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***FINANCIAL VS UNIFIED THEORY OF THE FIRM:
MAXIMIZING SHAREHOLDER WEALTH OR
MAXIMIZING COMMONWEALTH***

by

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A theory of the firm explains its reason for being, its purpose, its *ratio*, its ultimate end. In the US, the discipline of finance has sought to provide a theory of the firm. The theory in finance operates on the premise that

management's primary goal is stockholder wealth maximization. . . . This translates into maximizing the price of the firm's common stock. Firms do, of course, have other objectives; managers, who make the actual decision, are interested in their own personal satisfaction, in their employees' welfare, and in the good of the community and of society at large. Still . . . stock price maximization is the most important goal of most corporations, *and it is a reasonable operating objective on which to build decision rules* (Brigham et al., 10-11).

This claim of financial textbooks is a contentious one, even though the premise is relatively unchallenged in finance, economics, and organizational theory. The question of why maximizing shareholder wealth is *the* purpose of the firm with all other constituents in second place rarely gets addressed in any systematic way. When it is examined, the theory of the firm is provided a macro and micro rationale. The macro rationale stems from a philosophical liberalism that serves as the basis of a free market capitalism. This rationale is often articulated by economists such as Friedman, Hayek, and others. The micro rationale stems from the essential principles and techniques of finance. The two rationales are interconnected. But for purposes of this paper, I focus only the micro rationale of finance. Within this rationale is a theory of the firm that is based on an agency relationship to maximize shareholder wealth. Based on this theory, modern finance develop techniques to best execute the theory. The first part of this paper examines the relationship between theory and techniques within the finance discipline. The second half of the paper offers a critique that focuses on the rather limiting and narrow theory finance provides for the firm. My thesis is that a finance theory of the firm is essential but incomplete theory of the firm since it is too restrictive to provide a rationale for the purpose for today's complex firm.

FINANCIAL THEORY OF THE FIRM

A theory of the firm has two essential characteristics to its definition: 1) why firms exist or what are their purpose, and 2) "what determines [and limits] their scale and scope" (Conner, 123). According to Conner, most theories of the firm agree that it exists to maximize shareholder wealth (MSW). Differences arise in the scale and scope (or the means) in which a firm uses to MSW. In other words, the end or mission of a firm is agreed upon--maximize shareholder wealth; however, the means or strategies are multiple in which to implement the end of MSW. Much of the disagreement over the means or strategies in determining the scale or scope of a firm stem from economists examining questions of competition, market share, size of firms, innovation, product determination, efficiency, investments, etc., that best MSW (see Conner).

The theory of a firm from a finance perspective envisions the firm not in terms of the production of particular kinds of goods or services, but rather as "a conglomerate of assets and liabilities" that are used to MSW. Tarascio explains that

the firm not only produces specific outputs with specific inputs, it continually searches for the optimal structure of assets and liabilities which will secure it the largest long-run profits. Assets are only held because they potentially generate cash flows. Real assets (durable capital goods) are not purchased because they provide a specific product. Nor are they maintained because they produce a particular kind of output. Real assets, in this sense, are no different from financial assets; they are bought because their owners expect that they will yield an income stream (Tarascio, 10).

This notion of a firm as maximization of cash flows on assets is based on a contractual notion of exchange which serves as the basis to agency theory.

1. Agency Theory: The basis to the theory of the firm in finance is the agency relationship between managers and stockholders. "The theory of agency regards all social relationships as contracts between principals and agents" (Walton, *The Moral Manager*, 112). Agency theory describes relationships as contracts between principal and agent, in which the agent acts on behalf of the principal, just as a doctor acts on behalf of the patient, a lawyer for her client, union leader for his worker, and a manager for her shareholder. Agency relationship is "a contract under which one or more people (the principals) hire another person (the agent) to perform some service and then delegate decision-making authority to that agent" (Brigham, 19). A principal (stockholder) hires an agent (manager) to do a job (make money). Managers have been hired by shareholders to maximize their wealth. The nature of the relationship between agent and principal is one of trust. Shareholders have placed in trust their wealth to managers. The manager acts a fiduciary or trustee for shareholders so as to maximize their wealth (see also Perrow's description 224ff).

The firm then is an instrument of the shareholders. While ownership and control are separated by actors, they are not to be separated by intent. The intent of shareholders ought to be the intent of managers. "Stockholders own the firm and elect the management team. Management, in turn, is supposed to operate in the best interests of the stockholders" (Brigham, 15). Business is simply managing an investor's savings in a way that maximizes the best returns. Company management must align its objectives with shareholder wealth. It is a demand of both trust as well as equity. "If the company is not managed to create shareholder value and to give managers a stake in that value, its managers risk takeover or restructuring" (Reimann, 48)¹.

Within the theory of agency an obvious problem occurs called *moral hazard* (or shirking): what if the agent does not act on behalf of the principal's interests, but his/her own interests or someone else? Agency problems occur when either managers fail to act in the interest of owners or owners place undue burden on managers. "For example, the manager may not decide to work as strenuously to maximize shareholder wealth, because less of this wealth will go to him or her, or to take a higher salary or consume more perquisites, because part of these costs will now fall on the outside stockholders" (Brigham 19). This conflict of interest raises the additional problem of the principal spending time and resources to verify that the agent is acting on his/her behalf.

When shareholders lose control over their wealth they incur more risk and less information in general. A loss of control factor exists since agents have goals not always congruent with those of the principal (Walton, *The Moral Manager*, 112-113). Consequently, shareholders as principals rely on various governance mechanisms such as boards of directors, SEC government regulations, auditors, etc. to keep the agent honest by limiting his/her self-interests. These information systems "inform the principal about what the agent is actually doing [and] they are likely to curb agent opportunism because the agent will realize that he or she cannot deceive the principal" (Eisenhardt, 60). Shareholders also rely on outcome based incentives such as stock options which align principal interests with agent behavior. Both the information and the outcome based incentives incur costs to shareholders. The question is whether the costs or investments bring a greater return than if they were not in place.

Agency theory works on the assumption that organizational life is based on self-interest which either needs to be controlled (governance mechanisms) or aligned (incentives) (Eisenhardt, 64). From an economic perspective, so long as one reduces moral hazards, one reduces economic costs. In treating the problem of agency theory, Eisenhardt develops two principles in controlling agent self-interest:

- a. When the contract between the principal and agent is outcome based, the agent is more likely to behave in the interests of the principal
- b. When the principal has information to verify agent behavior, the agent is more likely to behave in the interests of the principal (Eisenhardt, 60).

For example, executive compensation is one obvious area where conflict of interest can occur between shareholder and executive. If stock options for executives are developed on the basis of increased shareholder price, then the interests of shareholder and executive are married. If information systems such as the board directors provide adequate information to shareholders, then executive opportunism can be curtailed, which decreases dependency upon "pay for performance." When neither outcome based or information systems are in place, overpay, greenmail, golden parachutes, etc. tend to find their way in to executive pay contracts which benefit executives but not shareholders (Eisenhardt 64). Another way to meld the interests of agents and principals are to make the agents principals, namely, make executives owners.

2. *Motive of MSW*: The fundamental obligation within this financial theory of the firm as informed by agency theory is to maximize shareholder wealth. MSW, for many in the finance world, is the purpose of a firm, and any discussion on the scale and scope of the firm must take MSW as the fundamental premise. The owners of the firm, shareholders, invest in the firm so as to maximize their wealth. A good decision in finance is one that increases shareholder wealth. It is important, however, to note that profit maximization does not always guarantee stock price maximization (Brigham 25). One can raise capital in such a way that it increases profits but decreases stock wealth. "*If management is interested in the well-being of its current stockholders, it should concentrate on earnings per share rather than on total corporate profits*" (Brigham 25).

3. *Social Dimensions of MSW*: But why do shareholders get such a primacy in position compared to all the other stakeholders? From the property rights perspective, shareholders are the property owners, and they have rights over the company. From a market perspective, a corporation does not exist unless it attracts capital (equity and debt). Maximizing shareholder wealth serves as the fundamental piece to a corporation's existence. The financial relationship between the firm and employees (wages), suppliers (payments), customers (affordable products), government (taxes), etc. is founded on the basis of generating shareholder wealth. Treynor points out that

Those who criticize the goal of share value maximization are forgetting that stockholders are not merely the beneficiaries of the corporation's financial success, but also the referees who determine management's financial power (Treynor, 71).

A company's ability to raise capital today depends upon its cash-generating ability in the future. It is the cash-generating ability that determines capital investment which determines shareholder wealth (Rappaport, 12). In other words, what's good for shareholders is good for everyone else.

Finance borrows from economics the invisible hand principle. Once the MSW principle is put into motion *the actions that maximize stock price also benefit society*. Brigham and Gapenski argue this point in their textbook on financial management.

First, stock price maximization requires efficient, low-cost operations that produce the desired quality and quantity of output at the lower possible cost. Second, stock price maximization requires the development of products that consumers want and need, so the profit motive leads to new technology, to new products, and to new jobs. Finally, stock price maximization necessitates business establishments--these factors are all necessary to make sales, and sales are necessary for profits. Therefore, the types of actions that help a firm increase the price of its stock are also directly beneficial to society at large. This is why profit-motivated, free-enterprise economies have been so much more successful than socialistic and communistic economic systems. Since financial management plays a crucial role in the operation of successful firms, and since successful firms are absolutely necessary for a healthy, productive economy, it is easy to see why finance is important from a social standpoint." (Brigham, 17).

If these responsibilities are performed optimally, financial managers will help to maximize the values of their firms, and this will also maximize the long-run welfare of those who buy for the firm." (Brigham 10.)

Milton Friedman has been one of the most articulate and popular defenders of the invisible hand mechanism. He has been critical of those theories of the firm that include in its central definition so-called social responsibilities that go beyond or put on par the responsibility of maximizing stockholder return. For Friedman,

there is one and only one social responsibility of business--to use its resources and engage in activity designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud. . . . the very foundation of our free society [is] to make as much money for their [managers] stockholders as possible (*Capitalism and Freedom*, 133)².

Friedman is not arguing that corporations are to be irresponsible, but rather responsibilities to employees, communities, customers, etc. are derivative from the responsibility to maximize shareholder wealth (MSW). Using Adam Smith, he argues that firms will promote society's good by first promoting its good, which is maximizing shareholder wealth. If shareholder wealth is not maximized, capital will dry up, wealth will not be created, and society will suffer the most for it.

In finance, everything is instrumental to the MSW principle. It is the prima facie principle of finance. Employee welfare and satisfaction, charitable contributions, product restrictions, environmental responsibility above the law, etc. are all instrumental to maximizing shareholder wealth. Such activities are done not because they are virtuous in themselves, but that failure to them may result in poor employee productivity, community disdain, government regulation, etc. which results in a decrease in shareholder wealth. The social context of the organization, such as laws, cultural norms, etc., must be taken into consideration when acting toward MSW. MSW is not performed in vacuum. If it is,

shareholder wealth is eventually minimized. When Heileman targeted its new PowerMaster malt liquor toward young, minority, inner city, low income males they sought to MSW without taking into consideration the cultural norms of society. When society and government protested they took the product off the market, and lost a good deal of money. According the maximum shareholder wealth principle, Heileman was not unethical, rather it was a poor reader of its own culture, or in other words, it was stupid which in context of MSW may be unethical.

