Christian Anthropology and the Theory of the Firm

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Introduction

Any attempt to evaluate the success or failure of corporate governance norms and practices has to begin with an understanding of their purpose. Theories of the firm try to supply an understanding of the nature and purpose of the corporation and they are the starting point for thinking about corporate governance. Detailed suggestions for reform of corporate governance will necessarily be based on an express or implied theory of the firm. A clearly formulated and adequate theory of the firm is a pre-condition for corporate governance scholarship. Defects at this level must necessarily have consequences at the level of policy and practice.

Agency theory has been very influential in the corporate governance arena. In particular, it has generated intense interest in creating systems of monitoring and control with associated incentives (both positive and negative) such as shares, options and performance related pay. Clearly, agency theory reflects, and gives formal expression to, a common sense intuition that those with a large degree of control over the assets of others might be tempted to use that control for their own purposes rather than for those on who appointed them. But there are signs that the cure may be worse than the disease and that agency theory’s “solutions” can actually be harmful to good governance; Enron is simply the most egregious example of a more widespread problem. Where does agency theory go wrong? It is argued that Catholic Social Thought (“CST”) supplies a framework for analysing theories of the firm (such as those based on agency theory). It
can supply a meta-theory that can be used to evaluate more specialised theories of the firm.

CST posits that there are knowable truths about human needs and the well-springs of human decision-making that analysis of social institutions must take into account. CST does not offer its own theory of the firm but an ethical approach that should guide the efforts of relevant specialists (in law, finance or management, for example) as they propose their own theories of the firm. CST is based on an effort to understand what makes the human person tick; its social ethics is based on its anthropology, its vision of the human person.

Christian anthropology offers a full, realistic and convincing picture of the human person and CST (the system of social ethics built on this anthropology) gives a fully human answer to inquiries as to the purpose of the firm and the nature of relations within the firm. Economic theories of the firm are partial accounts of reality that offer glimpses of the whole. They are useful, vital even, for certain purposes but need to be checked against reality if they are not to be pushed too far and then lead astray.

This article will outline Christian anthropology (the Christian vision of the human person). It will then consider the implications of Christian anthropology and Catholic Social Thought (“CST”) for theories of the firm. CST contends that the point of any organisation can only be understood in terms of how that organisation meets the needs of the individuals who form part of that organisation. Crucially, CST points out that those needs derive from the human urge to self-realisation and that we can understand what makes for self-realisation by reflecting on experience and observation and through use of theological data. Human preferences are shaped by concerns that we all have by virtue of
our shared humanity. To illustrate CST’s potential to offer guidance to people involved in discussion of corporate governance, the article will critique the assumptions found in Jensen and Meckling’s “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.”

As a prelude to that, it will outline the underlying assumptions of law and economics scholarship and sketch the theories of the firm that preceded and shaped Jensen and Meckling’s theory.

CST does not offer a theory of the firm; it would lose its value if it were to attempt to do so. Theories of the firm belong to specialist technical domains such as law, economics or management. They ask how we should think of the firm for particular purposes. Jensen and Meckling’s agency theory invites us to look at the firm from the perspective of a prospective equity financier in a market where there is separation of ownership and control. It asks about the safeguards that need to be in place before investors can be expected to part with their money. This is fine provided that we do not take this highly specialised perspective for the living, breathing reality that is the firm. CST provides a toolkit that can guide those concerned with the theory of the firm and with corporate governance generally.

I Christian Anthropology

CST is the branch of Catholic Moral Theology concerned with social ethics. It is primarily concerned with the integral development of each individual human person. To

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understand CST one needs a prior acquaintance with the vision of the human person on which it is constructed. CST explains the essential elements of human communities and the principles that have to be respected if communities are to foster the human dignity of their members (and this is their sole purpose). This section offers a brief sketch of the Christian anthropology on which CST is built. It is by no means a complete account of Christian anthropology but it seeks to provide a sufficient understanding for present purposes.

CST has always been personalist first and foremost in the sense that it has always put the well-being of the individual human person at the heart of its social ethics. Pope John Paul II emphasized this in his first encyclical, *Redemptor Hominis* when he said that man is the “primary and fundamental way for the Church.” He explained that he was speaking of: “Man in the full truth of his existence, of his personal being and also of his community and social being.”

Christian anthropology offers an account of the nature of the human person and of the purpose of human life founded on Revelation and philosophical reasoning (especially natural law). In particular, the Church draws its knowledge of the human person from its reflection on Christ who “fully reveals man to himself and brings to light his most high calling.” This, together with the knowledge of human affairs derived from reflection on two millennia of pastoral experience, provides a deep understanding of the human person. *Gaudium et Spes*, one of the texts of the Second Vatican Council, provides a concentrated summary of Christian anthropology. The relevant section begins by underlining both the urgency of the theme and by pressing the Church’s claim to be able to provide answers to

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4 *Pope Paul VI, Gaudium et Spes* ¶ 22 (1965).
the “unsolved puzzle”\(^5\) of “what is man,”\(^6\) to the deepest questions that the human person asks about himself or herself.

