The Nature of the Firm, Agency Theory and Shareholder Theory:

A Critique from Philosophical Anthropology

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Running Head: A Philosophical Critique of the Nature of the Firm, Agency Theory and Shareholder Theory

Abstract:

Standard accounts on the nature of the firm are highly dependent on explanations by Coase, coupled with inputs from agency theory and shareholder theory. This paper carries out their critique in light of personalist and common good postulates. It shows how personalist and common good principles create a framework that not only accommodates business ethics better but also affords a more compelling understanding of business as a whole.

Key Words: Nature of the Firm, Agency Theory, Shareholder Theory, Personalism, Common Good.

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The Nature of the Firm, Agency Theory and Shareholder Theory: A Critique from Philosophical Anthropology

Juan Fontrodona and Alejo José G. Sison

Standard accounts on the nature of the firm are highly dependent on explanations by Coase, coupled with inputs from agency theory and shareholder theory. Despite claims to objectivity and value-neutrality, it has been difficult to provide room for a kind of business ethics that recognizes the personal nature of the human being and the contribution of firms to the common good based on such premises. This paper begins by presenting the assumptions made by Coase that are implicit in agency theory and then carries out their critique in light of personalist and common good postulates. It endeavors to show how personalist and common good principles create a framework that not only accommodates business ethics better but also affords a more compelling understanding of business as a whole.

1. Assumptions from "The Nature of the Firm", Agency Theory and Shareholder Theory

In the 1937 article "The Nature of the Firm", Coase asked a simple question that sparked a far-reaching debate: Why the firm and not the market? Until then, economists had taken the firm as the smallest unit of business activity for granted. Coase's merit lay

in asking what made the firm a better means of managing production than the market.

For Coase, the firm exists to allow the entrepreneur —instead of the market— to coordinate production. A firm, therefore, consists in a system of relationships where the entrepreneur takes charge of managing resources (Coase, 1937). This contrasts with the account of classical economics in which the price mechanism of the market coordinates production. Although the individual makes forecasts and chooses among different options, resource management ultimately depends on market prices.

Coase points out that production decisions are often made for reasons other than price. An employee may switch jobs within a company not because of any change in prices, but simply because of a superior's orders. Thus, Coase concludes, while outside the company decisions are taken in accordance with market exchanges, inside, the superior decides.

Now then, why should the firm as a hierarchical organization coordinate production better than the market? For Coase the answer lies in the cost savings. Costs associated with determining prices and negotiating contracts would be saved when production is coordinated within the firm (Coase 1991b, 1937). Organizing production within the firm makes sense because operating costs are less than the transaction costs in the market. In a commentary on 'The Nature of the Firm' Coase explicitly states his purpose: to establish cost as the deciding factor after comparing between coordinating production within the firm and through the market (Coase 1991b).[1]

A couple of observations are here in order. By positing cost reduction as the reason behind the firm's existence, Coase falls into the same error that he criticized in classical economics. Once again it is price —reduced transaction costs— that

determines production decisions. Coase may have introduced greater complexity by comparing costs outside and inside the firm, but the decision-making paradigm has not changed.

Coase envisions the firm essentially as an instrument in the service of economic efficiency or cost reduction. It has been noted that based on these assumptions, the firm, as an economic actor, is not different from individuals who act solely on the basis of economic motives, maximizing their own interests. As an institution, the firm is of no value in itself. In fact, in an ideal market situation where transaction costs are reduced to a minimum, there would be no need for firms at all (Martínez-Echevarría, 2000).

However, Coase fails to explain exactly how and why the firm reduces production costs. He takes for granted that the firm, by its very existence, reduces transaction costs. Yet, as he himself admits, in some cases firms cause production costs to rise. For example, a growing company incurs extra costs and forfeits the advantages of a smaller size. Years later, Coase himself recognized this shortcoming: “The Nature of the Firm” had left the job half-finished (Coase, 1991a, 1991b). Still lacking was a cogent account of why transaction costs were lower in some firms than in others; that is, a precise explanation of how firms reduce production costs.