Practices or Techniques of MSW:

In light of this theory of finance, financial techniques are developed in order to MSW.

The maximization of shareholder wealth, however, is determined by different shareholders. Those shareholders who are investors with buying control (takeover or LBO) are particularly interested in the "break-up" values of particular corporate assets; whereas minority shareholders are interested in future cash flows in determining shareholder value (Reimann, 42). Since most shareholders are minority shareholders, most discussions in finance is on the relationship between cash flows and cost of capital.

Managers best maximize shareholder wealth by increasing future cash flows. In finance, "Cash flow is King." Yet, at the same time managers need to decrease the cost of capital which decreases the amount of discount placed on future cash flows. The difference between cash flows and cost of capital is the wealth created for the shareholder. Managers need to acquire capital as cheaply as possible (decrease costs of capital), and use the capital as efficiently as possible (increase cash flows) so as maximize the shareholder wealth³. Cash flow and costs of capital serve as the two essential pillars of financial practice.

1. Cash Flow: Cash flow and expected cash flow are important indicators to the financial health of a firm, and a key determining factor to shareholder price. Cash flow represents the difference between cash inflows and outflows that compensate capital providers. Any financial security (capital) whether in the form of debt, preferred stock or common stock is a claim on future cash flows. The present value of the security is determined by the future cash flow of the security. Consequently, in order to determine the present value of the security, one must discount expected cash flows in present values, since a dollar today is worth more than a dollar tomorrow. In order to maximize shareholder value, cash flow must be evaluated in terms of present and future values. Eventually, competition will "force the firm to earn a fair return, just equal to its cost of capital" (Reimann, 46).

Modern finance theory works from the assumption that "a business is worth the net present value of its future cash flows, discounted at the appropriate cost of capital" (Barfield, 100). Consequently, stock price works as a function of the present value net cash flows at a discounted rate (Reimann, 47). The bottom line in finance is that cash flows must be equal to or exceed cost of capital.

2. Cost of Capital: Capital is defined in one of two ways: 1) the *materials* necessary to produce goods and services (source of cash flow) which overtime are usually depreciated;

2) the *funds* necessary to produce incoming cash flows (Tarascio, 1-2). In this paper capital is referred to as the funds necessary to produce cash flows. In finance, capital is principally invested either in machinery and materials for projects, or it is invested in securities (bonds or stocks). In light of the MSW principle, the manager cares only about "the size and date of the yield from capital; the form his capital takes is of little consequence" (Tarascio, 3). While there may be more freedom and versatility in manipulating real capital, the bottom line in finance is that the funds go those areas which provide the greatest returns⁴. David Roderick, former CEO of US Steel, explains that

Investment dollars as I keep pointing out over time are only going to go to those investments that the shareholder can have a reasonable expectation of a fair return. Which means they are going to capital starve the marginal businesses and they are going to flow capital to those businesses that are attractive and offer a long-term return for the stockholder. The system works like that and its the best by far than any other option. Many people don't fully appreciate that the primary role and duty of management really is to make money. Our primary objective is not to make steel but to make steel profitably (Taken from "Business of America").

Within finance, capital ought to produce as much income as possible (whether in materials and machinery, acquisitions, or securities), and it ought to be acquired as cheaply as possible. The rest of this section focuses on the cost of capital.

Capital, whether in the form of debt, new equity, or internal funding, has a price to it. The structure of the capital, that is what proportion of debt, preferred stock, and common equity, is an important factor in maximizing shareholder wealth. Too much equity dilutes the value of the stock, whereas too much debt burdens the company with high fixed costs. In light of the MSW principle, "maximizing the value of a firm requires that the costs of all inputs, including capital, be minimized, and to minimize the cost of capital" it must be estimated (Brigham, 272). Capital is the costs to finance a business' assets and operations. The components of this cost is usually a weighted average among debt, preferred stock and common stock. This is called the Weighted Average Cost of Capital (WACC). Whatever the percentage this weighted average is, will be the minimum rate at which the firm must generate future cash flows. Consequently, a firm's capital must be employed at the WACC today⁵. The cost of capital, then is the threshold or "hurdle" rate of return required to justify an investment. Those investments which yield returns equal to the cost of capital provide a market (or fair) return. Investments which yield returns greater than the cost of capital increase shareholder wealth. And those investments which yield returns less than the cost of capital decrease shareholder wealth (Rappaport, 55).

The cost of debt is calculated not with previously outstanding debt, but on the current rate demanded in the market. As Rappaport points out, "the economic desirability of prospective investment depends upon future costs and not past or sunk costs" (Rappaport, 56). The cost of debt must also be based on a after tax basis at the present tax rate since it is currently deductible.

Concerning the cost of equity, a business can raise equity by issuing preferred or common stock, or by using retained earnings. If management uses retained earnings, it should employ the opportunity cost principle. The principle states that "*the firm should earn on its retained earnings at least as much as its stockholders themselves could earn on alternative investments of equivalent risk*" (Brigham, 278). If management cannot earn such a return it ought to pay out retained earnings in dividends and let the shareholders reinvest at the market rate with related risk. The market rate is determined by various methods. One way to calculate the cost of retained earnings is the Capital Asset Pricing Model (CAPM) which has helped distinguish finance as its own discipline. CAPM relates risk and return in the marketplace to the risk and return of specific companies. "Under the CAPM, the cost of equity is equal to the risk-free rate plus a risk premium that is based solely on the stock's beta coefficient and the market risk premium" (Brigham, 278). In other words, investors demand a return that equals or exceeds the risk-free rate plus an additional return or risk premium for investing in that particular company. The risk-free rate is determined by long-term Treasury bonds, since these bonds take into consideration expected inflation. The risk premium is determined by the expected rate of return of the market minus the risk-free rate times the firm's beta coefficient (Risk Premium = $(k_m - k_{rf})$ beta). The expected rate of return of the market can be acquired by various Wall Street firms such as Merrill Lynch. The beta measures a company's systematic risk. "The riskiness of a stock, as measured by beta, is the volatility of its return in relation to that of a market portfolio" (Rappaport, 58).

Underlying CAPM is the competitive characteristic of capital which serves as an essential dimension in understanding why finance maintains the MSW principal as central to its discipline. MSW principal is supported on two basic assumptions: a) markets are competitive as well as efficient in distributing information about the financial health of capital seekers; b) these capital providers are risk averse investors "who seek to maximize satisfaction from returns on their investments" (Mullins, 105). The point here is that the cost of capital differs little from the cost of labor, the cost of products, the cost of whatever. Capital providers (debt issuers such as bondholders, banks, etc., preferred stockholders, and common stockholders) seek out those who provide the best return for their capital, just as customers seek out the best return for their dollar with the products they buy (this is why discount stores such as Best Buy, Target, Rainbow Foods, etc. have done well). Firms that fail to offer market returns or better will be avoided by these risk averse investors.

A firm does not have an unlimited amount of capital to finance projects. If the firm decides to issue more equity, the value of the firm dilutes making the firm less attractive. If the firm decides to issue more debt, the risk of the firm increases, causing the risk of the firm to increase as well as its cost of capital. Nor can firms access financing continually at current market rates (Tarascio, 8). As with all goods, a scarcity factor exists which determines in part the cost of capital. Consequently, firms that fail to provide adequate returns to common and preferred shareholders, will find their sources of capital dried up, and their company eventually bellied up. In order to guarantee future capital access, which is based on the return of present capital holders, managers must choose those project cash flow streams that best MSW⁶.

see pg 419 in B and G: Risk factors and the cost of capital: the higher the risk the higher the cost--chapt 11 Capital Rationing and the MSW principle pg 438.

3. *Relationship between cash flows and cost of capital in strategic thinking*: In light of the prima facie principle of finance--maximize shareholder value, financial strategies must be measured by future cash flows discounted at the cost of capital. MSW principal disciplines managers to measure the economic returns of investments, whether they are capital expenditure, projects, mergers and acquisition, securities, etc., by discounting forecasted cash flows by the cost of capital. Rappaport explains that these "cash flows, in turn, serve as the foundation for shareholder returns from dividends and share-price appreciation." (12) While it is not easy to predict future cash flows, nor is it easy to predict the cost of common equity (debt and preferred are less complicated), the point of financial techniques is to think through strategic alternatives to best maximize shareholder wealth. "The approach uses the medium of cash flows forecast, discounted at a risk-adjusted cost of capital to crystallise management thinking" (Barfield, 100-101).

Cash flow/cost of capital analysis disciplines managers into a logic to question all assumptions toward whether shareholder value is maximized. By aligning the goals of management with the goals of investors, decision-making improves dramatically which causes stock performance to improve. While this approach is not infallible, it tends "to avoid profitless growth by rejecting opportunities that are less profitable" and instill discipline in planning future projects (Barfield, 101). It's logic guarantees that the strategic objectives of the firm is on shareholder wealth. Financial techniques based on cash flow/cost of capital analysis provides a guide to decide which projects or markets to participate in, as well as how to compete in such markets. The constant question with this approach is: "What will this do for shareholder value (as opposed to market share, sales volume, etc.)?" (Reimann, 43).

In justifying financial techniques, Barfield states: "If you think that this represents a narrow interest, remember that all the stakeholders in a business depend on it stability to generate long-term value in a competitive market." (101) Financial techniques also have the added benefit of avoiding hostile takeovers, since it closes value gaps in shareholder price and removes the incentives from raiders. Once again, finance serves the social good.

CRITIQUE OF THE FINANCIAL THEORY OF THE FIRM

What can a person, trained as a moral theologian, say about finance? When a person attempts to critique a discipline that is not his/her own, red flags should go up. The probability of not understanding the intricacies and nuances of another discipline increases dramatically. In the past, some philosophers and theologians have done a hatchet job in their critique of commerce which have made businesspeople suspect of any critique⁷. Because of the poor relationships as well as failed attempts by theologians and philosophers, many people, both businesspeople and philosophers and theologians, have concluded that the cross fertilization between the practical concerns of business and theoretical concerns of theologians is not possible.

This conclusion, however, is unfortunate as well as naive. It is unfortunate since it intensifies the fragmentation of learning into compartments that have no relationships. It is naive for two reasons: One, it fails to recognize the practical nature of moral theology.

Ratzinger points out that "A morality that believes itself able to dispense with the technical knowledge of economic laws is not morality but moralism. As such it is the antithesis of morality" (Ratzinger). If a moral theologian fails to engage with and understand other disciplines, it fails in understanding its own discipline. Two, the conclusion also fails to recognize the theoretical presuppositions on which business practice rests. While businesspeople pride themselves on being practical and results oriented, they have unfortunately not provided an adequate rationale of why they are practical and results oriented. Again as Ratzinger points out, an understanding of economics or management theory "that believes itself capable of managing without an ethos misunderstands the reality of man. Therefore it is not scientific." What is needed in finance is both a "maximum of specialized economic understanding, but also a maximum of ethos so that specialized economic understanding may enter the service of the right goals." Finance, as a discipline, has created sophisticated and complex models of economic thinking. Its ethos, expressed in terms of the theory of the firm, however, is simplistic, individualistic, and materialistic. Finance fails to move itself toward "the service of right goals." Yet, finance has the potential to exercise the right techniques toward human ends which can closer appropriate the idea of virtue (Ratzinger).

