The Shareholder and Stakeholder Theories of Corporate Purpose

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Introduction

There is a continuing debate about what the purpose of the modern corporation should be. On the one hand, there are many scholars and practitioners who draw on an impressive body of theory and research to argue that the sole purpose of business should be the maximization of shareholder wealth. On the other, there is a growing call by a broad base of constituency groups of business including customers, institutional shareholders, environmental and social activists, academics, government regulators, nongovernmental organizations, and businesses themselves for corporations to act responsibly toward the environment and toward all people affected by the corporation (The stakeholders).

Thus there are two contradicting and contrasting theories of corporate purpose. Shareholder value theory sets the purpose of the firm as the maximization of financial returns for shareholders. It is the dominant theory espoused and theory-in-use in business schools and in the vast majority of businesses in capitalist economies. Shareholder theory is then contrasted with stakeholder theory—the dominant theory espoused in the field of corporate social responsibility. Stakeholder theory expresses the idea that business organizations are dependent upon stakeholders for success, and stakeholders have some stake in the organization. Stakeholder theory suggests the purpose of the firm is to serve broader societal interests beyond economic value creation for shareholders alone.

Though lively, this debate is typically carried out in either/or terms. Either the purpose of a corporation to maximize shareholder value or it is to provide some larger service to society (Merton, 1976). Many researchers and leaders involved in business, however, desire a both/and
world. They want to find ways to maximize both shareholder value and societal contribution for all stakeholders.

**Shareholder Value Theory**

Shareholder value theory is the dominant economic theory in use by business. Maximizing shareholder wealth as the purpose of the firm is established in our laws, economic and financial theory, management practices, and language. Business schools hold shareholder value theory as a central tenet. Nobel Laureate Milton Friedman (1970) strongly argues in favor of maximizing financial return for shareholders. His capitalistic perspective clearly considers the firm owned by and operated for the benefit of the shareholders. He says ‘there is one and only one social responsibility of business - to use its resources and engage in activities 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. …’

Friedman’s statements reflect three fundamental assumptions that lend support to the shareholder view of the firm. The **first** is that the human, social, and environmental costs of doing business should be internalized only to the extent required by law. All other costs should be externalized. The **second** is that self-interest as the prime human motivator. As such, people and organizations should and will act rationally in their own self-interest to maximize efficiency and value for society. The **third** is that the firm is fundamentally a nexus of contracts with primacy going to those contracts that have the greatest impact on the profitability of the firm.

1. **Externalization of Costs**

According to this perspective, maximizing shareholder value as the goal of the firm is the means to most efficiently achieve the best outcome for society (Jensen, 2001). Taken literally, however, this theory holds that management should run the business to maximize cash flow to shareholders—maximizing revenue, minimizing cost, and reducing risk. One way to reduce cost is by externalizing it through such means as polluting the environment. A way to increase revenue is
to sell products that have a greater cost to society than is covered in the costs of the product, such as cigarettes or sport utility vehicles. In contrast to Friedman (1970), Carroll (1979; 1999) developed a framework for legitimizing ethical and philanthropic considerations in management action. Though Carroll’s stakeholder view of the firm is offered as an alternative to Friedman, both consider the economic aspect of business as the primary benefit for society. Carroll does go beyond Friedman in defining four legitimate roles of business. The following figure replicates Carroll’s four responsibilities of corporate social responsibility as presented in the Wheelen and Hunger strategy textbook (p. 39)

2. Self-Interest as the Prime Human Motivator

The fundamental assumption of modern economic theory is a view of the individual self, acting rationally in self-interest (Ferraro et al., 2005). Amartya Sen (1977) wrote: "The first principle of Economics is that every agent is actuated only by self-interest" (p. 317). The view of Friedman (1970) is traceable back to Adam Smith (1776)—every person acting rationally in their own self-interest maximizes efficiency and value for society. Building on “individual motivated by self-interest” model, agency theory (Berle & Means, 1932) predicts a conflict between shareholders (principals) and managers (agents) in a publicly owned corporation. Unless appropriate
governance structures are emplaced, managers will act in their own self-interest and not in the interests of the shareholder (Jensen & Meckling, 1976). This theory reflects a Theory X (McGregor, 1960) story of the individual manager seeking to maximize his or her compensation and avoid punishment.