The first account of the creation of man is found in the Book of Genesis: “So God created man in his own image, in the image of God he created him; male and female he created them.”\(^7\)

From this we can draw the insight that to be human is to be called to interpersonal communion.\(^8\) The ultimate source of human dignity lies in the call to personal communion with God.\(^9\) Man’s social nature is rooted, in the last analysis, in the fact of having been created in the image and likeness of God. In *Centesimus annus*, John Paul II points out that the human person cannot give himself or herself to an abstract plan but only to another person. God is the only person fully capable of accepting that gift. Thus:

> A man is alienated if he refuses to transcend himself and to live the experience of self-giving and of the formation of an authentic human community oriented towards his final destiny, which is God. A society is alienated if its forms of social organization, production and consumption make it more difficult to offer this gift of self and to establish this solidarity between people.\(^10\)

Part and parcel of the call to communion with God is a call to solidarity with other persons. Human self-realisation is necessarily pursued in society and social life (friendship in its various forms) is a vital component of human well-being or self-realisation. It is in relationships with others that each person pursues his or her integral self-realisation,\(^11\) and commitment to these relationships (to one’s friendships and

\(^5\) *Id.* at ¶ 21.
\(^6\) *Id.* at ¶ 12.
\(^7\) *Genesis* 1:27.
\(^8\) POPE JOHN PAUL II, *MULIERIS DIGNITATEM* ¶ 7 (1988).
\(^9\) *GAUDIUM ET SPE*, *supra* note 4, ¶ 19.
communities) is a basic element of self-realisation. Thus, Genesis provides us with the foundations of Christian anthropology: the inalienable dignity of the human person; the social nature of human beings and the meaning of human activity in the world.\textsuperscript{12}

When making practical decisions, great or small, the human intellect is guided by an inner urge to do good and avoid evil. Christian anthropology sees this inner tendency towards integral self-realisation as the driving force behind human acts. Fundamentally, the goods that the human person seeks to attain are not determined by unrestrained free choice. In the last analysis, human choices are directed towards certain categories of goods that are the same for all human beings and that the intellect discovers. That is to say that human goods, the building blocks of a good and happy life (integral self-realisation), are rooted in a human nature that is itself a reflection of the Divine Nature.\textsuperscript{13}

CST sees human life as a quest by each of us to participate successfully in the goods that serve to build up our humanity and to achieve the (ultimately transcendent) purpose of our life. These goods include life itself, family and social relationships, knowledge, work and worship. Ethics is the study of the ground rules for successfully pursuing these human goods in ways that will build us up as human beings. Revelation confirms a number of truths about what makes for the self-realisation of the human person. The Ten Commandments provide us with an account of the most fundamental and important building blocks of integral self-realisation of the human person. Pride of place is given to communion with God. Reason (conscience) is capable of distinguishing

\textsuperscript{12} Id., ¶ 37.
\textsuperscript{13} POPE JOHN PAUL II, SOLlicitudo Rei Socialis ¶ 33 (1987).
good from evil; that is to say of making choices that are guided by an understanding the goods (and ways of pursuing them) that are likely to build and reinforce our humanity.\textsuperscript{14}

Freedom is a fundamental value, an essential element of human dignity.\textsuperscript{15} It is true that there is a certain givenness about the goods that build up a human personality (as explained earlier). But, within the boundaries discerned by the intellect, there is almost limitless scope for creativity when it comes to deciding on how the goal of integral self-realisation is to be pursued. The ways in which we seek to pursue the goods and to give them expression in our lives is undoubtedly influenced by natural aptitudes and inclinations, upbringing and culture, sheer whimsy and so on. But the goods themselves and the ways of successfully weaving them into our lives ultimately precede these factors.

Each of us builds and shapes our personality through the immeasurably large number of free decisions that we take each day. Free choices of the human person shape the individual. For example, today’s decision to start work on time and to keep working despite temptations to yield to distraction make it more likely that the same decision will be made tomorrow. The same can be said for “bad” decisions (such as the decision to yield to sloth); they make it more likely (but not inevitable) that the same decision will be made tomorrow. Thus, freedom: “determines the growth of [man’s] being as a person through choices consistent with the true good.”\textsuperscript{16}

Freedom is, therefore, intimately united to truth. Free choices are only truly fulfilling if they serve the integral self-realisation of the person making the choice.\textsuperscript{17} The

\textsuperscript{14} \textit{Gaudium et Spes}, \textit{supra} note 4, ¶ 16.
\textsuperscript{15} \textit{Id.}, ¶ 17.
\textsuperscript{16} \textit{Compendium}, \textit{supra} note 11, ¶135.
\textsuperscript{17} Pope John Paul II, \textit{Veritatis Splendor} ¶ 35 (1993).
fruitful exercise of freedom is hampered by the disorder introduced into human nature by original sin and personal sin. God’s help is needed if free choices in accordance with the dignity of the human person are to be made consistently.18

To summarise this section, Christian anthropology points to a number of aspects of human nature as being its most profound characteristics. First, the human person is called to interpersonal communion and this profound need is only fully satisfied in a personal, filial relationship with God. The human person has an inner tendency to pursue certain goods that are fitting for the human person and these goods are discoverable by reason. Freedom as to how to pursue the good is a central human value and one of the foundations of human dignity. But this freedom has to be exercised in accordance with the truth as to the goods that help to build up the human person.

II CST and corporate governance

CST’s account of the nature and purpose of communities such as the corporation makes the development of the human person the central concern of its system of social ethics. This personalist anthropology and ethics is at the heart of CST’s guidelines as to how a community should be structured. It emphasises that the purpose of communities (such as the family, the firm or the state) is to facilitate the individual’s effort to achieve his or her integral self-realisation.