This critique will not reject the financial theory of the firm altogether. There is much to be gained from its emphasis on the economic dimensions of the firm. The financial theory of the firm brings to light the important economic dimensions of organizational life: 1) shareholders ought to receive fair returns; 2) financial techniques can control costs so customers can pay lower prices; 3) governance mechanisms ought to be developed to reduce shirking; 4) efficiency must be achieved in economic exchanges; and so forth. The essence of the firm within this theory is found in contracts, economic relationships, self-interest, and shirking. What is important to note is that a financial theory of the firm is not merely a descriptive account of what happens, but a normative argument of what *ought* to happen (Perrow, 222). Yet, the key question in criticizing the financial theory of the firm is whether it is *completely* accurate in light of the complexity of today's organization. In this paper, I argue that it is not on empirical, expedient, legal, and normative grounds. This critique is not a complete rejection of a financial theory of the firm, but rather a revision of it that takes seriously other noneconomic (which have economic consequences as well) factors that make up complex organizations.

Does a Financial Theory of the Firm Reflect Organizational Practices?

An Empirical Question

Do managers actually act in a way that conforms to a financial theory of the firm? From a finance perspective the answer is yes because it identifies two tracks: a) those who maximize shareholder wealth (the good managers) and b) those who don't (the shirkers or the bad guys)⁸. Of course all theories tend to create a construct and place all behaviors within the construct--Marxists, feminists, Weberians, etc. Certain indicators do bear out a

financial theory: many CEOs, mission statements, and behaviors are explicit in maximizing shareholder wealth, and many managers do shirk, and are pursued by angry shareholders such as T. Boone Pickens who organized shareholder rights groups to go after executives who fail to MSW.

Yet, certain experiences and factors call into question whether a financial theory of the firm has the whole story. In his study of boards of directors, Jay Lorsch states that "the majority of directors felt trapped in a dilemma between their traditional legal responsibility to shareholders, whom they consider too interested in short-term payout, and belief about what is best, in the long run, for the health of the company" (Lorsch, 49).

Directors felt the direct pressures of various stakeholders who had so much to lose in pursuit of the economic interests of shareholders (this is not to say that more often than not many stakeholders benefited from the economic interests of shareholders).

Some managers, many who tend to be in production or engineering, and especially founders of companies do not have as the first order of intention MSW. Rather, they first seek to provide goods and services then they achieve shareholder wealth but not in a maximizing way. This often conflicts with those managers, many of whom are financial managers, who pursue the MSW principle as the heart of the organization. Here we get at the traditional animosity between production and finance people that has been characterize throughout US businesses. It is important not to fall into the trap of siding with production or finance. Producing products that fail to optimize returns is a foolish operation; however, financing activities only on the basis of financial return creates a fragmented identity within the firm which may ignore long-term investment in important technologies and projects (see US Steel to USX).

What is important to note here is the order of intent. Do managers first intend shareholder wealth or do they first intend commonwealth, or do they first intend their own wealth? In

one study of 6000 managers the answer was a bit complex. The study divided the managers among supervisory, middle and executive managers. One conclusion of the report was that MSW principle was not the primary motivator of these managers. If any motive dominated, it was the self-interest motive. Supervisors ranked their interests #1 and middle and executive managers ranked themselves #2, and all managers ranked shareholder at 12 or 13. But like most motives, there is a mixed element that describes a complex person. From the survey, "managerial respondents seem to believe that running an effective organization that pays attention to its people (employees, subordinates, bosses, coworkers) will deliver value to the customer (and profits to its investors)" (Posner, and Schmidt, 207)⁹.

Chart on Stakeholders

That the survey does not confirm a financial theory of the firm is not a problem for the proponents of the financial theory of the firm. They would simply argue that their theory has not been accepted by today's managers, and if they were smart, managers should do so. However, such advocates need to be pushed. Is the financial theory of the firm attempting too much by allocating to one motive all the behaviors of a firm? Is the theory of the firm asking too much from itself, and is finance overstepping its bounds as a discipline? What is amazing to an outsider like myself is that financial theorists take little time to reflect and to examine MSW as a major presupposition and principle of finance.

Expedient: Is a financial theory of the firm effective?

A financial theory of the firm is too restrictive to provide a rationale for the purpose for today's complex firm. It provides an essential but incomplete view of corporate and social life (see Eisenhardt, 71). If I am correct, then the financial theory of the firm is not only morally suspect (we will examine this latter in the paper) but also partially ineffective as a managerial discipline. This is not to say its techniques of risk and return analysis, cost of capital determination, etc. are ineffective. Rather, the lenses of which financial theory attempts to see corporate reality is flawed. It is flawed because it fails to take seriously the multiple fiduciaries in its theory, and it restricts the definition of investors only to shareholders which reduces workers to an instrumental value. A financial theory of the firm also has a difficulty in allocating resources in terms of short and long-term planning.

These two problems are discussed in more detail below.

a. Are Workers Investors? Property rights to the ownership of a firm are never absolute. The ownership of a firm is mitigated by the various contributions of stakeholders who have certain claims on the organization. Debt holders such as banks, bondholders, etc. have claims on the firm before its common and preferred shareholders. They have first claim to cash flows.

Employees too have a "quasi-ownership right" which has been given little attention (Sharplin and Phelps, 44). Workers are investors and have access to future cash flows in similar although not in identical ways to shareholders. Whereas shareholders investments are money invested in the company, known as capital, the employees (this includes all employees) investments are their time and earning power, their risk involved in a company's failure, and the financial, psychological, and physical burdens that go along with unemployment. Most employees come to an organization with an accumulation of related skills and talents in which the company did not pay for. Employees also take on "reliance investments" so as to "commit themselves to the firm for some time into the future and are, therefore, vulnerable" (Furubotn, 167). Examples of reliance investments are buying a house, investing in the community, moving, etc. The more reliance investments that are made by the employee, the more stable and loyal they become to make a long-term commitment to the firm.

The financial theory of the firm only recognizes the resources that come from shareholders, and consequently, they are the only ones that are recognized as investors. The returns of production are due not only to the contribution of shareholders. Employees

provide a necessary and vital input that is necessary for profitable returns of production. "In effect, 'joint investment' takes place, and workers, just as conventional stockholders, contribute to the firm's total capital requirements" (Furubotn, 1968)¹⁰.

The price of investment of an employee described above is not easy to determine. However, certain laws have attempted to appropriate costs to companies when they have to let go of employees. The Plant Closing/Layoff Act (1988) recognizes that a company owes payment in form of advance notification to the employee, despite the costs to the company (Sharplin and Phelps, 44ff). The Europeans have by law provided employees more residual claims than in the US (see EC social charter, German Co-determination Laws: 1965 redundancy payment act 1965 in England, etc.). In the act of investing their labor in the company, employees acquire "quasi" property rights. Consequently, if employees lose their job, they have claims to present and future cash flows as a payment for loss of property. Yet, it is important to qualify employee property rights as quasi. If employees fail to invest in their companies as shareholders, their access to cash flows are limited. This creates an environment of conflict between shareholders and employees that is not easily resolved. While employee stock ownership is not possible in all situations, it does seem to be a reasonable solution that not only reduces conflict between shareholders and employees but it reduces agency costs as well.

Managers have responsibilities to both employees and shareholders (as well as to customers, communities, suppliers, etc.). If employees are not taken as investors in the sense that management acts as agents to provide equitable pay, decent working conditions, benefits, and other perks, then it is impossible to expect employees to reciprocate with loyalty, commitment, ingenuity, improved productivity, etc. And if shareholders are not treated as owners of the company, they will take their resources elsewhere. The problem with the financial theory of the firm is: can you maximize shareholder wealth and still be responsible to employees in a way that they are not instrumentalized to shareholder interests¹¹? The word "maximize" causes a tremendous amount of difficulty in the financial theory of the firm, since if one maximizes shareholder wealth, what happens to other stakeholders who are affected by the organization. Can one maximize employee wealth, customer wealth, community wealth, government wealth, supplier wealth, etc.? The word *maximize* used in the financial theory of the firm offers several problems. If you maximize the economic goods of shareholders, then what happens to the other goods for employees, customers, communities, etc.? Chester Barnard has pointed out that the success depends on the continued participation and cooperation of several stakeholders: customers, shareholders, debtholders, employees, suppliers, government, community, etc. If only one stakeholder suspends cooperation, a corporation is sent into disequilibrium.

b. Long and Short-term Horizons: How do the returns to shareholders affect the long-term health of a company? Are there limits to maximizing shareholder wealth when the long-term prosperity of a company is in danger? Some may argue these questions are *non sequitur*; however, in light of the mergers and acquisition in the 1980s, some shareholders profited handsomely in the short-term at the expense of the long-term

prosperity of the firm. In a document written by lawyers of large public companies and leading institutional investors (1991), they state that

Shareholders should not pressure companies to be managed to favor their own goals at the expense of the goals of others. Directors and managers should manage a company to be profitable and viable enterprise over the long term. Business decisions generally should not be focused on achieving returns to shareholders in the short term at the expense of the long-term growth and success of the company. Shareholders should not act in ways that frustrate or detract from the ongoing prosperity of the company (HBR, July-August, 1991).

For example, dividends will decrease the money available for future capital projects. "If the shareholders are not interested in the future of the company because they can sell their shares tomorrow, they will want to see dividends, not retained profits, in the accounts. The managers, on the other hand, with their own future linked to that of the business, will want to invest as much as they can in that future" (Handy). For example, managers can also have short-term horizons through executive compensation. To a degree, dividend payouts have a correlation to the short and long term horizons of the company. The larger dividend payout, the less faith in the long-run capabilities of the company. This of course is an over-generalization, and there are various reasons for dividend payouts, but the charts below show that US has higher dividend payouts than Japan and GM has higher dividend payouts than Toyota. It is an interesting correlation that in the US where the second most important person behind the CEO is the vice president of finance, one sees higher payout in dividends and lower investment rates in employee training and modernization; whereas in Japan the second most important person is the vice president of human resources, one sees a lower dividend payment and higher investment rate in employee training and modernization.¹²

2 CHARTS ON DIVIDEND PAYOUT (HELEN'S HANDOUT)

One factor that leads to short-term horizons is that the financial theory of the firm works on the assumption that investors are marginal profit maximizers who are ready to take their investments elsewhere if greater profits can be made (see Brigham and Gapenski, 287). Within the framework of the financial theory of the firm, the purpose of the firm is the maximization of wealth for shareholders. This vision of the firm tends toward a short-term horizon since there is no cause for personal sacrifice for some greater good. If, however, the investor is nonmarginal, such as in the case of banks in Germany and Japan, or in the case of institutional investors who are establishing long-term covenants with businesses (relational investing), the perspective of the investor takes pressure off the manager to perform short-term. Other nonmarginal investors could be employees, local communities, unions, certain pension funds (only parts of the fund), government, social investment funds, etc. One would say that nonmarginal investors seek to optimize wealth over the long-run and not to maximize wealth in the short-term¹³.

