, provided they guaranteed an adequate income to the shareholder, their goal was to make the firm grow by way of cash flow generation and incorporation. More generally, in Galbraith's time, the dominant motivation within the firm was not money: CEOs did not have very high salaries and did not hold shares. The motivation was the organization's survival, growth and autonomy.

At the organizational level, Galbraith described the big firm from the periphery to the center, as a series of concentric circles. The most peripheral and distant circle was that of the shareholders, who have no relationship to the company other than money; then came the circle of workers, who are related to the company primarily by money, but who also identified to some extent with the organization; closer to the center, another circle was made up of supervisors, management staff, support functions; this was followed by the circle Galbraith named *technostructure*, composed of technicians, engineers, sales managers, designers and other specialists; finally, at the core, were the highest echelons of management. Power in the Galbraithian big firm was related to such structure. It was not concentrated at the level of individuals, whether CEOs or shareholders, but at that of the technostructure. It was collective, and therefore considered legitimate, and bound by self-control (hence the absence of inflation in salaries).

Saint Jean-Baptiste prêchant,
Pierre Brueghel le jeune
(1601-1604)
musée de Cracovie

The representation by concentric circles with the CEO at the center is actually inconsistent with Galbraith's own perspective, since the center of circle, where power resides, should not be individual but collective – the technostructure, rather than the leadership. Galbraith observed that it was usual to think that the technostructure is limited to making basic decisions, while CEOs make the big strategic ones. He considered such view a myth, since so-called strategic decisions are so complex that they must be prepared, and are therefore largely determined by the technostructure itself. The last element of Galbraith's description of the firm was its already mentioned overlap with the state: the state usually serves the interests of big business.

What was the *explanation* behind such a description? In a sense, this did not matter much to Galbraith, who wished to remain descriptive. He nonetheless provided an essential theoretical idea, namely that power is associated with the agent of production which proves most difficult to acquire and replace. And that agent was not the capital, but the technostructure.

Galbraith's description reacted against the then-dominant economic theory, according to which firms maximize shareholder's benefit. He argued that economists had missed the transformations of the economy and remained prisoners of their theory. He believed such blindness was due to a specialization of the professional field of economics, which, in turn, he considered incompatible with the description of a phenomenon as general as the firm. His objective was to shake up the old theory: the targeted economists responded by the voice of Robert Solow.

An economist's response to Galbraith: Robert Solow

Solow (1967a & b) provided the economists' reaction to Galbraith. In many ways, the two thinkers resembled each other: both were Keynesians, both had been close to Kennedy and worked in his administration. There was no political and ideological opposition between them, as was the case with Milton Friedman. Their disagreement concerned the figure of the economist and the nature of economic theory. In 1961 Solow was awarded the prestigious John Bates Clark Medal for the best economist under forty. It is usually the prelude to the Nobel Prize in Economics, which he indeed received twenty years later.

Solow's critique began with an ironic characterization of Galbraith: one can meet him at official dinners with celebrities, and on the slopes of Gstaad. He gives the impression of not being an entirely serious economist. Solow believed that there were big and little thinkers. *The New Industrial State* was a big thinker's book, that is to say a book for dinner in town. But genuine economists are little thinkers. Solow then criticized Galbraith's arguments one by one. At present, he pointed out, big firms are mainly present in the manufacturing sector. However, trade and services are developing very rapidly, and it is difficult to say which direction they will take. Galbraith may have therefore exaggerated the role of big companies. The idea that the big firm can control the consumer, the market, and the state is overblown. In fact, companies often fail to make consumers buy the products they have launched with great publicity, and lose market share. Economists take profit maximization as an approximation, since some firms in the real economy do not maximize profit. Moreover, as Berle and Means highlighted in 1932, the gap between ownership and control has grown. Economists nonetheless believe that financial markets require firms to behave as if they were controlled by shareholders and thus seek to maximize profit. If the CEO of a firm sacrifices too much profit, the market will value the company at a low level. Aggressive raiders may then target the firm for a merger or a hostile takeover. On this point, the debate between Solow and Galbraith went nowhere, since Solow acknowledged that big companies cannot be the target of such hostile takeovers. Galbraith (1967b) replied that, since he was interested in precisely those companies, Solow merely confirmed his point.