The firm is one expression of the human drive to pursue one’s needs in communion with others. Relationships within the firm (and between the firm and those who deal with it) are largely shaped by actual or implied contracts. But there is more to the firm, or to any other community, than a bundle of contractual relationships: “A

18 Gaudium et Spes, supra note 4, ¶ 17.
business cannot be considered only as a ‘society of capital goods’; it is also a ‘society of persons’ in which people participate in different ways and with specific responsibilities, whether they supply the necessary capital for the company’s activities or take part in such activities through their labour.”\(^\text{19}\)

The point of any community or “society of persons”, such as the firm, is to allow its members to pursue their integral development; this is what leads shareholders and employees to participate in the firm. CST has always made it clear that ownership of private property, such as shares in a corporation, serves a number of important human values.\(^\text{20}\) At the same time, a primary purpose of the firm is “the integral development of the human person through work.”\(^\text{21}\) The firm meets the needs of customers or clients, it provides scope for the productive use of capital and the exercise of entrepreneurial ability. In addition, however, the firm derives much of its importance as a provider and organiser of work and CST has repeatedly emphasised the importance of work for the development and expression of the human personality and as a way for the human person to live out the likeness to God that Genesis speaks of.\(^\text{22}\)

Membership of the firm as a society of persons provides, or should provide, an altered perspective for shareholders and employees. If relations within the firm are working well then its members will come to see the common good of the firm as an element of their own well-being. The common good of a community can be thought of as the set of conditions that allows the co-operative endeavour of the community to be carried on successfully; it is: “[T]he sum of those conditions of social life which allow

\(^{19}\) CENTESIMUS ANNUS, supra note 10, ¶ 43.
\(^{20}\) See generally POPE LEO XIII, RERUM NOVARUM (1891).
\(^{21}\) CENTESIUMS ANNUS, supra note 10, ¶ 43.
\(^{22}\) See generally POPE JOHN PAUL II, LABOREM EXERCENS (1981).
social groups and their individual members relatively thorough and ready access to their own fulfilment."\textsuperscript{23}

Corporate governance arrangements can be thought of as an aspect of the firm's common good; they make it possible for employees and shareholders to work together to achieve certain aspects of their self-realisation.\textsuperscript{24} The pursuit of integral development in community requires every member to act for the sake of that community’s common good. In the last analysis, this is to act for the sake of one’s own good and that of the other members of one’s community. Thus, actions carried out for the sake of the common good are performed with the good of individual persons in mind; the common good is a distinctly personalist concept.\textsuperscript{25}

Freedom, the ability to make one’s own choices as to which goods are to be pursued and the way in which they are to be pursued, is a vital element of human dignity. Accordingly, CST insists that every member of a community should be given some ability to make their own decisions (within the framework of an effective governance system). One of the challenges facing any community, including the firm, is to organise itself in such a way as to allow the proper exercise of freedom.\textsuperscript{26} We can see an example of this in CST’s treatment of the role of employees in the governance of their working environment. Consistent with CST’s stress on the subjectivity of the human person (the idea that the human person is primarily someone who acts rather than someone who is acted upon), CST has always emphasised the need to give employees the greatest

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\textsuperscript{23} \textit{Gaudium et Spes}, supra note 4, ¶ 26.

\textsuperscript{24} See generally Domenec Mele, \textit{Not Only Stakeholder Interest: The Firm Oriented Towards the Common Good}, in \textit{Rethinking the Purpose of Business: Interdisciplinary Essays from the Catholic Social Tradition} (Steven Cortright \\& Michael Naughton eds., 2002).

\textsuperscript{25} \textit{Compendium}, supra note 11, ¶¶ 164-70.

\textsuperscript{26} Id., ¶ 137.
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possible scope to participate in decisions that affect their work. Although CST has never
gone so far as to require codetermination, it has made it clear that human dignity requires
that employees should have a substantial degree of influence over the important decisions
concerning their work; they should never simply be instruments of a corporate
bureaucracy. Thus, in Laborem Exercens, Pope John Paul II said: “We can speak of
socializing only when the subject character of society is ensured, that is to say, when on
the basis of his work each person is fully entitled to consider himself a part-owner of the
great workbench at which he is working with every one else.”

The passage goes on to outline some of the types of institutional reform that might
achieve this goal, but the important point is that, whatever the details, firms and
intermediate associations should help to unleash the freedom of each individual. Social
structures that do not give primacy to, or which ignore, the subjectivity of the human
person are alienating.

CST emphasises freedom as a fundamental human value to be respected in the
design of a community’s governance mechanisms. This is true at the political level, at
the level of relationships between the state and intermediate associations, such as the
firm, and within the firm. CST’s principle of subsidiarity is a reminder that the
community exists, in the last analysis, for the sake of the well-being of the individual and
that it should facilitate the self-directed action of the individual towards his or her own
self-realisation. The principle of subsidiarity takes on its deepest meaning when seen as
an expression of a profound respect for human freedom that leads CST to press for every
member of the community to have the greatest ability to participate in decision-making

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27 LABOREM EXERCENS, supra note 22, ¶ 14.
28 POPE PIUS XI, QUADRAGESIMO ANNO ¶ 79 (1931).
that is compatible with effective governance of the community. When applied in the context of the firm, it may very well lead to greater efficiency, but that is not the only goal at which the principle of subsidiarity aims.