The distinction between nonmarginal and marginal investors rest in why they invest. Handy points out that "If there is no common cause, no agreement on the longer-term goal, the more pressing priority, or the most powerful party, will win out" (Handy, 95-96). MSW is not a goal in which employees in particular can rally around in the long-run. Rather, such a goal encourages employees to seek their own interests where they begin to maximize their own gain which intensifies the problem of agency costs. One can see this with the obscene compensation packages for company executives. In response, institutional shareholders and shareholder rights groups are fighting back by ousting such executives and getting SEC to pass legislation friendly to shareholder interests. This rather inimical relationship will change only if a majority of shareholders are committed to the long-term interests of the company where they will forego a reasonable amount of present gains for future long-term wealth. While Japan and Germany's financial structures are far from perfect, the shareholders in those countries (largely banks) have tended to lock in for the long-term (Handy, 96)¹⁵.

While there is nothing explicit in the financial theory of the firm which dictates a short-termism point of view, there is also nothing that guarantees or at least tends toward a long-term view. And while the evidence does not seem to be conclusive, evaluations of businesses tend toward quarterly results rather than 3 or 5 or even 10 year results. Short-term rather than long-term results are dominate. There are exceptions to this rule, of course¹⁴. But the financial theory of the firm is bankrupt from a teleological perspective, since it fails as a theory to provide any long-run vision in which a company can set its sights toward. As Handy explains "Where there is no vision, there you find short-termism" (Handy, 96)¹.

An Evolving Legal Environment in International Business

Thus far, I have only focused on the theory of the firm as a theory of behavior. The traditional financial theory of the firm has made its way also into the theory of corporate law. It is always difficult to determine the order of influence of something. Did US corporate law influence financial theory or did financial theory influence corporate law? At any rate, the US corporate law and financial theory of the firm have been compatible philosophically up to the 1980s. In this section of the paper, I examine corporate ownership law and its compatibility and recent incompatibility with the financial theory of the firm. I will also examine briefly Germany's codetermination laws and contrast it with the US financial theory of the firm. The conclusion of this section is simple: financial theory cannot work within a vacuum. Its presuppositions must take seriously the social environment in which a corporation exists. Corporations are forced by the socio-political environment to balance the diverse constituencies it engages. To build a theory where the shareholder is the only constituent taken seriously builds a theory on a misperception of reality.

a. US Corporate Law: US corporate law, until recently, has been dominated by the fiduciary relationship of managers to shareholders. In the *Dodge v. Ford* (1919) case, the court ruled that it was illegal for Henry Ford to consider the interests of stakeholders other than the economic interests of shareholders. The Dodge brothers who were major

shareholders of Ford Motor brought Henry Ford to court because Ford diverted retained earnings to reduce the cost of cars and to increase employee wages on the *motive* of "social altruistic reasons." The judge ruled that the purpose of business is to maximize shareholder wealth, and if Ford "wanted to pursue a particular eleemosynary policy he should do it with his own money, not with other people's" (Hank, 89, quoted from Tavis).

In the 1980s when stockholders began to exercise their economic muscle, managers began to exercise their political muscle by getting twenty-five states (not including Delaware) to enact "laws which broaden the legal authority of boards to consider in their decision making stakeholders other than shareholders" (Minnesota and Wisconsin were among the twenty-five, Steiner and Steiner, 635). These state laws have evolved corporate law into a multi-fiduciary approach where the purpose of corporations exist for communities, employees, and customer as well as for the returns of shareholders¹⁶. As Steiner and Steiner explain, "this legal position, in contrast to the stark doctrine of stockholders supremacy, focuses the accountability of directors on the overriding role of the corporation in society" (636). These statutes essentially overturned the Dodge v. Ford ruling which unlocked the hold of shareholder dominance on boards and managers (see Tavis). Boards can now consider, within the law, noneconomic factors which include: "the interest of the company, its subsidiaries and shareholders; the interests of employees, creditors, customers, and suppliers; and the interests of the local, state, and national communities" (Insight, 26, quoted in Tavis)¹⁷.

One rationale in support of the new constituency laws is that owners of corporations are not the same as owners of partnerships or sole proprietorships. A key distinction is that shareholders have limited liability. This limited liability grants firms to take the necessary risks for expansion and modernization without committing everything they own (Handy 173). Since shareholders have been given a privilege of limited liability, they also have limited ownership which is beginning to be reflected in the law through constituency clauses. Is this unfair to shareholders? No, for two reasons: 1) Because of limited liability there should be limited ownership. 2) Corporations, especially public corporations are power agents for social change. Their power carries with it certain social responsibilities that goes beyond the principle of MSW¹⁸.

b. Germany's Codetermination Laws: In discussing the financial theory of the firm in the US, it is helpful to see whether it is exportable, and whether countries have attempted to adopt a different theory of the firm. For example, one study asked managers from various countries whether the goal of business was to maximize the bottom line, or whether stakeholders were an intrinsic element to be taken into account: 97% of Japanese managers, and 83% of German managers took a stakeholder approach, while only 24% of American managers took the same approach (Handy, 172). These differences point out that there are different notions of what the theory or the purpose of the firm is (such studies also point out that there are different types of capitalism as well). Here, I examine only Germany's codetermination laws which serve as the basis to their theory of the firm.

Chart from Helen's handout.

The German's theory of the firm has been heavily influenced by codetermination laws. Codetermination laws ensure in corporate governance that labor has control rights in the firm (Furubotn). These laws originated as an anti-Nazi movement after World War II. Occupying Germany at the time, the allies sought to break up the political powers in the coal and steel industry, who were supporters of Hitler's regime¹⁹. The corporate leaders who were not jailed for war crimes were fearful of losing the industry, and thus settled on codetermination, which mandated democracy with the workers on what is called the board of supervisors.

The Codetermination Law of 1951--The Montan Act: The first codetermination law was only applied to the Montan industry consisting of coal, iron and steel. It reorganized the Montan industry by establishing full parity between labor and management. This meant that the stockholders would elect five board members, the union would appoint three union officials and the work councils of the particular company would elect two employees to the supervisory board²⁰. An eleventh neutral member is appointed by the elected board representatives to avoid stalemate situations that may occur, and ideally represent the public interest in the company. Under the act the supervisory board elects the executive board which must include the industrial relations vice-president (a union member). The supervisory board has three main responsibilities: 1) to institute investment policy; 2) to approve plans of the management and 3) to appoint the director of the executive board²¹. The executive board is responsible to implement the directives of the supervisory board.

The Works Constitution Act of 1952: The second major piece of legislation, the Work Constitution Act, implemented three levels of employee participation. The first level established individual employee rights, e.g. rights to information, work conditions, remuneration, etc. The second level established work councils with firms with more than five employees. And the third level guaranteed one third of the supervisory board to be labor representation elected by the firms employees²².

The Act of Codetermination of Employees (1976): The third major codetermination law came as a compromise between management's "bottom up" employee participation in corporate decisions and unions "top down" representation of labor on the board level²³. Similar to the Montan Act, the 1976 act gives employees and unions equal representation with the stockholder, but it differs from the Montan Act by eliminating the tie breaking neutral member, and confers on the chairman of the board, who is the stockholder representative, a double vote in case of stalemates²⁴. The 1976 act also deviates from prior codetermination acts by mandating that a managerial employee have representation on the supervisory board. The provision, it seems, indicated the change in the make-up of management. It was always assumed that the interests of management were the same as the interests of the stockholder; however, recently management has broadened its concerns to see stockholder as one interest among many²⁵.

One of the problems from the perspective of a financial theory of the firm is that mandatory codetermination in Germany grants workers control over financial investments without making financial commitments. Labor representatives in Germany have been able to secure close to half of the seats on the corporate board without any financial investment to the firm. According to Furubotn, Germany's codetermination laws violate the economic principle of rational allocation--that "those making decisions should bear the full consequences of the decisions they make" (Furubotn, 178). While many employees have personal investments of time, talent and loyalty to the firm, the lack of financial investments by employees is a serious drawback to Germany's codetermination system. For example, some firms in Germany such as Volkswagen failed to reduce its workforce when it was economically necessary because of a coalition of labor and government board members (Hanke and Walters)²⁶. This may in the long-run cause more lay-offs for Volkswagen, in which its financial viability will be seriously threatened. Of course this is similar to the problem of many US boards of nonowning executives who tend to increase their salaries and benefits unconnected to the long-term health of the company. The disconnection between financial ownership and governance has always been a problem, and neither Germany nor the US have done a good job overcoming it²⁷.

The German legal theory of the firm is very different from the US. Germany takes seriously that financial ownership does not dictate total servitude to shareholders. In Germany, the purpose of the firm is not to maximize shareholder wealth. Within the very constructs of Germany's codetermination laws, companies are prevented from instrumentalizing employees to shareholder benefits. This is not to say that all US companies instrumentalize employees. There are certain companies in the US that treat their employees more humanely than in Germany. But Germany has instituted a juridical framework which has been influenced by and influences societal and corporate culture. This juridical and cultural framework contextualizes managerial decisions within a triad of shareholders, employees, and communities (Tavis). Within the German view, corporations cannot be dictated by the interests of a single group given the influence and power of contemporary corporations (see Appendix I for comparisons among various cultures on this point). Although US managerial decisions are now legally less restricted to shareholders, culturally and theoretically (note our textbook) it is changing, and the power of shareholders, at least legally is diminishing (see Thurow and Ròna).

Ordering the Goods of Business--A Unified Theory of the Firm.

From a finance view point, this paper would seem to be over. I have covered the empirical, efficient, and legal reasons of the theory of the firm, and my argument will stand or fall on its own merits. Yet, these reasons fail to penetrate the human meaning of the purpose of the firm. I find the financial theory of the firm problematic not only because it is inefficient as well as out of whack with changing corporate law, but because of the moral meaning it creates in an organization. This moral meaning describes the organization only in economic terms and not in communitarian and social terms²⁸.

While proponents of the financial theory of the firm may not want to engage in moral arguments, they have nonetheless committed themselves to a form of moral philosophy

by attempting to develop a theory of the firm. Their notion of the firm assumes that organizational life "is nothing more than a series of contracts between people with the resources to pick or choose the contracts they like" based on the principle of MSW (Perrow, 235). Once the MSW principle is violated, according to the financial theory of the firm, managers have stepped into the realm of immorality. In their financial textbook, Brigham and Gapenski argue that managers who do not MSW are often motivated by power, greed and ego. Taking the moral high ground, they make the following comment on the issue of mergers and MSW:

Financial economists [like the authors] like to think that business decisions are based on only economic considerations. However, there can be no question that some business decisions are based more on managers' personal motivations than on economic analyses. Many people, business leaders included, like power, and more *power* is attached to running a larger corporation than a smaller one. . . . In particular, managements of acquiring firms may be motivated by factors other than shareholder wealth maximization; for example they may want to merge merely to increase the size of the corporations they manage since increased size usually brings *larger salaries and more job security, perquisites, power, and prestige* (963 and 981). [emphasis mine]

If managers are motivated by the vices of power, greed, ego, prestige, etc. that prevents them from attaining MSW, the goal of MSW, at least from the perspective of the financial theory of the firm, must be the primary principle.