As Solow predicted, Galbraith's description had a resounding public success. *The New Industrial State* went through three editions in a few years and was translated into many languages. Some terms, such as "technostructure", passed into common parlance. Reread today, the book seems completely anachronistic – so major have been the changes in the nature of the firm. It was successful – but was it right? It seems that an erroneous description seemed relevant to a large number of people working in or with firms. How come? Was perhaps Galbraith's description true at the time he wrote it? An affirmative answer to this question implies that it is almost impossible to compare the firm as it operates today with the firm as it operated in the 1970s. The status of Galbraith's description remains a fascinating conundrum, which questions our way of understanding the firm. Moreover, it makes us wonder if today one can provide a description of the firm that would be the equivalent for our time of what Galbraith's was for his. If yes, then how? If no, then why?

Solow ended up summarizing his critique in two points. On the one hand, as he claimed with abundant irony and even sarcasm, Galbraith was not a scientist but a moralist. On the other hand, no one needs a description consisting only of anecdotes, which was in his view what Galbraith offered, but a model, "a simplified description" (Solow, 1967a, p. 103) free of normative intent and making it possible to predict a firm's behavior. A few years later, economists came up with a model, agency theory; but this theory was inherently normative. And, besides, the relationship between finance and firms will be profoundly affected in the 80s.

Agency theory and the deal decade

The second edition of *The New Industrial State* was published in 1972. Four years later, Jensen and Meckling (1976) proposed agency theory as a simplified description of the firm. In fact, as the authors stated, the theory was an attempt to explain the difficulties encountered by collective action in general. But it was mainly applied to the relationship between a principal and an agent, where the principal is the shareholder who asks the agent to make his capital yield a profit. There is an asymmetry of information between principal and agent, and their interests do not fall in line with each other. Agency theory eventually models Galbraith's description: CEOs can manage the firm in their interest rather than in the shareholders'. Here enters the normative dimension of the analysis, which suggests two ways of re-aligning those interests: via the market and restructuring, or by way of corporate governance.

Agency theory provided economists with the simplified description that allowed them to reduce the gap between empirical reality and the traditional theory, which posits the firm as a profit-maximizing agent. According to the new model, due to agency costs the firm does not necessarily maximize profit. Such a model is not only descriptive, but also normative insofar as it postulates that mechanisms must be found to neutralize agency costs.

In the 1980s, in a context of economic crisis (Blair's [1993] "deal decade"), reality would actually move in the model's direction. A sharp rise in interest rates ended the Galbraithian situation of abundant capital and attractive investment opportunities. Capital became expensive and these opportunities dwindled. Shareholders and financial institutions put pressure on managers to generate higher returns on investment. A wave of hostile takeovers took place, and executive salaries skyrocketed. The trend accelerated, with increasingly risky acquisitions causing fraudulent bankruptcies, including that of the Maxwell group. Governance became the subject of regulatory measures, culminating in the Cadbury report of 1992.

In an article co-authored with Ruback (1983), Jensen welcomed the fact that the financial markets, by promoting restructuring, came to play an active role in the functioning of companies and thus solved the problem of the agency relationship. Because CEO strategies often remained too far from shareholders' interests, companies were frequently undervalued. Raiders noticed, and restructured acquired firms in ways that realigned those strategies with these interests. The (normative) problem that had to be solved was thereby solved.

Thus, in the last fifteen years of the twentieth century, the description of the firm, its theory and the related value judgments appeared to be in harmony. Things were as they should be, and theorists had a good theory to explain how that came about. What most likely happened is that the theory developed so as to justify actual changes brought about by rising interest rates and a scarcity of profitable investments.

All that may be changing today again – and, again, probably not for intellectual reasons, but because it is increasingly difficult for firms to ensure high return rates, and such a situation causes a crisis in the system, which in turn calls for a rethinking of the firm.

Questioning agency theory: an alternative vision of the firm

Is agency theory false? In other words, does the vision of the firm as being based on an agency relationship, with asymmetric information and divergent interests, thus necessitating a control over that relationship through the development of governance and financial market intervention, give a false picture and lead to wrong policies? Several authors think so, question the theory, and wish to produce a more accurate description. We will follow here the attemps by Segrestin and Hatchuel (2011), Jensen (2005) and Mayer (2013).