The opening sections of the paper have outlined CST’s anthropological basis, the system of social ethics constructed on it and CST’s implications for corporate governance. The human person is called to integral self-realisation; communion with others is both the context in which this self-realisation is pursued and an element of this self-realisation. Men and women are called to self-giving; a proper understanding of what makes for human fulfilment includes a recognition of this fact and an effort to act in consequence. Inability to live out this self-giving (which could be self-inflicted) is a source of alienation; governance structures that make it impossible or difficult to live out this self-giving are alienating. CST suggests that corporate governance has to aim at (or allow other governance mechanisms to aim at) the integral self-realisation of the members of the firm as a community of persons (typically the shareholders and employees). Sensible governance will take account of the dynamic set in motion by the firm’s nature as a community of persons and the way in which the principle of solidarity (the virtuous tendency to act consistently for the sake of the good of one’s communities) alters the inner logic of the firm’s members; fully reasonable members of the firm will see the point of co-operating for the sake of the common good of the firm. The firm’s relationships are heavily shaped by contract, but those contracts have to mesh with the inner logic of the firm as community of persons. The firm does, in one sense,

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30 *SOLLICITUDO REI SOCIALIS*, supra note 13, ¶ 38.
have a primarily economic purpose but the economic purpose cannot be pursued in isolation from the broader set of goods that make up the human lives of its members.

III Law and Economics

Contemporary corporate governance scholarship, policy and practice is heavily influenced by economic theories of the firm (such as agency theory) The next section looks at agency theory. But a brief explanation of the Law and Economics approach to thinking about norms and institutions is called for to help explain the assumptions and methodology involved. Economic theory has imposed limitations on itself. These limitations allow economic propositions to be modelled mathematically but have the practical effect of building in a certain unreality. This fact has to be borne in mind when it comes to applying economic theory to real-life institutions such as the firm.

The first assumption is that human beings are utility maximisers; we are driven to act by a desire to maximise the pleasure, happiness or satisfaction to be obtained by that action. The rational consumer is at the core of economic theory. This rational consumer, *homo economicus*, ranks alternatives according to the extent to which they meet his or her preferences. This allows preferences to be assigned a numeric value and allows an individual’s utility function (ranking of possibilities according to the individual’s preferences) to be created and depicted on a graph.

One of the most significant differences between CST’s understanding of the human person and that of neoclassical economics concerns the intelligibility of human preferences. CST sees them as necessarily reflecting the urge to self-realisation and the goods that are the building blocks of that self-realisation. For law and economics
scholars, there is no way of knowing where these preferences come from. As Sargent puts it: “Preferences are what they are, and an individual’s well-being depends entirely on legal rules’ ability to enable individuals to realize their preferences.”31 For law and economics, rationality simply involves being able to rank those preferences in an internally consistent way.

A second core concept in economic theory is that of “equilibrium” defined as: “a pattern of interaction that persists unless disturbed by outside forces.”32 The rational consumer strives to maximize the satisfaction of his or her consumer preferences; this maximising impulse drives us to action. We are in a constant state of flux or desire, the theory suggests, until we have achieved the best package of goods and services that our budget constraint allows. The rational consumer considers the effect of a marginal change from his or her current situation and asks whether the marginal benefit exceeds the marginal cost. The consumer will make changes until the marginal cost equals the marginal benefit. If we were ever to achieve that state then we would stop striving and we would come to rest. Economists describe this state of perfection as equilibrium. Although we are never likely to achieve equilibrium, we are always tending towards it.

The third basic concept is that of “efficiency” which is applied to the evaluation, inter alia, of production processes (and, for this purpose, a firm or an entire economy might be viewed as a production process). One version of efficiency is “Pareto efficiency”. An interaction, or series of interactions or potential interactions, would be Pareto efficient if no change to the status quo ante could be made without making at least one person worse off (in his or her own estimation) as a result. Thus, for example, one

could consider a possible change to corporate governance (such as the introduction of
mandatory employee representation on the corporate board) and ask whether any affected
actor is likely to be made worse off. If, for example, shareholders could complain that
they fear that a reduction in the value of their shares will be the likely result of the change
then that reform will not be Pareto efficient and should not be made. The condition
associated with Pareto efficiency, that no-one should feel worse off as a result of the
change, is so strict, however, that it would probably rule out the making of any change
no matter how desirable it appears to be. It is hard to imagine any possible change that
would please absolutely everybody affected by it.

A more relaxed version of efficiency is that of Kaldor-Hicks (or potential Pareto)
efficiency. Here the criterion is whether the gain to those who benefit from the change
exceeds the loss to those who suffer as a result. This would allow the “winners” to
compensate the losers, though the Kaldor-Hicks criterion does not demand that they
actually do so. Kaldor-Hicks efficiency does allow for interpersonal comparison. It
allows wealth to be used as a kind of common denominator. It relies on an ability to
translate all of the relevant gains or losses (whether material or immaterial) of those
affected into financial terms. This allows the necessary interpersonal comparison to be
made, as Cooter puts it: "The measuring rod of money makes different goals, material
and nonmaterial, commensurable."33

Efficiency is a goal worth striving for. To the extent that an economy promotes
efficient exchanges, it is said to be productively efficient. This means that the greatest
possible output is achieved with a specified amount of input or, put another way, a

33 R. Cooter, The Best Right Laws; Value Foundations of the Economic Analysis of Law, 64 NOTRE DAME
specified level of output is achieved with the lowest possible level of output. Corporate governance mechanisms can, it is thought, make a contribution to productive efficiency by reducing the costs associated with the bringing together of the firm’s inputs (such as labour and capital). An efficient economy also ensures that goods and services are produced of the type and in the quantities that consumers desire (allocative efficiency).