The financial theory of the firm describes adequately the material dimension of organizational life, but it leaps to a philosophical *materialism* by restricting the definition of the firm only to its material qualities. Like all theories, a financial theory of the firm with agency theory as its base, assumes an understanding of human nature. A notion of human nature is inescapable once relationships are discussed. Here, finance has borrowed heavily from classical liberal economic theory which is based on philosophical liberalism. A major proponent of this theory is Milton Friedman who argues that "as liberals, we take freedom of the individual . . . as our ultimate goal in judging social arrangements" (see Rappaport, 6, as well as Friedman). This understanding of human nature centers on individuals (agents and principals) rather than group or culture as the central unit of analysis. The relationship between individuals are based on maximizing economic utility rather than maximizing social utility. And the primary purpose of the firm is to maximize shareholder wealth, rather than to maximize commonwealth. In that this theory of the firm is riddled with values--the question is: are they good values. No value neutrality exists here, and the attempt to escape the question of values is an escape from an essential aspect of finance or any discipline.

The financial theory of the firm, then, is based on a wealth maximization ethic. The core value of this ethic is efficient economic relationships. Increased efficiency means better use of resources and contributes to the interests of shareholders. Proponents of this theory point out that positive externalities occur from this theory. For example, MSW provides

benefits for society through an expedient use of resources. Consequently, in the end, a maximization of shareholder wealth will maximize the commonwealth²⁹. But can the principle of MSW serve as a philosophical basis of the firm? While returns for shareholders is a crucial dimension to any firm, it does not fully explain the cause, rationale or purpose of business. According to Peter Drucker, shareholder return "is not the purpose of but a limiting factor on business enterprise and business activity." (60)

Financial consideration serves not as the sole basis of a theory of the firm but as a function of the firm. It does not provide the purpose or end of the firm but rather finance provides efficient means for the firm to use toward other ends. According to Drucker, the purpose of business must be found not in business, but in society, since the enterprise "is an organ of society."

Drucker's distinction between a function and a purpose of business may sound like merely a semantic move, but it is pointing to a relationship that the financial theory of the firm has reversed. A financial theory of the firm defines the goal of business as wealth maximization to shareholders. This goal will have a non-intentional secondary effect of more wealth throughout society (positive externalities). The purpose of the firm is to MSW, it is not to "enhance the value of resources employed," "to create a customer," or "to maximize the commonwealth." Even though the financial theory of the firm maintains that these purposes will be attained through the MSW, such goals are secondary and essentially immaterial to its theory. Many of those who actually work out of this financial theory of the firm are not at all interested in whether their actions in a secondary order positively contribute to the social good. Dale Hanson, CEO of the California Public Employees Retirement System (CalPERS) explains that he is not interested in accomplishing social values, "unless through the accomplishment of these goals the corporate value will be increased" (Steiner and Steiner, 643)³⁰.

For Drucker, this financial ordering of a firm's purpose not only fails the empirical test, that is, many managers do not act this way, but also it is very dangerous to get managers to act in such a way. He explains that MSW (or as Drucker states the maximization of profits) "is a major cause for the misunderstanding of the nature of profit in our society and for the deep-seated hostility to profit which are among the most dangerous diseases of an industrial society³¹." When MSW is the primary end of a business it does not necessarily guarantee social contribution (products such as tobacco, malt liquor, pornography, some financial services, etc., as well as various strategies in a firm concerning the environment, product and worker safety, etc. should make this clear). The financial theory of the firm only guarantees the economic goods to shareholders.

The financial theory of the firm needs to take seriously the following question: Is a theory of the firm adequate with only one purpose? In biology, self-preservation provides a fundamental explanation of how organisms work, but we find it rather crude to explain human life totally in biological categories. Similarly, in organizational life, economics provides a fundamental explanation of a corporation. Without economic and statistical analysis corporate bankruptcy is not far behind. But economics does not provide a full explanation of organizational life³². Managers must also take seriously the psychological and social dimensions not only in an instrumental way (how do they serve the MSW), but

in an integral way with the economic goods of the organization. The rest of this paper examines these three goods and their interrelationships.

Economic Goods: Economic goods are the returns of productive activity. The returns are expressed in three primary ways: increased wealth to shareholders, wages and salaries to employees, and affordable prices to customers (others are taxes to government, income to suppliers, etc.). For shareholders, the economic good is a fair return on their investment.

But what satisfies a fair return? At the very minimum a return for shareholders must exceed the risk free rate that is attainable from a 30 year Treasury bill. Investors are practically guaranteed this rate since it is unlikely for the Treasury to go bankrupt. Companies that fail to exceed this rate of return in relation to their risk will not attract capital on the open market. Returns beyond the risk free rate will be dependent on the risk of the company. If one is not successful in attracting capital, modernization and growth come to a halt, new products do not get developed, productivity decreases, wages dwindle, prices rise, etc. Similarly, if wages and salaries are not high enough the company will not attract productive, well trained, and innovative employees. A company will lose out to competitors who recognize their value. And, if prices are not low enough and the quality not high enough, the company will lose out to more astute competitors³³.

Shareholders have given their money in trust to managers, customers have placed trust in receiving good products and fair prices, and workers have entrusted managers to provide fair wages. One could get theological here and speak of an economic trinity of capital, wages and prices--three items one reality. Once management shirks one, the others in the long-run will suffer. The financial claims by these three stakeholders point to the importance of managing and generating cash flows. When managers fail to generate cash flows the company ceases to exist, and when managers fail to manage and distribute cash flows they become highly vulnerable to shareholder revolts (low returns), consumer boycotts (high prices), and worker strikes (low wages). These assaults on management are indicative (although not always) of it's failing to take seriously the economic goods that are intrinsic to the practice of management.

The finance discipline provides a great service when its knowledge serves to increase cash flows as well as minimize cost in raising productive capital. Yet, the financial theory of the firm does not have within itself the theoretical capacity to direct economic activity to production which serves in a mutual manner shareholders, employees, and customers.

For example, as a discipline finance devotes a fair amount of time in speculation. Here the service of finance is divorced from productive capital where its techniques are turned to pure speculation, such as the options market³⁴. This speculation serves only the shareholder. In the past decade, it became painfully clear that certain investment policies were shifting to serve the interests of only a few powerful individuals through speculation. These decisions had very little to do with the production of goods and services, let alone realizing the good of employees and customers. Investment policies in the 1980s were dominated by short-term high-yield thinking that took the form of the unprecedented growth of mergers and acquisitions. Arbitrage firms or departments of firms would actively seek out potential takeover targets based largely on forecasts of the financial benefits to the acquiring firm through break-up value. Little or no consideration

was given to the employees and communities of the acquired firm, or to whether the new owner could do a better job at producing a better product. The bottom line was shareholder price. In this atmosphere, investors, including pension fund managers, did not feel it was their responsibility to consider what a particular merger or investment decision would do to or for the community³⁵. While not all mergers and acquisitions took this form, the thrust of its growth, particularly hostile mergers, has largely been for financial speculative gains.

A theory of the firm needs to direct economic goods toward productive capital that serves multiple stakeholders, namely shareholders, employees, and customers. Yet, a theory of the firm must also see economic goods as a necessary *but insufficient* condition of what it takes to create a human organization³⁶. A financial theory of the firm is inadequate since it fails to recognize that economic activities in the long run must at the same time have a psychological and social dimension to it. People are not economic animals (despite what certain economists maintain). To manage well is to know what one is managing. This is why management as well as a theory of the firm must be viewed as a multidimensional, not unidimensional activity³⁷. Economic concerns are fundamental goods to the organization, but they are not the only factors in running an organization. To argue this way is analogous to saying that the purpose of human life is the accumulation of material goods. As John Paul explains, "Profit is a *regulator* of the life of a business but it is not the only one; other human factors must also be considered which, in long term, are at least equally important for the life of a business³⁸." Profits and cash flows serve as *regulators* or referees to the physical continuation of a corporation. But profits do not provide the *human quality* of its existence. Economic goods cannot sustain themselves over the long run since without a larger integration of other human goods, management tends to destroy organizations either through the inside with poor worker morale, or through the outside with government regulation or consumer distrust (there are of course exceptions to this rule). A theory of the firm, then, must be integrated with psychological and social goods.

Psychological Goods: The second good necessary for a theory of the firm is establishing a workplace community which is tied closely to the psychological health of those who work for the company. An essential component to a workplace community is a place where people flourish by exercising their talents and skills. Employees spend one-third to one-half of their waking hours in the organizations. The kind of community that takes place impacts significantly the kind of organization it will become. Hence, the nature of this good is extremely personal, in that its accomplishment is intrinsically tied to the development of the person. This personal development, as with most personal development, is done within the social context of the organization. We are social persons, and our own personal development cannot be seen outside the social context of the organization. This is why management must have a strong participatory dimension to its self-understanding. Drucker, for example, claims that "In their internal operations, managers serve their fellow employees by helping them to become participants in a cooperative endeavor whose scope would have remained beyond the capacities of any of them, considered as individuals" (Drucker, 233). The quality of this cooperative activity is substantially based on how the manager organizes those within the institution.

Managers must create a community where workers really contribute to the whole, and in the process contribute to their personal development. It is assumed here that the individual and corporate interests can coincide, but tensions do arise between psychological and economic goods³⁹.

Social Good: The third good for a theory of the firm is meeting the needs of the community through marketable goods and services. This good provides in its most concrete form the service dimension of management. Management serves society by providing through efficient distribution channels and affordable prices goods and services that meet the needs of society. A theory of the firm that fails to recognize this social dimension degrades the management profession. The danger of a financial theory of the firm is the tendency to turn executives into financial technicians praying the mantra of "maximize shareholder value." Most executives see themselves as professionals who strive to contribute to the betterment of society by meeting the needs of customers. A key managerial discipline in the determination of customer needs is marketing. Through consumer research, pricing strategies, product design, distribution methods, and promotion, marketing makes it possible for more goods to reach more people. However, what the goods are and what they do, for and to customers, cannot be taken out of the equation in determining which products will be produced. Deciding needs is not an easy task. Drucker, for example, argues that management is to "*create a customer*," not to decide the needs of the customer. For Drucker, needs are determined by consumer sovereignty in the market. This response is insufficient. While determining needs within a larger principle such as the common good poses certain problems, at least it is conducive to an understanding of a theory of the firm with a social dimension. If managers are merely to decipher marketable goods, they can hardly see themselves as agents engaged in meeting needs of the community. Rather, they become simply maximizers of shareholder wealth or market technicians. Creating necessary goods and services provides a social dimension to the workplace community⁴⁰. Managers and workers are not only working for themselves but for society as well.

A proponent of the financial theory of firm may be getting nervous at this point because of the highly moralistic tone of my argument. But as I pointed out at the beginning of this section, the financial theory of firm with the primary principle of MSW is also a moral statement out of a liberal economic tradition. What I am arguing for is a unified theory of the firm with the primary principle of maximizing the commonwealth that derives from a Thomistic tradition.

Ordering and Prioritizing the Goods: In light of these three goods, a question of order arises: "Of the three goods what is the most important?" For the financial theory of the firm, all goods are instrumental to the economic goods of shareholders. While financial theory of the firm can be crudely expressed in maximizing shareholder wealth and damn the rest, many advocates of the financial theory of the firm would argue that if a company violates the psychological goods of workers and the social goods of society, the company will eventually undermine the economic goods of shareholders. This line of reasoning is known as the "enlighten self-interest argument." According to this argument, wealth maximization must be achieved through personal and social benefits, since in the long-

run it allows the company to attain more profits by avoiding regulations and penalties⁴¹.