Shankman (1999) has signalled that Coase's insights on the purpose of the firm went unnoticed for decades until they were rediscovered by Ross (1973), and Jensen and Meckling (1976), under the guise of agency theory. Cost reduction is achieved in firms largely through the establishment of what Jensen and Meckling call *agency relationships*. These relationships take the form of contracts —not necessarily explicit nor formal— in which one party (the *principal*) engages another (the *agent*) to perform

some service on its behalf, delegating certain decision-making power (Jensen and Meckling, 1976). In firms, the shareholder stands for the principal and the manager, for the agent. The agent thus acquires legal and economic obligations towards the principal. Supporters of agency theory underscore, among its positive features, the realism with which it describes relationships among individuals in a company (Eisenhardt, 1989). The firm is no longer considered as a single, monolithic actor but the complex set of interactions among several individuals. The firm is now presented as a nexus of contracts between principals and agents (Shankman, 1999; Martland, 1994).

Typically, there are different goals and interests among individuals involved in an agency relationship. Agency theory presupposes that individuals are opportunistic, that is, they constantly aim to maximize their own interests (Bohren, 1998). Thus, there is no guarantee that agents will always act in the best interests of principals. Rather, there is a constant temptation for agents to maximize their own interests, even at the expense of principals.

Under conditions of incomplete information and uncertainty prevalent in business settings two kinds of problems arise: adverse selection and moral hazard (Eisenhardt, 1989, p. 58). Adverse selection refers to the possibility of agents misrepresenting their ability to do the work agreed; in other words, agents may adopt decisions inconsistent with the contractual goals that embody their principals' preferences. Moral hazard, on the other hand, refers to the danger of agents not putting forth their best efforts or shirking from their tasks.

This divergence between the interests of the principal and the agent unavoidably generates costs. *Agency costs* are residual costs that result in a failure to maximize the

principal's wealth. These may be incurred by the principal ––through measures to control the agent's behavior— or by the agent —through efforts to demonstrate his commitment to the principal's goals.

The whole point behind agency theory is to come up with mechanisms that ensure an efficient alignment of interests between agent and principal, thereby reducing agency costs (Shankman, 1989, p. 321). Here it coincides fully with what Coase had set as the purpose of the firm. Principals are thus challenged to design contracts that protect their interests and maximize their utility in case of conflict. These contracts are based on several assumptions regarding agents (self-interest, limited rationality, risk aversion), organizations (goal conflict between members) and information (assymetrical) (Shankman, 1989, p 332).

The time has come for a closer look at the assumptions agency theory makes regarding actors, assumptions it shares with neoclassical economics. Methodologically, agency theory subscribes to individualism: its basic unit of analysis is the human being fully constituted as an individual and bereft of any social dimension. In every endeavor individual agents seek above all their own utility (utilitarianism) or pleasure (hedonism), the satisfaction of their own desires. They form groups not to fulfil any requirement of their proper flourishing as human beings but only to further their particular interests (contractualism). Outside of this, agents do not subscribe to any moral imperative; they willingly engage in immoral conduct whenever convenient. Acting morally would be reasonable only if it presented a greater economic incentive in terms of utility and pleasure than the contrary (Bohren, 1998).

These assumptions of individualism, utilitarianism or hedonism, and

contractualism regarding agents bring forth a number of implications when agency theory is applied to firms. They bear heavily on the understanding of property and of the firm, as well as on the subsequent management philosophy. These propositions may be summarized as follows:

1. Shareholders own the firm.

2. Shareholders act in accordance with the criterion of utility maximization.

3. The firm is a nexus of contractual relationships.

4. The purpose of the firm is to maximize shareholder value.

Critics of agency theory mostly focus on these assumptions (Brennan, 1994; Perrow, 1986). For De George (1992), they are sufficient to render agency theory applied to firms incompatible with any ethical theory. Duska (1992) admits that they may provide a plausible explanation of the firm; nonetheless, it would be better to adopt non-egotistic assumptions. For similar reasons, Koford and Penno (1992), on the one hand, and Wright *et al.* (2001), on the other, have all proposed to relax the force of these assumptions. One way of doing so has been explored out by Aoki (1984) who, like Evan and Freeman (1993), has studied the relationship of agents to multiple principals apart from just shareholders.