The three core economic concepts; utility-maximisation, equilibrium and efficiency can also be applied to suppliers (firms). Firms are understood to be engaged in a process of seeking to maximise profits. To state the obvious, they do this by increasing their income and reducing their costs. The currently dominant theories of the firm claim that appropriate governance structures help firms to maximise their profits by reducing their governance costs. They seek to explain the existence of the firm, its inner workings and the behaviour of those who interact with it (such as the board, shareholders and employees) predominantly in economic terms.

Pareto efficiency grew out of utilitarian philosophy. It has been argued, however, that while it retains certain of the characteristic assumptions of utilitarian philosophy, it is no longer committed to it.34 It understands itself as a policy science that is capable of being used in conjunction with a wide range of approaches to law and governance. Implicit in this understanding is the consideration that the economic analysis of law is capable of being put to good or bad use; it does not understand the economic analysis of law to be a complete system of social ethics (or, at least, not all of its adherents do). The economic analysis of law can be understood as a tool to be used to determine the efficiency of laws. It adheres to the belief that efficiency is a positive value and that it would be perverse to promulgate inefficient laws (to choose a more costly rather than less

34 Cooter, supra note 33, at 817.
costly route to a proposed end). But it is not committed to the view that efficiency is the 
raison d’etre of all laws or that efficiency is the end of individual or social life.

That said, the economic analysis of law does retain certain of the central 
characteristics of utilitarian philosophy: it is only concerned with the present or future 
effects of a proposed change; it characteristically takes a strictly individualistic view of 
value and it thinks purely in terms of self-interest (and self-interest that is narrowly 
conceived in terms of the individual as a locus of pain or pleasure). There is clearly the 
danger of losing sight of the fact that these assumptions have been made for special 
purposes and that they are artificial, and in many senses unreal, characterisations of 
human nature and society. As will be seen (when considering the economic theory of the 
firm and the system of corporate governance built upon it), there is the danger that these 
assumptions will (when they come to shape law, self-regulatory systems and market 
based transactions) come to shape the inner world of the actors most affected by the 
relevant systems. We will see that this might not only be ethically corrupting but, 
perversely, might lead to very significant inefficiencies. Thus, it is certainly unsafe to cast 
the burden of providing a conceptual framework for corporate governance theory 
exclusively on economic theories of the firm; economic theory necessarily leaves 
important truths about organisations and their participants to be studied by other 
disciplines.

At this stage, it is possible to make a brief comparison of the human person as 
understood by Christian anthropology and homo economicus. The former sees the human 
person as being radically inclined to interpersonal communion (and thus readily able to 
see co-operation with others as not only useful but as a good thing in its own right); homo
*economicus* looks at social relations through the prism of an atomistic individualism (even game theoretic approaches seem to rest on this understanding). According to Christian anthropology, human choices are rational when the choices made are directed towards goods that are fitting for human beings and that tend to enhance human dignity. Economic rationality treats the sources of human preferences as being unknowable; it involves the choice of least-cost means to achieve given ends. Economics does not inquire into the fittingness or otherwise of those ends for human dignity. On the face of it, both Christian anthropology and economic thought emphasise freedom. To an extent this is true and it might well be a genuine meeting point between the two approaches. The freedom of *homo economicus* does, however, have certain nuances: it is a freedom to consume and a freedom to make choices through market-place exchanges insofar as one has the means to participate in the market. So it is a restricted form of freedom. Christian anthropology is, as we have seen, at the heart of CST as a system of social ethics. The concept of *homo economicus* shapes the economist's evaluation of social institutions, including the firm and its governance mechanisms.

**IV Theories of the firm**

There are many theories of the firm; these are explanations, stories or metaphors that try to explain, amongst other fundamental questions, why firms come into existence. Many of the most influential and well-known theories of the firm are economic in nature; they look at the efficiency of firms relative to other ways of co-ordinating economic activity, such as the market or the state. Ulen\(^\text{35}\) argues that modern economic theories of the firm all owe a debt, to a greater or lesser extent, to Coase\(^\text{36}\). This section will briefly

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outline the ways of thinking about the nature of the firm inspired, more or less directly, by Coase.

Coase argued that the firm is a mechanism for co-ordinating the allocation of resources used in production. The entrepreneur can choose either to use the market to secure inputs as they are needed or, alternatively, bring inputs (such as labour) into the firm. Within the firm, contractual relations are replaced by administrative fiat as the mechanism for allocating resources. Coase points to transaction costs (such as the cost of discovering the price of the input in the market, negotiating the contract and so on) as being a crucial factor. Coase argued that bringing resources into the firm would remove these transaction costs, but that organising production in the firm would impose costs of its own. Inputs would be brought into the firm until the cost of doing so equalled the saving in transaction costs. The essence of Coase’s theory is that the firm relies on administrative fiat, rather than contractual exchange, to deal with co-ordination issues within the firm.