3. The Firm as a Nexus of Contracts in Service of Profitability

The nexus of contracts theory (Alchian & Demsetz, 1972; Coase, 1937) depicts the firm in a web of implicit and explicit contracts with stakeholders; however, the shareholder has primacy over other stakeholders (Margolis & Walsh, 2003). The board and management continue to have a fiduciary responsibility to maximize shareholder value (Bainbridge, 2002). The firm as a nexus of contracts describes the firm in relation to its environment—a view of the firm looking outward into its environment. Resource dependency theory provides a similar view wherein it describes power/dependence relationships (Pfeffer & Salancik, 1978) between the firm and other actors in its environment and enables primary attention to those stakeholders in the environment who have the greatest impact on the profitability of the firm.

Legitimization of Shareholder Theory

That business exists to maximize the interests of shareholders is so socially ingrained into the financial community, many of us believe it to be an uncontestable truth. It takes form in business school, is proliferated in and reinforced in practice, and is legitimated through other sources, from the U.S. Securities and Exchange Commission (Levitt, 2000) to the Royal Swedish Academy of Sciences and Bank of Sweden who award the Memorial Nobel Prize in Economics. The work of the Nobel laureates in financial theory (under the field of economics) accepts shareholder wealth maximization as a given assumption (Markowitz, 1952; Modigliani & Miller, 1958; Sharpe, 1964). In sum, dominant views on corporate governance and curricula of most business schools support the perspective that the sole purpose of business in our community is business. Business acting beyond its economic concerns is at best misguided (Jensen, 2001) and is misallocating and/or misappropriating societal resources (Easterbrook & Fischel, 1991; Friedman,
1970; Sternberg, 1997). Business adds value to the economy through the efficient delivery of goods and services. Social and environmental concerns are related to business through the marketplace and governmental regulations.

**Stakeholder Value Theory**

The intention of stakeholder theory is to offer an alternative purpose of the firm. Stakeholder theory suggests the purpose of the firm is to serve broader societal interests beyond economic value creation for shareholders alone. It is becoming central to the important story of business in society. The concept of Stakeholder theory is ascribed to R. Edward Freeman (1984) whose original concept was that managers have a moral obligation to consider and appropriately balance the interests of all stakeholders. Evan and Freeman (1993) stated, “A stakeholder theory of the firm must redefine the purpose of the firm…the very purpose of the firm is…to serve as a vehicle for coordinating stakeholder interests” (pp. 102-103). Stakeholder theory expresses the idea that business organizations are dependent upon stakeholders for success, and stakeholders have some stake in the organization. Stakeholder theory is now foundational to business ethics courses in MBA programs (Carroll & Buchholtz, 2006; Jennings, 2002). Schneider (2002) posits that stakeholder theory extends the concept of ownership of the firm beyond that of the traditional legal or economic owners of the firm, who become a stakeholder by contribution of capital or other means that results in equity ownership.

The question of who is a stakeholder is controversial. Questions arise such as whether stakeholders represent a broad class of those who are affected by or affect the corporation (Evan & Freeman, 1993, p. 79), or are only “those individuals and constituencies that contribute…to [the firms’] wealth-creating capacity and activities” (Post, Preston, & Sachs, 2002, p. 19). If stakeholder theory includes only those who affect the corporation and its profits, then it becomes subordinate to shareholder value theory, not an alternative to it. A broad framework of stakeholders is offered by Wheeler and Sillanpää (1997). They include four categories of stakeholders: primary social, secondary social, primary non-social and secondary non-social.
Primary stakeholders are vital to a corporation’s success and secondary stakeholders are less influential.