What follows is an attempt to evaluate agency theory assumptions and their application to the firm from the perspective of philosophical anthropology. We shall call this the "humanistic model". Our choice of philosophical school is that which understands the human being as a person, that is, with a nature that is equally social or relational and individual at the same time. The different groups that human beings form

—including the firm— receive their ultimate justification in the measure that they contribute to the common good. By distancing ourselves from Coase's view on the nature of the firm and Jensen and Meckling's perspective on agency theory, we hope to provide an explanation for both the firm and agents more in keeping with true human nature.

2. Who owns the firm?

A common form of agency relationship is that found between managers and shareholders in a firm. Managers are agents of shareholders who, as principals, seek returns on their investment (Quinn and Jones, 1995). The normative implication is that managers maximize the net present value of the firm, which is supposed to be the shareholders' goal (Shankman, 1999). Two assumptions are involved here: first, that shareholders own the firm, and second, that the shareholders' interest is to maximize the value of the firm. In this section, we shall consider the first of these assumptions and leave the second for later.

The assumption that shareholders own the company is not justified even within the framework of agency theory itself. If the firm is a "nexus of contracts", then no one owns the firm, because one cannot own a mere nexus. There can only be owners of the various production factors; but even then, there is no reason to equate "owning capital" with "owning the firm" (Fama, 1980).

The modern business enterprise distinguishes between providers of capital, on one hand, and managers, who make and execute decisions regarding the firm's activities, on

the other (Maitland, 1994). Undoubtedly, there may be people who play a double role: shareholders who take on managerial responsibility or managers who acquire shares. However, although some investors may want to take an active part in running the business, the majority would be content with being able to sell their shares at a profit (Fama, 1980). Whether these uncommitted shareholders should really be called owners of the firm is indeed questionable. Since they limit themselves to lending money and seeking returns, perhaps they should not even be called partners in the enterprise (D'Ors, 1979).

Certainly, investors assume risks in entrusting their capital to a company, and somehow, these risks increase because decisions on its use depend on someone else, that is, management. Capitalists are said to assume the greatest risk —they are the last in line when the firm goes bankrupt— and because of this, it is argued that company activities should be directed primarily towards protecting their interests.

However, several arguments can be made against this reasoning. First of all, other parties —such as managers and employees— take risks as well by committing their labor to the company. Secondly, while shareholders can reduce their risk by diversifying their investments, this is more difficult for employees to do. And even if workers were to hold different jobs, most likely, they do so not to diversify risk, but simply to make ends meet. Furthermore, shareholders normally have access to efficient capital markets that guarantee liquidity; employees have no such equivalent in the job market. That shareholders are the ones with the greatest risk is, therefore, controversial, to say the least. Consequently, there is no straightforward justification for giving them preferential treatment (Buchholz and Rosenthal, 1998).

Capital is never anonymous; it always belongs to someone, to a person called the capitalist. The ownership and use of capital is subject to moral considerations (John Paul II, 1991, n. 36). However, the link between capital and the capitalist is weaker than the one between work and the worker (Llano, 1998): People *own* capital, whereas they *do* work; the worker is internally linked to his work, while the capitalist is only externally linked to his capital.

There is another, more radical objection besides. Only things, plants and animals can have owners; except for slaves, people do not have owners. People therefore should not be owned, because that would reduce them to the status of something non-human. Neither then should organizations —which are ultimately composed of human beings— have owners. A family, a club or a political party has members, and a local community, residents or citizens, but not owners. To say that a firm has owners implies either a mechanistic view, that reduces it to a sequence of processes, or an economistic view, according to which the company is the mere sum of its physical and financial assets. If the firm is not just a thing, then it cannot have an owner. Otherwise, we may inadvertently be preserving a remnant of slavery within our modern capitalist system (D'Ors, 1979).

In sum, agency relationships by themselves do not imply that there should only be one principal nor that he should own the firm. Rather, there are multiple relationships among the owners of the different factors of production. For this reason, *stakeholder theory*, which takes into account the different actors owning labor, capital, and so on, offers a more comprehensive view of the firm than shareholder theory (Shankman, 1999).