Williamson added detail to the study of the transaction cost theory of the firm. He builds the notions of bounded rationality and opportunism into the transaction costs framework. “Bounded rationality” refers to our inability to accurately predict how future events will unfold. “Opportunism” refers to self-seeking behaviour on the part of the contracting parties. Williamson argues that, taking these human characteristics into account, transaction costs can be minimised by finding the governance structure best suited to the type of transaction. Unless appropriate governance structures can be found to cope efficiently with bounded rationality and opportunism then input providers will

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refuse to make transaction-specific investments and socially desirable contracts and projects will not take place.

Williamson applied this approach specifically to corporate governance.\textsuperscript{38} He states that there are three types of "constituency" or "stakeholder": those whose contractual needs are served by classical contracting; those who need "full" board membership rights (ie right to vote as well as a right to information) and those who do not need board membership but can devise a structure of bilateral governance to safeguard their interests. Efficiency demands that each exchange is conducted through the appropriate mechanism. Full board membership is reserved for those who are investing transaction-specific assets to facilitate the proposed exchange of goods. This type of investor will either be given appropriate contractual protection against the hazards of expropriation or will charge a higher price (wage, price, interest rate) to reflect the increased risk. If safeguards are needed but are difficult to create then board membership is justified. Shareholders are the type of investor for whom board membership is efficient in transaction cost terms because: their contract does not come up for periodic renewal (so there is no opportunity to adapt terms to changed circumstances); and it is difficult to craft contractual safeguards against the hazards of expropriation.\textsuperscript{39}

Another important economic theory of the firm is the team production theory developed by Alchian and Demsetz.\textsuperscript{40} Alchian and Demsetz argue, disagreeing with Coase, that relationships within the firm are also contractual in nature. In their view, what

\textsuperscript{39} \textit{Id.} at 1210.
distinguishes the firm is the team use of inputs.\textsuperscript{41} The assumption is that team production is efficient for some types of production (on the basis that the sum of the whole is greater than the parts) but creates the possibility that, under certain conditions, individual team members might be able to shirk and take an unobserved free ride on the efforts of other team members. Thus, there must be a monitor with the ability, incentives and power both to detect shirking and to punish or remove shirkers. The unmonitored monitor needs some form of incentive and this takes the form of the right to receive residual profits of the firm. The board and, ultimately, the shareholders are the monitors of team production.

Berle and Means\textsuperscript{42} pointed out the separation of ownership and control in the largest corporations. In principle, directors are supposed to run businesses on behalf of shareholders. But when shareholdings are dispersed across a large number of shareholders, it is very difficult for shareholders, either individually or collectively, to exercise any control over directors. As a result, directors are largely free to run companies for their own benefit. Agency theory departs from the fact of a separation of ownership and control in the corporation. In a company where shareholdings are dispersed, the senior management have the ability and incentives to use their control over the corporation for their own personal benefit. Potential shareholders will appreciate the problem and, unless market forces can be relied on to dispel these fears, management will have to offer monitoring devices to overcome them.\textsuperscript{43}

\textbf{V Jensen and Meckling’s theory of the firm}

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\textsuperscript{41} Id. at 794.
\textsuperscript{42} A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
\textsuperscript{43} Jensen & Meckling, \textit{supra} note 1, at 313.
\end{flushleft}
Jensen and Meckling’s, ‘Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure’\(^\text{44}\) is a study of the ownership or capital structure of firms. At the outset, however, they point out that their analysis has broader implications for the definition of the firm.\(^\text{45}\)

Jensen and Meckling focus on the agency problem. Agents to whom decision-making authority has been delegated by their principals will not always act in the best interests of their principals.\(^\text{46}\) Agency costs include the costs incurred by principals in monitoring agents and by agents in providing assurances that they will not deviate from the pursuit of their principals’ interests. Jensen and Meckling seek to explore the ways in which agency costs determine the ownership or capital structure of the firm.

It is the set of assumptions that Jensen and Meckling make about the nature of the firm that is of most relevance for this article. Like Easterbrook and Fischel\(^\text{47}\), Jensen and Meckling adopted a nexus-of-contracts theory of the firm as the background against which they elaborate their study of the agency problem. They say:

> The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting.\(^\text{48}\)

\(^{44}\) Jensen & Meckling, \textit{supra} note 1.

\(^{45}\) See \textit{id.} at 306. Jensen and Meckling claim that their analysis has implications for, among other issues, the definition of the firm, the separation of ownership and control and the social responsibility of business. They do not confine the use of their model to an analysis of the agency problem; this article contends that this is a serious error.

\(^{46}\) See \textit{id.} at 308-310. The assumption is that both the principal and the agent are utility maximisers. The agent’s self-interest may sometimes lead him or her to disregard the promise to further the interests of the principal.


\(^{48}\) Jensen & Meckling, \textit{supra} note 1, at 311.
All of this is true, properly understood. The corporation clearly does operate as a counterparty to the contracts Jensen and Meckling refer to. But it is not the whole truth. The corporation as legal fiction is, in the case of a corporation providing goods or services, an expression of the corporation as a community of persons comprising its shareholders, employees and managers. Reference to the corporation makes sense because there is a relationship between the employees, shareholders and managers that is largely contractual but that has at least the potential to be very much more than the sum of its contracts. CST’s understanding of why people gather in organizations and of how membership of an organization can affect their motivation is left totally out of account by the Jensen and Meckling approach. Further, their insistence that the defining characteristic relates to claims to cash flows and assets leaves the role of the corporation vis-à-vis its employees out of account. Their unreal characterization of the corporation is reasonable if one bears in mind the issues that concern them. But it is dangerous if it is not set right by a broader, more realistic understanding of what the corporation really is.