Mayer (2013) sets out by pointing out that theories of the firm ignore the existence of the law. Yet a company, as Segrestin and Hatchuel (2012) also emphasize, is a legal entity independent of its shareholders and its directors. As they point out, in the law, or at least in French law, the CEO does not represent the shareholders, but the company. Mayer goes further. He thinks one must put agency theory back on its feet. If shareholders receive a satisfactory financial return, it is not despite the fact that the company and its managers have a separate existence from that of shareholders, but rather because of this separation. If the company did not exist autonomously, shareholders simply could not invest and reap dividends and capital gains. Thus, conceptually, agency theory erred in its normative dimension: shareholders are not potential victims of the company's autonomy, but its beneficiaries. According to Mayer, agency theory missed the very nature of the firm as a "commitment device" (Mayer, 2013, p. 145). Similarly, Segrestin and Hatchuel propose to replace the notion of *stakeholders*, too vague and ill-defined, by that of "committed actors" (*acteurs engagés*). These are the people who "participate in the community of the company" by agreeing "to submit their potential of action to the firm's decisions" (Segrestin & Hatchuel, 2012, p. 97). The two authors go further, showing that the company is a joint project of a particular and unique type, since "it supports both innovative activity, its organization and its market valuation" (Segrestin & Hatchuel, 2012, p. 29).

Fundamentally misconceived in theory, the agency and shareholder value theory is also criticized at the empirical level. At the world level, shareholders, including those who go through markets, finally bring the company a limited share of funding, as shown in the following table (Mayer, 2013, p 36.):

	$ trillion
Market equity	50
Private equity	100
Bank and other loans	90
Bonds	60
Labour capital	30

Actually, between 2007 and 2009 for example, companies bought more shares than they issued. From the theoretical and descriptive level, Mayer moves to the normative, and argues that shareholders should not have power over the firms' decisions. He elaborates a simple model to illustrate that when shareholders have that power, they drive firms to engage in risky strategies. If the firm wins, they pocket huge gains. If it loses, they lose their bet but charge the lenders with the losses; in turn, lenders evoke a systemic risk, and try to get states and taxpayers to pay in last resort. In the short term, the system works:

> […] it is very easy to devise strategies for earning 'abnormal' returns over extended periods of time before abnormal events that impose exceptional losses transpire. (Mayer, 2013, p. 52)

In the long term, however, the system's perverse effects become visible, and lead to a vicious circle: each crisis is an opportunity to ask for improved governance, that is to say, to give shareholders more direct control over the firm, resulting in even riskier strategies and, as a result, in a deeper future crisis.

Mayer sees hostile takeovers at the heart of this process. In the theory of corporate control (Jensen & Ruback, 1983), hostile takeovers play a regulatory role, since their threat ensures that CEOs manage firms in the shareholders' interest. In contrast, Mayer argues that they play a destabilizing role. According to him, case studies show that hostile takeovers do not target poorly managed firms, but companies with moderate and regular profits resulting from a prudent strategy. Hostile takeovers aim at destabilizing firms that follow a low risk strategy, in order to lead them toward riskier approaches.

What are the normative consequences of this analysis? Segrestin, Hatchuel, and Mayer agree on two points: first, universal rules, concerning for example corporate governance, cannot work due to the diversity of firms; second, alternative models of business, such as cooperatives, are of limited value. New models must therefore be tried out. Segrestin and Hatchuel (2012) focus on new forms of solidarity as company's foundation. In turn, Mayer's proposal revolves around two points. First, the company must be based on multiple values beyond profit; second, there should be a requirement of commitment, such that there is "no representation without commitment" (Mayer, 2013, p 209). Mayer imagines a system in which the voting rights attached to the shares are proportional to the commitment to the company over the long term (shares that can be sold any time receive no voting rights; a share has voting rights attached only if the holder agrees not to sell it for some time, and the extent of these rights is proportional to the length of the commitment). In such a model, CEOs decide, but control is exercised by a board of trustees representing the committed shareholders. The result would be trust companies that look like the German or Indian firms controlled by a foundation (Mayer mentions Tata). Such a system simultaneously overcomes the problems of the family firm (the risk of conflict among relatives) and those of the firm controlled by uncommitted shareholders, while it maximizes the positive sides of the family firm (long-term commitment) and those of the conventional firm (shareholders' serious control over the CEO). The board of trustees should ensure that the company complies with a plurality of values (not only profit) and that its decisions are inspired by a long term vision.