Llano (1998) concludes that the firm results from the conjunction of at least three factors, capital, management and labor. There is no compelling reason for capital to be the principal factor (Llano, 1998).

As Drucker (2001, p. 16) says, a firm's chief asset is its human capital:

> The means of production is knowledge, which is owned by knowledge workers and is highly portable. . . . Knowledge workers provide 'capital' just as much as does the provider of money. The two are dependent on each other. This makes the knowledge worker an equal – an associate or a partner.

We then ought to find a different way of thinking about the firm besides ownership. As Handy (2001, p. 86) recently remarked:

> My guess is that we shall, eventually, have to abandon the myth that shareholders own a business. They will be more like mortgage holders, entitled to a rent for their money, in this case a variable rent depending on the profits, but with no rights to sell the company or to close it down, unless it defaults. The shareholders contribute their money. Others contribute time, skills, ideas and experience. These, too, are entitled to a rent, variously fixed. No one owns anything. The very idea that a collection of people turning ideas into products is a piece of property that can be owned by someone else will come to seem absurd.

In a knowledge economy, there are no longer owners in the traditional sense. Firms, like other human organizations, have members or stakeholders bound by a "nexus of contracts". They all bear risks in exchange for rents. In such a society, it is the knowledge worker —not the shareholder or capitalist— who has the strongest claim to the firm among the various stakeholder groups.

3. Is there any other interest apart from economic interest?

The methodological individualism of neoclassical economics teaches that human beings always seek to maximize their own interest, and that this interest is invariably economic. Hence, a two-fold reduction is effected: that of interest to self-interest, and that of self-interest to economic self-interest.

Undeniably, whenever a subject decides, his decisions serve an interest. However, his self-interest should not be the only one considered. If the interests of other people are not taken into account, there will be less information available and it will be more difficult to make the right decisions (Pérez-López, 1991). Some theories suggest that an agent can only take other people's interests into account by adopting a 'neutral' or 'impartial' attitude (Rawls, 1971). It is difficult to see, in practical terms, how anyone could make decisions from such a neutral position without considering the particular context in which decisions take place (O'Neill, 1997). What is needed is not so much 'impartiality' as the willingness to consider all available information, including the interests of others. It is not that decision-making must be disinterested, but the overriding interest need not always nor exclusively be one's own.

The expression 'enlightened self-interest' has sometimes been used to skirt the troubles caused by individual self-interest. However, this needs to be understood correctly, as *prudence* or care in taking other people's interests into consideration. Otherwise, as *cunning* or readiness to use other people to advance one's own selfish interests, it would not mark any improvement over methodological individualism.

The theory of motivation has come up with a host of alternatives to purely economic self-interest. If motivation is the attraction toward certain goods, we have to

acknowledge that human beings are driven by various motives besides money. Furthermore, motives have been enriched with new, mostly non-economic elements, and the decision-making process has become more complex, with the inclusion of criteria other than self-interest (Vélaz, 1996).

If behavior within the firm were simply a matter of maximizing profit, the main problem would be making correct calculations among the expected results. But since motives are not exclusively economic and belong to different orders, mere maximization in a single realm is not a viable option.

An alternative to profit maximization would be the following decision-making procedure. First, one must guarantee a minimum level of satisfaction in the different motivational areas (ethical, economic, societal). Afterwards, managers could then choose from among different options the one that best fosters economic growth (Pérez-López, 1991). Their choice will reflect both the ethical quality and the economic acumen not only of themselves but also of the organization they represent.

The variety of motives for which individuals join organizations poses an additional problem. Managing a business makes it necessary to bring different individual goals into harmony. As Barnard pointed out in *The Functions of the Executive* (1938), the efficiency of an organization depends on maintaining its members' willingness to work together; this, in turn, depends on the degree to which every individual achieves his goals.