"Why do managers manage⁴²?" "Why do they treat their employees well?" "Why do managers contribute to the social welfare?" From an enlightened self-interest position, the answer is simple: MSW. What is important to note here is that treating employees well, contributing to the common good, and doing the right thing are not legitimate ends in themselves from the enlightened self-interest position. Rather, they are instrumental means which serve the higher end of shareholder wealth⁴³.

The enlightened self-interest interpretation of a financial theory of the firm does not deny the existence or importance of the three goods described above. What becomes the issue is how the goods are ordered. The financial theory of the firm provides an *instrumental* ordering that leads to a fragmented theory because it is unable to adequately incorporate the necessary goods of an effective firm. What I argue for the remainder of this paper is that an adequate theory of the firm must provide an *organic* ordering of the economic, psychological and social goods that I call a *unified theory of the firm*. A theory of the firm not only locates what is good, but must also prioritize and integrate the various goods of the firm. This is why a financial theory of the firm has to face up to the ethical challenge of justifying how it orders its own theory.

Theory of the

Firm	End	Order	Relationship	Direction
Financial Theory	Shareholder Wealth	Instrumental	Dominant	One Way
Unified Theory	Commonwealth	Organic	Inclusive	Dual

It should be first pointed out that the unified theory that I propose in no way undermines the good of shareholders. The insight gained from a financial theory of the firm cannot be understated: shareholder wealth is the necessary condition of a firm's existence. What a unified theory of the firm does differently than a financial theory of the firm is that it places shareholder wealth in a different hierarchial relationship with the psychological and social goods of the firm. A financial theory of the firm places shareholder wealth in a dominant relationship with the psychological and social goods of the firm. In this theory, shareholder wealth serves as the reason for being for the organization. It is the highest good in the organization. The financial theory of the firm has only one direction in which its hierarchy proceeds: up to shareholder wealth. This is why the theory is so adamant on *maximizing* shareholder wealth, since all goods are ordered to shareholder wealth. The financial theory of the firm provides a hierarchy of goods that is dominated by shareholder wealth.

Financial Theory of the Firm

In a unified theory of the firm, the hierarchy within the theory must be understood not in oppressive and dominant terms, but in inclusive, participatory, and subsidiary (design to serve) terms. In this theory of the firm, a proper hierarchy of goods provides an outline of what a firm ought to be, "what goods it will incorporate, and what relation those goods should have to one another⁴⁴." These goods are not merely arbitrary goods but stem from the physical, psychological, and social nature of the human person, all of which are essential to a developed human life within society. Nor are the goods related in an external to internal way, but rather organically where each good influences an other and is dependent on the other for a human life that flourishes⁴⁵. In order to understand what this properly ordered life looks like it is imperative to understand the hierarchical order of the goods.

In a unified theory of the firm, a hierarchical order of the economic, psychological, and social goods works in both an ascending order of excellence, and a descending order of fundamentality. It is in this dual order of excellence and fundamentality that the hierarchy takes on the characteristics of inclusion, integration, and subsidiarity. In the order of excellence, the higher goods, namely the social and psychological goods, are pursued in a way that the lower goods, namely the economic goods, are subordinated to the pursuit of the higher goods⁴⁶. Namely, the pursuit of economic goods are subordinated to the more excellent pursuit of psychological and social goods.

But at the same time there is an order of fundamentality that prevents the economic goods from being destroyed by the higher psychological and social goods, since it is on the basis of the economic goods that the psychological and social goods are built. Hence, as the goods involved in a firm move from first to third in an order of increasing excellence, they also move in the same direction in an order of decreasing fundamentality⁴⁷. Note here that the hierarchy is not oppressive nor exclusionary because it is not one way, unlike the financial theory of the firm. The fundamental goods "are empowered by participation in a larger whole and in which influence flows both from the top down and from the bottom up⁴⁸." By providing a dual direction as well as a dual control, the hierarchy of goods are inclusive by participating in each other in a way that one is needed for the other to flourish. Economic goods control the psychological and social goods in that there are limits to what can and cannot be done; yet the psychological and social goods direct the economic goods to the fulfillment of themselves. This dynamic and complex relationship of goods is precisely the reason why a financial theory of the firm is incomplete. Financial theory of the firm removes the complexity of the relationship and simplifies the organizational reality to one principle: MSW.

Unified Theory of the Firm

Order of Order of

Fundamentality Excellence

An analogy may prove helpful. Aquinas points out three inclinations within human nature: self-preservation, procreation, and social living and to know and love God. If we do not preserve and procreate ourselves, the social inclination has little relevance; however, if all we do is preserve and procreate we would say that something is missing to what it means to be a human person. Similarly, without profits and other economic goods, personal development and the common good has little relevance, since they cannot exist without economic sustenance; however, if the organization is only concerned about economic goods, we should say that there is something missing to what it means to be a human organization. Management, as an economic activity, must include the economic goods of management, but it also must order these goods to the communitarian and social goods of human living. Yet, economic goods cannot be annihilated or squeezed out in achieving psychological and social goods; otherwise, eventually such goods are undermined themselves. Rather, an organic unity of the goods exists in subsidiary relationship, that is, each serves the other.

I realize that the language of hierarchy, goods, order, etc. has a highly abstract tone to it. But let me illustrate what I mean with an example mentioned earlier in the paper--malt liquor. Within a financial theory of the firm products are produced not because of their contribution to society but *solely* on whether they will maximize shareholder wealth. For instance, G. Heileman's malt liquor, *PowerMaster*, elicited condemnation from Surgeon General Antonia C. Novello and was eventually ordered out of the market by the federal government. The ubiquitous presence of malt liquor advertising on inner city bill boards revealed its target market--those who are already highly prone to health risks--namely, black men between the ages of 25-44 who are 10 times more likely than the general population to die of cirrhosis of the liver. While most malt liquor products have been historically marketed toward lower income minorities, *PowerMaster* ostensibly crossed the line of acceptability by bragging that its product had more "kick" than other malt liquors, namely 1/3 more alcohol. In addition, advertising by other malt liquor producers had associated their product with machoistic power, aphrodisiacs, crack, and street gangs (*Wall Street*).

In hindsight, the maximizer of shareholder wealth might argue that *PowerMaster* would not have been a good product to budget for, since he/she could anticipate social and government condemnation, which would make the product unprofitable. I indicated this point of view in the first part of the paper, but people do not make decisions in hindsight. Take the maximizer of shareholder wealth facing the decision of whether to produce and budget for *PowerMaster*. The maximizer has a product in the fastest growing beer market in the US. He or she has also been in an environment of deregulation for the past 10 years by a republican administration. Within the malt liquor industry, *PowerMaster* is not out of the ordinary with how it markets the product. Also take into consideration the habit of mind the maximizer is in: MSW, MSW, MSW, etc. Wealth is written all over the product. The maximizer has successfully produced and marketed malt liquor for inner

city customers, and he/she has seen competitors profit handsomely from the same activity. From the financial theory of the firm's perspective, it would be immoral *not* to market *PowerMaster* since it would fail to MSW. In one sense, Heileman's *PowerMaster* was unfairly singled out, since it was relatively within the bounds of industry behavior. Malt liquor is produced for one reason according to a financial theory of the firm: MSW. While certain proponents of malt liquor have attempted to respond to their social critics by arguing that the social value of malt liquor lies in its substitution effect for crack, its laughable to think they produce malt liquor for that reason.

From a unified theory of the firm, a different thought process must take place. Increasing shareholder wealth is a fundamental but insufficient principle in examining the issue. If a product does not increase shareholder value, in most cases it should not be produced even when a tremendous amount of social value is attached to it. A firm cannot sustain itself on products that do not increase shareholder wealth both because shareholders will withdraw from such a firm and because shareholder wealth is a responsibility of management. But it is not the only responsibility. Management must ask whether the product contributes to the welfare of society. Within the unified theory of the firm, the manager must develop a more complex habit of mind than the maximizer. He/she must constantly order the economic, psychological and social goods in a way that general prosperity is served. Concerning the *PowerMaster* example within the context of the unified theory of the firm, the manager is in conflict of whether to produce and budget for the product. The fundamental good of shareholder wealth is met. We will assume that Heileman is a decent place to work where psychological goods can be met. The social goods in this case, however, face a serious hurdle. What are the social effects (externalities) of *Powermaster*? A unified theory of the firm must ask what relationship will occur between producer and consumer from the product offered. Obiora Ike points out that products and services "brings us into relationship with other people, including future generations. It is a major means of integrating us into community, of giving us a place, status, belonging, and value⁴⁹." It would seem hard to argue from a unified theory of the firm that *Powermaster* would provide any social value.

At its very core, then, a unified theory of the firm is teleologically ordered toward general prosperity in terms of economic, psychological, and social goods for those inside and outside the organization through the efficient production of necessary goods and services. A financial theory of the firm is teleologically ordered toward the economic prosperity of shareholders. At the very heart of both theories are moral statements of the purpose of an organization and role of managers in an organization. The question for both theories is which one can maintain a hierarchy so that all the goods are met and people become "more human," where one does well and good at the same time?

Conclusion

Can an organization be concerned only with MSW? Yes, just like a person can exist concerned only with self-preservation and procreation. But the quality of the existence cannot be said to be fully human in both cases. A theory of the firm must be able to order the economic, psychological and social goods in a way that the firm becomes more

human. Management must strive for higher goods while at the same time maintaining the lower goods that are foundational. If employees are psychologically stilted and degraded, management becomes a form of oppression that not only dehumanizes the employees but the managers as well. For often the perpetrators of injustice are more dehumanized than the victims⁵⁰. Human development is an essential ingredient to any true community of work. If an organization does not place, as a key center piece to its understanding as a community, the duty to provide quality and necessary goods and services to society, its so-called community degenerates into what Robert Bellah *et al.* calls a life-style enclave (a group of individuals who gather to produce goods and services on the basis of their own private interests, preferences, consumptive patterns, etc.). Although self-actualization and self-fulfillment are noble aspirations, they cannot be attempted without moral principles and virtues to guide and achieve these aspirations⁵¹. The corporate financial officer arranging multi-million dollar mergers only in light of break up value, or marketing agents for large tobacco companies who seek markets among the young and the developing world may find their work fulfilling, exciting, and creative. But does that mean their supposed self-actualization and personal creativity contribute to the larger social good? When they seem unconcerned about the consequences of displaced workers, ill-health, and social disruption can they truly be satisfied and have a workplace community? Personal satisfaction and workplace community must be conditioned by moral norms and virtues which derive from the very nature of the human person; otherwise, work can degenerate into selfishness.

To reiterate once again: this paper is not meant to cast dispersions on the innovative, complex, and scientific techniques of finance. Such techniques provide the necessary access, use, and evaluation of the economic dimensions of the firm. Rather this paper has attempted to point out that the presuppositions of the financial theory of the firm are problematic on the basis that the financial theory of the firm misses the mark of what it means to be a *human* organization and not simply an economic one.