Contrary to Segrestin and Hatchuel (2011) and Mayer (2013), who elaborate their descriptions and models against the agency theory, Jensen remains within its framework. In the 1970s, agency theory was born from the belief that CEOs did not take sufficient account of shareholders' interests, and that, as a consequence, firms were undervalued. In the 1980s, mergers and acquisitions rectified the situation and pushed companies' worth upward. Jensen (2005), however, believes that the main problem was merely displaced. Agency theory has led to create incentives for managers to increase the financial results of the firm. Linking pay to performance led management to manipulate goals and results (Jensen, 2003). Companies had been undervalued; they became overvalued. This is a large-scale phenomenon, with overestimates ranging between 100 to 1000 %. The consequence is that, exceptional circumstances aside, companies are unable to achieve performances justifying their supposed value. This may lead to major crises, which profoundly undermine the economic system and further affect the company's value. Caught in the spiral of overvaluation, CEOs are structurally forced to lie and to fudge accounts: they postpone spending and anticipate revenue. Once engaged in a process that begins with minor tricks, they are drawn to increasingly large ones. According to Jensen, this is what happened with Enron. The company was innovative and viable, and was said to be worth 70 billion dollars at its peak. However, according to Jensen's calculations, it was worth only 30. Its managers had two possibilities: they could have the courage to make estimated value and actual value coincide; or they could lie and manipulate accounts. They chose the second option, and the result was the largest bankruptcy in industrial history.

Conclusion

Several observations emerge from the preceding analysis.

Over the long term, a dominant theory seems to remain stable. It states that firm maximize profit for shareholders. Economists like a simple theory that provides a straightforward model of the firm. Moreover, the model is both descriptive and normative, showing things as they are and asserting that they must be so. The entanglement of the descriptive and the normative revolves around the concept of performance. The normativity at stake seems purely economic, but it has been recently characterized as being also moral (Vermaelen, 2009). Serving the shareholders' interests would be a moral obligation; contrary to other stakeholders, such as employees, managers or suppliers, who are protected by contracts, shareholders are not and thus appear to be the most vulnerable.

As regards the theory of the firm, Jensen played a special role. He is one of the fathers of agency theory, which renewed in depth the comprehensive approach to the firm. Although he formally remains within the framework of that theory (in identifying agency costs of overevaluation), his recent shift is significant. He seems to have become aware of the excesses of the model he himself contributed to elaborate. He explains that the overvaluation of corporate assets does not result from errors of judgment, but from a generalized systemic effect. Although Jensen does not call into question managers' personal morality, he does introduce a moral vocabulary, which he judges necessary to describe real events:

> I realize it is not fashionable to use such harsh language to describe what are almost universal practices. But when numbers are manipulated to tell the markets what they want to hear (or what managers want them to hear) rather than the true status of the firm—it is lying, and when real operating decisions that would maximize value are compromised to meet market expectations real long-term value is being destroyed. (Jensen, 2005, p. 8)

Faced with the dominant theory, several authors (Galbraith, Segrestin and Hatchuel, Mayer, and even Jensen himself) called for a more detailed description of the firm. This leads us to a second set of observations. First, all descriptions critical of the prevailing theory are rooted in the pioneering work of Berle and Means (1932). This is the case for Galbraith, Mayer, and Segrestin and Hatchuel. Second, authors do not spell out their thinking concerning the status of the description. Clearly, its purpose is to undermine the dominant theory by showing that it does not match empirical reality. But what is its exact status? Is it just the opposite of the descriptions assumed by the dominant theory? No, because these descriptions do not seem to lend themselves to the techniques of modeling as agency theory does. But then, what is the nature of the description (Dumez, 2013)? Third, the descriptions aimed against the dominant theory are descriptive/prescriptive, "entangled" in Putnam's sense (2002). With Galbraith, normativity takes the form of biting irony. With Mayer, the irony is lighter, more British. As for Jensen, his evolution is particularly surprising. He seems to have moved from a theory whose normative status was related only to economic performance to the description of an inherently moral situation (since lying and fraud appear as structural effects). In short, apparently no interesting description of the enterprise is free of value judgment.

And yet, have we really drawn all the consequences of the idea that the firm is a descriptive/normative concept, that the normative and descriptive dimensions of the firm are inherently entangled and cannot be separated? Are we able today to produce a description of the firm that would be the equivalent of the one Galbraith offered in 1967? ■

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Le portail extérieur (Kleparska) de la barbacane