In looking for incentive or control systems that persuade the agent to respond as the principal requires while at the same time subscribing to the principle that individuals act out of self-interest, agency theory falls into an inconsistency. If human beings

always pursue their own selfish interests, there is no reason to suppose that agents will not renege of their commitments when it serves their interest. This means that the firm is built on very shaky foundations. We would have principals motivated by self-interest demanding loyalty from agents as self-interested as themselves (Duska, 1992). This would be the epitome of an 'economy of suspicion', in which ethics becomes a frustrating attempt —with its attendant cost— to try to ensure that agents fulfil the principal's wishes.

The solution commonly adopted is to provide incentives for managers and employees that align their interests with those of shareholders. Apart from its negative secondary effects which surface right when the economy flags (just think of the controversy over stock options), we need to question whether this is really the best for the firm. This policy may lead to an impoverishment of business activity instead. Economic incentives by themselves do not tend to foster long-term patterns of conduct, but only short-term, opportunistic behaviors. Yet, the idea of stable, long-term relationships was precisely one of the main arguments used to justify the existence of firms. Therefore, resorting to short-term economic incentives alone runs counter to the long-term survival of the firm as such; it only ends up generating higher costs.

We deduce from the foregoing that agents cannot be motivated solely by economic self-interest. What is more, non-economic interests (ethical, societal, and so on) are precisely the ones that favor the long-term survival of the firm. It is not so much a matter of maximizing profits as ensuring that each agent obtains the minimum motivational satisfaction, thus sustaining his willingness to participate in the firm.

4. Is the firm anything more than a nexus of relationships?

According to agency theory, the firm is primarily a nexus of contractual relationships among agents and principals. It is a legal fiction that stands for the complex process of maintaining an equilibrium among conflicting individual goals (Jensen and Meckling, 1976). However, the firm does not necessarily have to be understood that way. Indeed, such a notion of the firm fails to comprehend fully the social nature of the human person.

As Llano (1998) pointed out, a company can be described in several ways. One would be in terms of the things it produces; another, through the activities it carries out; and a third, by way of the people who work in it. This third way of looking at the firm introduces a small but significant shift. It emphasizes the nodes of relationships, not the relationships themselves. As a result, people are accorded importance in their own right and not merely seen as playing a role in the company.

When the emphasis is on relationships, people tend to be understood in terms of their functions. By contrast, when the emphasis is on the nodes of relationships, people are accorded a value in themselves. Thus, the firm is understood as "a community of persons, in which the condition of being a person prevails over any other condition, including the condition that derives from their belonging to the community that we call a firm" (Llano, 1998, p. 54). The person is not reduced to what he does for the firm and, instead, his intrinsic worth is recognized. Every person has a value and goodness in his own right which clothes him with dignity.

Koslowski (1983) compares two different views of business and the role that the person plays within each of them. According to the mechanistic view, the firm is no more than the sum of its parts. This undervalues people by considering them as mere parts that are interchangeable within the whole. On the other hand, the organicistic model teaches that the firm as a whole is greater than the sum of its parts; it is an entity greater than the people who comprise it. However, the organicistic view also underrates the value of individual members by subjecting them completely to the organization. Thus, he concludes, the organicistic view encourages a manipulative environment and is not a good alternative to the mechanistic model.

The model that we propose coincides with the organicistic model in considering that an organization is more than just the sum of its parts. Unlike the organicistic model, however, it upholds the intrinsic value of every person. From this perspective, the firm is understood as a community of persons, that is, as a plurality of persons united by a common goal of a moral rather than a material nature. The firm is justified through its contribution to the common good. As Alford and Naughton (2001, p. 41) explain:

> Historically, a common good is considered to be a human perfection or fulfilment achievable by a community, such that the community's members all share it, both as a community, and singly, *in* their persons. A common good, then, is *neither* a mere amalgam of private and particular goods *nor* is it a good of the whole that disregards the good of its members. While we argue that business is not responsible *for* the common good, it is, like all communities, responsible *to* the common good.

An interpretation of the organization in terms of relationships implies subjecting it totally to the logic of the market. In contrast, when we put the emphasis on the persons who sustain these relationships, we are saying that they are the ultimate points of

reference. The resolution of conflicts of interest will, therefore, have to begin with the acknowledgement and safeguarding of fundamental human rights before proceeding with a market-like negotiation of interests.