A little later, Jensen and Meckling say:

[I]t makes little or no sense to try to distinguish those things which are “inside” the firm (or any other organization) from those things that are “outside” of it. There is in a very real sense only a multitude of complex relationships (ie contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output. \(^{49}\)

But there are at least two reasons for thinking that one can usually distinguish between those contracting parties who are inside the firm and those who are outside. First, one can focus on the concept of the common good. Those who are “inside” the firm see the firm’s success as a component of their own well-being; they look to the firm as a way of meeting the need for an outlet for their capital or labor. They see the success of

\(^{49}\) Id.
the firm as a constituent of their own well-being. CST’s concept of the common good helps us to understand this. Second, those who are inside the firm see themselves, whether happily or reluctantly, as being subject to the firm’s governance mechanisms. Employees, in particular, see the point of abiding by management directives. This is vital for the success of the firm. There are, no doubt, grey areas and difficult cases but, in general, it is possible to distinguish, for the reasons just given, between those who do form part of the corporation and those who do not.

To summarise, while CST sees the firm as a society of persons, at least some of the dominant economic theories of the firm see it as a nexus of contracts. The latter view empties the concept of the firm of any reality. It is a mere rhetorical device used to refer in a shorthand way to a complex web of implicit and explicit contracts between input providers. To say that a firm is a society of persons is not to deny the existence and relevance of these contracts. It is, however, to affirm that the firm is something real and that it has a logic that includes, but transcends, the logic of contract. The tendency to pursue the good of others and to see the point of acting for the common good comes into play. To say that a firm is a society of persons is to say that it exists for the sake of meeting some real need or needs of each of its members. It is not simply a device to overcome opportunism or shirking.

The ideas that the firm is a nexus-of-contracts, that the agency problem is the central concern of corporate governance and that opportunism is a defining characteristic of human behaviour have had a profound impact on corporate governance practice. They have resulted in an emphasis on systems of monitoring and associated sanctions and rewards. In the UK, for example, a great deal of time and effort has been devoted to the
search for adequate monitors of the performance of executive directors. Particular attention has been paid to the roles that non-executive directors and institutional shareholders might play in this regard. Companies have been encouraged to use the grant of shares, stock options and performance-related pay as significant elements of executive remuneration in an effort to persuade directors to pursue the interests of shareholders rather than their own. Some of the criticisms of contemporary corporate governance are purely technical; for example, some argue that the use of options is ill-conceived and actually exacerbates the agency problem. 50 One commentator has gone so far as to describe the approach to executive remuneration in the UK as deeply flawed and corrupt. 51

Again, the problem is created by the theory of the firm underpinning the emphasis on high-powered incentives in the corporation. Jensen and Meckling say: “[T]he ‘behaviour’ of the firm is like the behaviour of the market.” 52 CST’s explanation of the nature of the corporation leads us to doubt that this is true. The corporation, like any community, has a structure and a logic that are different from that of the market. They draw on the intelligibility of obeying commands by those with managerial authority and of co-operating for the sake of achieving some common goal.

Agency theory’s fears of opportunist behaviour are sensible but they are given excessive emphasis. Like any human community, the firm’s role in the life of its participants is essentially a positive one; its purpose (as explained above) is to help them

51 See Alan Sykes, Overcoming Poor Value Executive Remuneration: Resolving the Manifest Conflicts of Interest, 10 CORP. GOVERNANCE 256, 260 (2002) (Sykes talking of a “corporate malaise”).
52 Jensen & Meckling, supra note 1, at 311.
to achieve some aspects of their integral self-realisation. And, if it is working well, it will be able to count on the willingness of its members to work for the common good of the firm. Ghoshal and Moran\textsuperscript{53} reach essentially the same conclusion. They point out that firms have an inner logic which is very different from that of market place exchanges. Firms, they say, have an ability to harness their members’ sense of shared purpose. This allows them to adapt to situations of high uncertainty (such as those faced by firms in innovative markets). The values and preferences of members of organisations are altered by organisational context and this creates an energy that managers can harness for the benefit both of the business and of the individuals who work in it. Organisations are capable of adapting because of the activity of the individuals who work in them and who come to see a fit between the organisation’s goals and their own. But hierarchical controls, if applied to organisations, destroy the sense of shared purpose on which they rely.

Echoing Ghoshal and Moran, Roberts has pointed out that agency theory’s core assumptions of autonomy and narrowly-conceived self-interest become self-fulfilling prophecies and Stout has made the same point.\textsuperscript{54} Systems of performance measurement and accountability, with matching systems of incentives and sanctions, have been built around agency theory’s assumptions and values. It can be no surprise if executives learn the rules of the agency theory / shareholder value game and absorb the utilitarian spirit that underlies it. Roberts has argued that the system of accountability associated with shareholder value creates a particular type of person. He argues that the exclusive focus