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Endnotes

1. Within the agency relationship there is a question over whether the principal owns the firm as distinguished from owning capital of the firm. see Oviatt.
2. Note here that financial theory speaks of increasing shareholder wealth not profits.
3. For example, if interest rates fall which represents the cost of debt, the cost of capital decreases which increase stocks. This has certainly occurred recently with interest rates decreasing and the stocks increasing. Two essential terms to understand in financial techniques are cash flow and costs of capital, and the relationship between the two.
4. There is debate on this point, however. From the discussion above on the theory of the firm, one may conclude that it matters little whether cash flows are attain from financial assets or real assets; however, according to Tarascio, such a conclusion is a tad too simplistic (10). Cash flow from financial assets are either fixed (bonds or preferred stock) or are out one's control (common stock). He explains that a "real asset, unlike a financial asset, represents a large number of different income streams. The firm, the owner of the real asset, must choose a potential income stream from the myriad of possible service streams" (Tarascio, 10). Tarascio's point is that real asset cash flows can be modified by their owner that provides more versatility in increasing future cash flows.
5. One of the problems of Earning Per Share is that it "assumes that there is no cost of equity--at least not above the risk-free rate" (Reimann, 44).
6. Over the years there has been much discussion over the cost of capital internationally. Japan, some have argued, have the distinct competitive advantage with a lower cost of capital. US companies have been faced with lose/lose situations: invest in projects that can be financially justified in lower cost of capital countries, but such projects do not meet the US companies hurdle rates. Or in starker terms "forgo such investments and pursue what becomes over the long run 'a going out of business strategy.'" (Morone and Paulson, 15). The cost of capital is particular acute in low margin businesses such as steel, machine tools, etc. (In high margin businesses such pharmaceuticals, cost of capital is not as critical, see Morone and Paulson, 17).

7. The relationship between theologians and businesspeople have been strained, particularly since the release of American Catholic Bishops pastoral on economic justice. Business practitioners and academics have argued that bishops and theologians do not understand the fundamentals of economics and consequently do not understand the workings of corporations. They further argue that bishops and theologians do not have practical experience in running organizations (they forget of course that bishops run organizations far larger than many business people run).

8. It is interesting to note how moral language gets used by people in finance themselves when economic goods are not met, yet, these same people adamantly maintain that ethics has no part of their analysis. Take for example the following sentence in a finance text book on takeovers: "If the team that currently controls a firm is not maximizing the value of the firm's assets, then an acquisition will likely occur and increase the value of the firm by replacing its *poor* managers with *good* managers" (Brigham and Gapenski, 1980).

9. This chart may not look the same today as it did back in 1984. MSW seems to be an increasing factor in the decisions at today's businesses. Some theorists think that agency theory is revolutionizing organizations, although firms such as Johnson and Johnson's, and others still describe their firm according to the attitudes reflected in the survey than those in financial textbooks.

10. "Equity capital is equated with venture capital, which is defined as money invested or available for investment in stocks. The worker's investment in an enterprise is his time and earning power; his risk involved in a company's success or failure is the dreaded specter of unemployment, either the financial, psychological, and physical burdens that it entails. . The fruits of production are neither due to the sole efforts nor wholly payable to, investors of money; (b) equity involves a right to share in ownership based (according to natural right) on one's contribution to the value of a property; and (c) the worker's investment of time and effort is not only contributory to the value of the enterprise or property but involves a substantial risk on his part. All three factors combine to show that workers have equity in their company, to the extent of the value, length of time, and faithfulness of their service to the company" (James Bowman, "A Wave of Profit Sharing Sets Our Industrial Future," Social Order (November 1963): 40).

11. Take for example the two lists below. Within the financial theory of the firm, the possible conflicts between these two lists will always be resolved on the side of shareholders; yet, such a conclusion seems unrealistic both in terms of law and expediency, since employees play such a major role in the company (lists taken from Sharplin and Phelps, 47-49).

Shareholder Issues

1. Boards of directors, at least often ostensibly elected by shareholders, often set managers' pay based on changes in the value of a firm's securities.
2. Managers are disciplined by one another, especially by those brought in from outside the firm, to increase shareholder wealth.
3. Interdivisional monitoring in multi-division companies opposes opportunism and certain technical advantages within the bounds of rationality.
4. Outside directors monitor managerial behavior and at least weakly retard opportunistic behavior.
5. Institutional investors, especially since formation of the Council of Institutional Investors, are effective in monitoring managerial performance.

6. Stock option arrangements offer powerful incentives for managers to increase shareholder wealth.
7. The norms and values of managers typically favor firm survival and financial performance -- in short, managers might subscribe to the notion that shareholders are owners in some fundamental sense.
8. The threat of a hostile takeover which may result in demotion or dismissal of managers encourages them to maximize shareholder wealth.
9. Rivalry among various stakeholders -- for scarce rewards the firm can allocate -- encourage efficient management.
10. Managerial labor markets may enforce full ex-post settling up for any breach of the agency contract.
11. U.S. law and custom holds the manager accountable for representing certain shareholder interests.

Employee Issues

1. Employees may decrease or increase the support and affirmation they give to management.
 2. Employees may decrease or increase work effort and benefit demands, thereby affecting the wealth management controls and from which it draws its own pay and benefits.
 3. Employees may band together (as in unions or informal quality circles) or disperse, and increase or decrease their collective activism, to the benefit or detriment of management.
 4. Employees may transmit favorable or unfavorable information to other principals, such as shareholders or the community (as by buying or selling company stock, talking to the press, or engaging in industrial espionage).
 5. Employees who have received exceptional (good or bad) treatment may sabotage or advance management interests to restore a sense of equity.
 6. The norms and values of managers typically favor beneficial treatment of employees -- in short, managers might simply have close and caring relationships with employees.
 7. U.S. law and custom (e.g. the Plant Closing/Layoff Act of 1988, the provisions of the Bankruptcy Code which accords labor contracts special treatment, and the custom of time off for jury duty) hold managers accountable for representing certain employee interests.
12. See Thurow, 54, and Tarascio, 13 on the multiple dimensions of the theory of the firm. Handy points out that since 1975, "British companies have retained, on average, 45% of their profits for re-investment, American firms 54%, Japanese firms 63%, and German firms 67%" (171). British shareholders then take their money and invest it overseas in firms that are investing in the long-term.
13. One issue where this could distinction could be explored is in diversification. It is often argued that diversification stabilizes a firm's earnings stream and in the end MSW. Brigham and Gapenski point out, however, that "Stabilization of earnings is certainly beneficial to employees, suppliers, and customers, but its value is questionable from the standpoint of stockholders. If a stockholder is worried about the variability of a firm's earnings, he or she could diversify more easily than could the firm. Why should Firms

A and B merge to stabilize earnings when a stockholder in Firm A could sell half of his or her stock in A and use the proceeds to purchase stock in Firm B? Stockholders can create diversification more easily than can the firm" (962).

14. Institutional investors are beginning to establish long-term covenants with businesses in return for participation in the strategic planning of the company. This is referred to as relational investing. In Britain, institutional investors hold individual business shares an average of four years. (Handy, 173-174) Handy says that pension fund managers are prohibited from sitting on boards of directors in which they invest. (176) This trend is beginning to look like the relationships of banks have with businesses in Germany and Japan.

15. See Reimann, 42 on time horizons of Japanese and US; see Morone, and see Eisenhardt, 62. The distinction between investors and owners, and shareholders who invest for the long-term vs those for the short-term does one thing: it increases the cost of doing business by increasing the agency costs. Once control and ownership are separated, an agency relationship enters which was described in the first part of this paper. Its emphasis on contracts has focused on agents who abuse the interests of principals (very little has been on when principals abuse the agents) (Perrow). In its idea form, agency theory assumes that organizations are built on long-term contracts between owners and managers. Yet in reality, moral hazards arise when the principal, unable to monitor the agent, looks only at bottom line results, which threatens long-term profitability of the organization, since when moral problem increase so do economic costs.

Theorists of the financial theory of the firm spend a tremendous time attempting to get around the inefficiencies of shirking, by setting more and more structures to prevent the inefficiencies of the past structure they set. Its like a scientific theory that cannot quite explain everything in the experience, so it continues to offer explanations for the quirks that are not consistent with the presuppositions of the theory. Financial theorists will be always plagued by agency costs unless they provide a better grounding for their own theory that is able to unify the interests of employees and shareholders. One answer is ESOPs which ties the shareholder and employee good as one. One still have the problem of the customer and community, but even these are better connected once employees get involved in the picture (see Eisenhardt, pg 69). A natural alignment between employees and shareholders, which make an easier alignment a better line of sight with customers and community, will reduce agency costs in the future.

16. See Goodpaster on the debate between a multi-fiduciary and stockholder approach.

17. Douglas Birsch explains that "The legal system . . . is moving away from the agent/principal model as the proper description of the employer--employee relationship. The courts are declaring that employers cannot direct their employees to act in ways that violate the employees' legitimate interests or the interest of the public. The legal system is protecting employees who 'blow the whistle' on the employers or refuse to perform actions in violation of law or public policy, or who are discharged or disciplined by employers who are acting unfairly or in bad faith These decisions constrain the kind of directives employers can give employees and may lead to the complete rejection of agency theory" (33).

18. In one sense these laws should not be surprising in light of what is called "The Iron Law of Responsibility." If power is not used responsibly it will be either taken away or restricted by government. See Brigham comments on social responsibility and competitive disadvantage which encourages government regulation rather than self-regulation.

19. Harry and Joanne Bernstein, *Industrial Democracy in 12 Nations*. Washington: U.S. Department of Labor Bureau of International Labor Affairs, (1979) p.21.

20. Thimm *Challenge* p.81

21. Mason, 162

22. Hans, 71.

23. Thimm, 15. The 1976 act does not reject the Montan Act of

24. Ibid.

25. The post war Germany economy has favored remarkably well until recently. It has had the best record in the West of reconciling high employment, rapid growth and low inflation. Germany also enjoys the lowest level of strikes in the West as well. However, since 1981 Germany has suffered set backs with high unemployment (8-10%) and high inflation. Despite recent difficulties, codetermination laws, work councils and government sponsored quality of work life projects have reduced alienation factors on the work, which often accompany technological progress, although recently there are some concern over whether Germany's highly regulatory environment is impeding technological progress (Benjamin).

26. Three other major criticisms of codetermination in Germany: 1) there is doubt concerning the influence of the employee and outside member supervisory board. The board meets approximately three to four times a year which forces the employees and the neutral member to depend on management for information in order to meet realistic decisions. Management, it has been accused, already have predetermined decisions before the board meets. This calls into question whether the codetermination laws really attend to the participatory element of the individual worker; 2) codetermination laws has focused employee participation on the board level which reduces participation to only a few employees in each corporation; 3) Government legislation is not the best means to implement effective participation for the firm. Forced participation, according to these critics, is a contradiction in terms.

27. For the most part, German managers have accepted codetermination as a good thing but it is interesting that many multinationals view the laws as a threat to their autonomy, which, as we noted before was initially the fear of German's management. Multinationals, particularly those from the U.S., are hostile to any government regulation which imposes democracy in the work-place. Stressing their rights to productivity and growth, U.S. companies in the international field views codetermination and work councils as "a creeping expansion" of worker powers which limit the decision making and self-interest of the parent company.

28. Rosenbrock argues, however, that moral arguments cannot be made since to "develop such argument we need a set of shared beliefs upon which to build the intellectual structure." (169) According to Rosenbrock no shared belief system exists on to build an intellectual structure. The only problem with Rosenbrock's conclusion is that a share belief system has to take place, and that excuse him or others other alternatives.