The humanistic model modifies the traditional agency theory assumption that the firm is a mere nexus of contractual relationships. Beyond that, the firm is a community of persons, each possessing intrinsic worth and dignity. The nodes of relationships that represent persons are more important than the relationships themselves, which only represent the persons' functions.

5. What is the purpose of the firm?

The fourth and final assumption of agency theory flows logically from the previous three. If agents are committed to achieve the goal set by the principal or shareholder, and the principal's only interest is economic, then the purpose of the firm is to maximize shareholder wealth. However, if we accept that the shareholder does not own the company, then he is not the only one whose interests must be taken into account. Furthermore, if the interests of the different agents go beyond the purely economic, then the firm is no longer just an instrument to maximize economic utility.

A firm must produce things that people want and do so efficiently such that consumers are able to acquire its products at a good price. This could only happen if it has a well-trained workforce. In such conditions, the company could expect satisfactory sales and profit levels (Buchholz and Rosenthal, 1998). That the business process ends with the company earning a profit does not mean that profit is the end for which the

company exists. Similarly, human beings need to eat in order to live, yet nobody would suggest that our sole purpose in life is to eat. Companies need to make a profit because without it they would not be able to stay in business, but that is not, strictly speaking, their purpose.

Profits result from doing things well, but they are only one result among many. In like manner, when we do things we enjoy or when we satisfy a need, we feel pleasure. But that does not mean that happiness lies in the pursuit of pleasure; rather, it consists in carrying out certain tasks and obtaining certain goods that in turn afford us pleasure. Profits, like pleasure, are a supererogatory end that is achieved when activities are done properly.

Just as the direct pursuit of pleasure ends up justifying any manner in which it is obtained, the direct pursuit of profit ends up justifying whatever means employed to achieve it. Profit may also be obtained by doing what is not right (for example, selling harmful products, giving way to corruption or engaging in fraud). Therefore, a company's income statement does not necessarily reflect its ethical level. Justifying a company's existence exclusively by its profits is unacceptable.

Rather than a single purpose of the firm, it seems more appropriate to speak of multiple purposes, including non-economic ones. Among these we find the production of goods and services that contribute to the improvement of society, the provision of an environment in which employees can develop themselves personally and professionally, the creation of wealth and its fair distribution, and so forth (Buchholz and Rosenthal, 1998; Melé, 1997).

Business schools usually base their teaching on the assumption that the purpose of

the firm is to maximize shareholder wealth. Finance and accounting theories are heavily influenced by agency theory, and students are taught that the best way to keep employees and managers in line with the company's goals is by creating appropriate incentive systems. From these assumptions, acting honestly is not a matter of moral excellence but an unintended offshoot of the market itself (Bohren, 1998).

If managing companies were that simple, it would be sufficient to teach ever more sophisticated measurement and control techniques. But since management is above all a matter of choosing goals, requisite observation skills are, in truth, more important than measuring instruments. Above all, moral skills or virtues —a distinct form of capital (Sison, 2003)— have to be developed. The analytical skills provided by the empirical sciences need to be complemented with a humanistic education.

This does not mean that business education should be the exclusive preserve of the humanities. We simply would like business executives to receive a sound humanistic grounding and that research centers formulate theories based on personalist assumptions (Llano, 1994).

Although economic logic presents itself as value neutral, it has a clear normative intent: any action that contributes to the maximization of profit is ethical. This becomes the only acceptable option. What sets this discourse apart from others is not its apparently 'non-normative' nature, but that it assigns ethics an instrumental role in the maximization of economic utility.

The financial paradigm, which equates excellence with efficiency in gaining material goods, has made virtue the handmaiden of profit. However, as Dobson (1997) has pointed out, unlimited material wealth coupled with moral ignorance eventually

becomes an obstacle in achieving what in the long run is more valuable and necessary. The emphasis on ‘creating value for the shareholder’ implies a ‘short-term’ outlook, which leads firms to sacrifice long-term goals (Kennedy, 2000).