\textsuperscript{54} Lynn Stout, \textit{On the Proper Motives of Corporate Directors (or Why You Don’t Want Homo Economus to Join Your Board)}, 28 DEL. J. CORP. L. 1 (2003). Stout comments that by treating directors as entirely self-interested we increase the chances that they will actually behave that way. \textit{Id.} at 16.
on financial reporting and on incentives linked exclusively to financial results fosters an individualistic and narcissistic preoccupation with how one is being perceived. He suggests that the atomistic conception of the human person used by economics makes ethics almost impossible. Shareholder value’s accountability mechanisms lead people to absorb the standard of utility-maximisation. In his view, contemporary corporate governance measures, by concentrating attention on the principal – agent problem and methods of overcoming it, have merely intensified the process by which shareholder value shapes the character of the successful corporate employee. There is the danger that the agency theory-based prescriptions for corporate governance end up being part of the problem, rather than providing solutions. Kulik brings evidence to bear suggesting that the Enron scandal can be attributed to the presence of a strong agency culture that spread from senior executives to all levels of the organisation. He suggests, that is, that agency theory was used habitually to solve agency problems with the result that it became instilled in members’ values, beliefs, assumptions and expectations. He suggests that executives at all levels probably first absorbed the culture during their University and Business School years.

Critics of the current exclusive reliance on agency theory point out that it has the potential to distort the effective functioning of the corporate board. Roberts argues that agency theory can lead to an excessive emphasis on the monitoring role of NEDs (to the prejudice of their role as contributors to the setting of corporate strategy). Empirical evidence shows that NEDs, if they are to be truly useful to the corporation, have to

combine monitoring and strategic roles and to generate a beneficial tension between the roles; NEDs need to know how to collaborate and to monitor.\textsuperscript{58} Hendry makes a similar point. He points out that, in the real world, honest incompetence is as much of a problem as out and out self-seeking.\textsuperscript{59} Daily \textit{et al}, make many of the same points. They argue that there is now an urgent need to supplement research and reforms based on agency theory with ideas based on other theoretical frameworks (such as resource dependence theory or stewardship theory). Agency theory is attractive because of its simplicity and its exclusive focus on self-interest. But, as we have seen, the simplicity of agency theory is deceptive; it gives a partial and reductionist account of human behaviour and of the way that corporate governance operates.\textsuperscript{60}

\textbf{Conclusion}

CST does not offer a theory of the firm. Theories of the firm are concerned with technical issues (such as the need for efficient governance structures) and this is not the domain of the Church, nor of moral theology. CST does, however, provide an anthropology and an ethical system that can be used to evaluate theories of the firm and that can provide a useful framework for economic theorists to use. As we have seen, it is easy for economic theorists to stray into the terrain of the moral theologian or moral philosopher. CST’s explanation of the human person as someone having an inner tendency to self-realisation achieved through a self-directed and intelligent participation

\textsuperscript{58} John Roberts, Terry McNulty, \& Philip Stiles, \textit{Beyond Agency Conceptions of the Work of the Non-Executive: Creating Accountability in the Boardroom}, 16(S1) \textsc{British J. Mgmt.} S5 (2005).
\textsuperscript{59} See John Hendry, \textit{Beyond Self-Interest: Agency Theory in a Satisficing World}, 16(S1) \textsc{British J. Mgmt.} s55 (2005) (arguing that more emphasis should be placed on the positive contribution that NEDs can make to the work of the board and that this should be given greater emphasis than their monitoring role).
in certain goods that are constitutive of human persons adds detail, depth and colour (realism) to *homo economicus*, the economist’s laboratory rat. CST explains that the human person has an inner tendency to seek communion with others, that communities such as the firm are realities not fictions, that responsible members of communities are prepared to act for the sake of the good of those communities and that employees are at the heart of the firm as a ‘society of persons’. All of this has very clear implications for those seeking to formulate a theory of the firm all. The concept of sin provides an explanation for aberrations such as opportunism and shirking. While opportunism and shirking may well be widespread and must be taken into account, they are not defining characteristics of the human person.

A particular vision of, and profound concern for the well-being of, the human person lies at the heart of CST. CST has constructed a model for properly functioning communities on the basis of Christian anthropology. Of particular interest to corporate governance scholars is the fact that CST has increasingly reflected on the implications of its own core principles for the evaluation of free markets and for relations between capital and labour in the context of the firm. Modern CST combines a realistic acknowledgement that the firm has a primarily economic purpose with an insistence that this does not mean that it can treat human persons as if they were mere raw material or robots.

There is every reason to believe that CST can enter into fruitful dialogue with the social sciences, even though the latter do not acknowledge revelation as a source of knowledge. Christian revelation and reason are made for each other. CST provides

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61 *See John Paul II, Fides Et Ratio* (1998) (The following passage gives something of the flavour of the entire encyclical: “Deprived of what Revelation offers reason has taken side-tracks which expose it to the danger of losing sight of the final goal. Deprived of reason, faith has stressed feeling and experience, and so run the risk of no longer being a universal proposition.”). *Id.* At ¶ 48.
reasonable explanations (accessible to any reasonable person) as to where the underlying theoretical mistakes have been made. It also suggests areas that demand urgent attention by corporate governance scholars such as the need to understand that employees as well as shareholders are members of the firm and the need to maximize the scope for all members of the firm to participate in governance in reasonable ways that do not compromise the effective running of the firm. CST does not offer a theory of the firm. It operates at the ethical level rather than at the level of the choice of the most appropriate technical means to achieve the chosen ends of the firm. The theories of the firm reviewed earlier in this article operate at the technical / economic level; they need to be compatible with a sound ethical theory but they operate at a different level of knowledge.

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