29. But such an ethic is problematic on several grounds which will be discussed throughout the remainder of this paper. Its fundamental problem is materialistic: all events are reduced to economic explanations. For example, Richard Posner, a proponent of the financial theory of the firm, argues that slavery is no longer feasible today not because it is morally reprehensible, but rather that "monitoring the output of a slave today would be much higher than the costs of monitoring a free man's output through contract. . . . Arguably, this, rather than moral progress unrelated to material condition, may be the main reason that slavery is no longer a common institution" (Posner, 94). While one could debate Posner's interpretation of history, especially the role of abolitionists in freeing slaves, Posner's logic is at least consistent with his presuppositions. All activities are reducible to economic principles.

30. Altruism is justified only when it serves the stockholders interest. Quoting Adam Smith, Friedman argues that "By pursuing his own interest, an individual frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good" (Friedman 1972, 133). But altruism is the exception not the rule. This money can be better spent on advertising than on CSR programs. The basic principle of this philosophy was the belief that the free play of human motives, all in themselves selfish and acquisitive, works out to promote the highest benefit to society.

31. Drucker explains that this financial theory of the firm has created dispersions in the wider public that "there is an inherent contradiction between profit and a company's ability to make a social contribution."
(60) He finds this conclusion a mistake. "A company can make a social contribution only if it is highly profitable." (60)

32. See McCann and Brownsberger's discussion of Aristotle's 4 causes.

33. This is not to say the market is that efficient to supply just wages and prices by itself. It takes a tremendously long for the market to react. This is why I would argue that government regulation has an important role regulating wages, prices and capital. But that topic is for another time.

34. I realize here that hedging stock portfolios through options can reduce the risk of the portfolio, but I suspect that most hedging is done purely on speculative basis. This is not to cast dispersions on option theory which has developed helpful financing techniques such as warrants and convertibles.

35. Marcia Berss, 63. Wisconsin Investment Board, the state agency that manages the pension fund, has benefited from hostile takeovers as a shareholder by fighting any form of tactics that would prevent them. Yet its state legislators passed laws within its own state that have regulated hostile takeovers to protect the company employees and ostensibly the community. Berss explains that the irony gets better. "The Wisconsin Investment Board is one of the top five pension fund investors in leveraged buyouts. . . . including the RJR Nabisco takeover" (63). Although Berss argues for state deregulation, I think it would be better if the Investment Board would place other criteria as part of its investment policy besides maximization of shareholder price.

36. Investing is work. As work, it is a human activity and must be guided by more than economic criteria. If investment strategies fail to include a moral criteria such as the realization of the common good, the very act of investing fails to contribute to human development. Rather, it only contributes to "having" and ignores "being." If virtues such as magnificence are absent from the process of investments, the opportunity is lost to further human development in the act of investing. While the very nature of investments dictates an economic purpose, by itself economic decision making cannot lead to moral and spiritual development. Fortunately, the 1980s brought more than a growth in mergers. In the same decade, there also appeared an increase in mutual funds based on a socio-economic criteria of investment. The moral character of what was produced as well as the effects of producing it became an important criteria in whether a particular mutual fund would invest or not. More and more investors were unwilling to let their money be used to support a racist government in South Africa, tobacco and alcohol companies, abortifacients, defense industries, and so forth, even though the investment offered a high yield. While not everyone agrees on what moral criteria should be used, people at least saw an inconsistency of enabling companies through their investments to produce and service what they thought was morally reprehensible. For example, the Parnassus Fund is an investment option whose main objective is to achieve long-term capital growth. Their prospectus states that the Fund's portfolio selects securities using a three-fold criteria: 1) Contrarian Method: This method acquires stocks that are out of favor with the investment community either because of bad luck or a management mistake that has caused investors to overreact. In other words, buying what other people do not want to buy. For example, the Fund will not buy a stock that is selling for more than 65% of its 5 year high so as to capitalize on a company's downside. 2) Financial Considerations: The Fund applies a set of financial criteria to the stock that meets its contrarian standards to determine whether the company is financially sound to survive the long-term. The Fund analyzes the company's net assets, annual sales compared to sales five years ago, outlook for future earnings, and the dividend and earnings of the past ten years. 3) Renaissance Principles: This criteria specifically addresses the product dimension of work. The Fund will invest in only those companies that create useful and quality products and services. It will not for example invest in any company that is involved in tobacco, alcohol, gambling, and weapons. Other criteria for the Fund is the company's corporate citizenship in the community, and the proper treatment of employees. The Parnassus Fund and mutual funds like it attempt to practice the virtue of magnificence, by investing in organizations that contribute products and services to the common good, and excluding organizations from investments that harm the common good. The Fund also attempts to be prudent by applying financial criteria to those companies which meet the Renaissance principles.

A concrete instance of implementing the virtue of magnificence, that is, provide a good and useful product and needed employment, is the cooperative spirit behind a new Milwaukee based firm called Steeltech. The manufacturing base of the city of Milwaukee was hit hard during the 1980s. The city lost 60,000 well-paid manufacturing jobs during that time. The group who bore the brunt of this job loss was inner city African-American males. Today the city has one of the highest unemployment rates for blacks (20.1%), over half of all blacks in Milwaukee receive some form of public aid, the homicide rate has doubled in three years from 78 in 1988 to 165 in 1990, and it is one of the most segregated cities in the U.S. The inner city of Milwaukee needs well-paying jobs that produce good and useful products. Steeltech Manufacturing is one small attempt to revitalize the inner city. It is a start-up minority-owned metal finishing (necessary product) firm backed by several Milwaukee businesses which plans to open its facility in the inner city. While it will create only 100 jobs, they would go largely to inner city residents who need them. Currently, David Guerrero who heads Steeltech is looking for investors, particularly although not exclusively, minority investors. He is receiving help to get Steeltech off the ground from other indirect employers, such as Milwaukee Area Technical College (MATC), city, state, and federal government, banks, and Supersteel. MATC is providing the job training in welding and other trade skills for inner city residents. City and county government have provided, with little red tape involved, the land acquisition and development of the plant site within the inner city. Federal government will most likely provide contracts to Steeltech because of their minority quota system. Banks have provided loans to the minority investors at no personal risk. Supersteel, a local steelmaking plant, is providing the initial marketing, managerial, and technological know how to help Steeltech off the ground.

Fred Luber, CEO of Supersteel and initiator of Steeltech, has proposed that Steeltech work as a national model that can be transplanted through the country as one way to revive the inner city. The cooperation of various stakeholders such as government, investors, financial institutions, minorities, educational services, and labor toward the revival of U.S. cities through productive organizations is the epitome of the virtue of magnificence as well as solidarity and the principle of subsidiarity.

While investing in Steeltech may not retrieve as high a return as an investment in some other product such as real estate or plastics, investments must include a criteria that is both moral and financial. Investment decisions must be prudent, which may determine Steeltech a poor investment. However, investments must be informed with a sense of purpose--a sense of magnificence. Without investments informed by the virtue of magnificence the inner city has little chance to recover. The problems that plague the inner cities need good jobs that produce useful and good products, however, that responsibility cannot be bore by direct employers alone nor by government alone. Indirect employers need to provide services and incentives that make the practice of virtue, such as magnificence, easier.

37. I received this idea from Robert Kennedy. For example, Peter Drucker notes that profit is not "the explanation, cause or rationale of business and business decision, but the test of their validity. *Management*, 1974. I would argue here that Drucker overstates his case, although his point is well taken. Profit is a partial explanation of business in that its presence is an absolute necessity to the existence of a business. My sense, however, is that the difference is of semantics and not substance.

38. CA, 35.

39. Community cannot be maintained within a workplace that does not permit the participation of workers. With socio-technical design, cellular manufacturing, work-teams, and other participatory programs, organizations are becoming better places to work because workers are able to involve their full personhood in their work. Although some see such programs as a fad (time will tell), others, including myself, believe that the last 15 years in management studies has uncovered the importance of the organization as a community. In order to create a community, managers need to have a good grasp of operational techniques and human resource programs.

40. *Management* pg 60-61; see McCann and Brownsberger, 233.

41. For example, a CEO of a multinational company told me that he does not like to do business with "not nice people" (that is, those who want bribes to secure contracts). When I asked him why, he explained that it was bad strategy, and that eventually it would come back to haunt him in terms of the bottom line. This CEO may have had other reasons why he would not deal with "not nice people," but his argument is very popular in the business world. It is based on the enlightened self-interest principle that in order to maximize the bottom line, ethical conduct is an essential means. The rationale of enlightened self-interest is also popular among many business students and practitioners, especially those who see themselves as streetwise. For example, when I ask "Why are corporations socially responsible?" many students argue that it is out of economic self-interest. They maintain that corporate goods acts are extensions of the public relations division--they are motivated by the desire to create a good image so as to make more money. The students then go on to argue that intentions of managers for such good corporate acts are irrelevant. What matters are the consequences, that is, the organization contributes to the greater good of society so as to attain a good image and be profitable.

42. One of the habits that Stephen Covey explains in his book *The 7 Habits of Highly Effective People* is the habit of "having the end in mind." It is the habit that tells us why we do the things we do. Covey defines it as "the image, picture, or paradigm of the end of your life as your reference or the criterion by which everything else is examined." Within the financial theory of the firm, the end has been narrowly defined to MSW. The narrow definition represents not only a moral failure among organizations, but usually in the long-run productivity failure. Leider claims that "people who perform most energetically, creatively, and enthusiastically are those who believe they are contributing to a purpose larger than themselves [and shareholder wealth]." This of course is not always true. Many profit based people are extremely motivated, and many high-idea minded people are incompetent and uncreative. But as an organization, people committed to common social goals act more as an organic unit than an organization committed to primarily monetary goals expressed through MSW. Managers of course have not just one end in mind, but several ends. But what is important to note is that most managers have the three goods described above (economic, psychological, and social), however, what is different about managers is the way they prioritize them.

43. However, what happens when treating employees well no longer serves one's self-interest so narrowly understood? As T.S. Eliot noted, "to do the right deed for the wrong reason" is the greatest treason (T.S. Eliot, *Murder in the Cathedral* (San Diego: Harcourt Brace Jovanovich, Inc., 1935), 44). To implement participative and distributive programs only to further one's self-interest, prestige, or profitability will eventually have negative ramifications. Employees will eventually perceive the manipulation.

44. Jean Porter, *Recovery of Virtue* (Louisville: Westminster, 1990) 90.

45. See Terence Nichols, "The Role of Hierarchy in the Church." Unpublished.

46. In her book *The Recovery of Virtue* Porter speaks not of goods but of inclinations. For her inclinations are natural dispositions that describe what it means to be human. She does not describe the goods as I describe them here.

47. Ibid., 89-90.

48. Terence Nichols, "The Role of Hierarchy in the Church." Unpublished manuscript.

49. Ibid., 243-44.

50. *Gaudium et Spes*

51. Although Herzberg and McGregor mentioned the social element of humanity, they understand social as simply interpersonal. "Man is essentially a social animal primarily in search of social gratification" (Herzberg, 41). In other words, people strive for community because they do not want to live alone. If they do not socialize they will not be accepted and have a difficult time in life. However, Herzberg and

McGregor do not extend this understanding of the person's social nature to social responsibility for society and the attainment of the common good.