The firm is a social organization, in which individuals pursue a common goal without excluding their own private goals. The common goal is what unites the organization. Adopting a distinction made by Pérez-López (1995), we can say that this goal has a dual dimension: internal and external.

The external mission of the firm is to efficiently produce goods and services that contribute to the well-being of society. In view of the customers’ dignity, the firm cannot offer just any kind of good or service. It has the duty to offer goods and services that meet real needs. Moreover, the firm’s mission is not only to create economic value, but also to distribute it fairly.

In order to carry out its activity, the firm draws on the abilities and skills —not only technical skills, but also moral habits or virtues— of its people. This internal mission of the firm sometimes goes unnoticed; yet it clearly differentiates one company from another. Each firm tries to develop a specific and distinctive range of competencies that is hard to imitate. This is what gives the firm its competitive advantage, its distinctive source of value. Martínez-Echevarría (2000) notices that the firm’s singularity —what the Greeks called *arete*, excellence— resides first and foremost in its people, secondly in the organization, and lastly in its products.

From this humanistic perspective, we realize that the firm is an institution meant to provide a favorable environment for individuals to better themselves, both materially and morally, through reciprocal relationships: “Individual virtue —by minimizing

agency costs— supports the economic role of the firm, while the structure of the firm itself as a nurturing community encourages individual virtue" (Dobson, 1997, p. 148). The assumption that the purpose of the firm is to maximize shareholder wealth is not only excessively narrow but also false.

6. Conclusion

We propose that the firm be understood as a body of agents who, without renouncing to their personal interests, agree to coordinate their activities to achieve a common goal. However, the assumptions of agency theory to date have been inimical to this concept of the firm. In the previous sections, we have analyzed these assumptions and identified their flaws. We then put forward an alternative set of assumptions for a new, humanistic conception of the firm.

Coase justified the existence of the firm in terms of a reduction of costs although he never explained what made this possible. Our critique of the assumptions of agency theory yields a different answer to the question of why the firm and not the market. It also accounts for the cost savings Coase was unable to explain. Firms exist, primarily, not because of cost reduction, but because of the need for different competencies or the division of labor. These competencies are the fruit of the combined efforts of individuals seeking a common goal. Understanding the firm as a node of competencies goes beyond methodological individualism, because it is no longer the result of a mere aggregation of individual skills, but the product of a shared culture and a common goal (Martínez-Echevarría, 2000).

The way business has evolved in the knowledge economy reflects Coase's ideas to some extent. Everyone agrees that new technologies have the advantage of reducing transaction costs. Firms are opting more and more to transfer operations to external providers and manage them in the market. Coase's ideal world with no need for firms comes closer to becoming a reality. It has even been suggested that, eventually, the firm's only competency will be its ability to coordinate activities already subcontracted in the market (Sawhney and Parikh, 2001).

Clearly, there is no reason that firms should continue to exist in the same way as they have until now. But in anticipating changes in how firms will be organized, it is important to ensure a series of norms or principles. First, the new forms of organization should give priority to persons rather than to relationships; second, utmost care should be taken such that social capital does not diminish (Putnam, 2000) and people continue to have a favorable environment to develop their abilities; and lastly, the logic of the market should not be allowed to rule over the entire sphere of human relations.

All these can be achieved to the extent that agency theory is rehabilitated with a new set of assumptions centered on the human person:

1. The firm, since it is a human institution, has various members and no single owner.

2. The members or stakeholders of the firm do not only pursue economic interests, but non-economic ones as well. Neither does their self-interest necessarily exclude the interests of others.

3. Rather than as a nexus of contractual relationships, the firm is more

appropriately defined as a community of persons, each of whom is endowed with a unique dignity.

4. The purpose of the firm is not to maximize shareholder wealth but to provide an opportunity for stakeholders to develop themselves both materially and morally through the relationships they establish.

Notes

[1] In a conference to commemorate the fiftieth anniversary of the publication of "The Nature of the Firm", Coase gave his thoughts on the significance of his paper, "The Nature of the Firm: Meaning" (Coase 1991a), and its influence, "The Nature of the Firm: Influence" (Coase, 1991b). These valuable reflections complement the original text and we shall take them into account in our argument.

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