**Table 1. Stakeholder Framework**

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<th><strong>Primary Social Stakeholders</strong></th>
<th><strong>Secondary Social Stakeholders</strong></th>
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<tbody>
<tr>
<td>* Shareholders and other investors</td>
<td>* Government and regulators</td>
</tr>
<tr>
<td>* Employees and managers</td>
<td>* Civic institutions</td>
</tr>
<tr>
<td>* Customers</td>
<td>* Social pressure groups</td>
</tr>
<tr>
<td>* Local Communities</td>
<td>* Media and academic commentators</td>
</tr>
<tr>
<td>* Suppliers and business partners</td>
<td>* Trade bodies</td>
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<td></td>
<td>* Competitors</td>
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<table>
<thead>
<tr>
<th><strong>Primary Nonsocial Stakeholders</strong></th>
<th><strong>Secondary Nonsocial Stakeholders</strong></th>
</tr>
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<tbody>
<tr>
<td>* The natural environment</td>
<td>* Environmental interest groups</td>
</tr>
<tr>
<td>* Future generations</td>
<td>* Animal welfare organizations</td>
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<td>* Nonhuman species</td>
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While stakeholder theory began as an alternative to shareholder value theory, it has diverged along two paths: **normative** and **instrumental**. The normative stakeholder path continues in the tradition of a view of the firm in relationship to its various stakeholders with no stakeholder having preeminence. The instrumental path, however, attempts to connect stakeholder management to wealth creation. In doing so, instrumental stakeholder theory becomes a subset of shareholder value theory.

Goodpaster (1991) builds on the work of Freeman (1984) and divides stakeholder theory into three approaches of strategic, multifiduciary, and a synthesis. The **strategic approach** to stakeholder theory views stakeholders instrumentally. Stakeholders are means to generating a profit for shareholders. Stakeholders might be considered depending on the extent they can positively or negatively influence profits. The **multifiduciary approach** views the firm as having a fiduciary responsibility to all stakeholders, not just shareholders. The concerns of the broader community of stakeholders are taken into account and no one stakeholder is assumed dominant. The **synthesis approach** combines elements of both. The corporation has a moral and ethical duty to stakeholders, but the fiduciary responsibility remains solely to shareholders.
Stakeholder theory represents a continuum of assumptions as shown in Figure 2. Depicted on the right end of the continuum, normative stakeholder theory stands in antithesis to shareholder value theory. It presents a view of the corporation balancing a community of interests for the benefit of all. At the other end of the continuum, on the left side under shareholder value theory, instrumental stakeholder theory describes managing stakeholders who are vital to the firm’s profitability—essentially the same perspective as shareholder value theory.

**Figure 2. A Continuum of Stakeholder Theory**

The central question of stakeholder theory is whether it is primarily an instrumental tool to advance the interests of the shareholder or a normative guide balancing the legitimate interests of all stakeholders. Whether stakeholders are ends in themselves or a means to an end for the benefit of shareholders?

**Instrumental Stakeholder Theory**

According to Donaldson and Preston (1995), the instrumental view “…establishes a framework for examining the connections, if any, between the practice of stakeholder management and the achievement of various corporate performance goals” (pp. 65-66). From the instrumental body of research come the terms corporate social performance (CSP), corporate financial performance (CFP), and stakeholder management. An assumption of the instrumental argument is that managing stakeholders will lead to greater profits. Over thirty years of instrumental research
suggest a clear positive association between the CSP and CFP of a corporation (Margolis & Walsh, 2001; Orlitzky, Schmidt, & Rynes, 2003). In general, of over 130 articles assessing a possible relationship between CSP and CFP, approximately 85% have used CSP as the independent variable predicting CFP. In their seminal article, “Corporate Social Responsibility and Financial Performance,” Cochran and Wood (1984) measured and linked socially responsible corporate behavior to financial performance. They proposed that action taken for the benefit of a broader group of stakeholders have a positive influence on shareholder wealth creation. Many other studies support this perspective. For example, Waddock and Graves (1997) found corporate social performance to be positively correlated to past and future financial performance.

Hillman and Keim (2001) describe stakeholder theory from a strongly instrumental view in testing relationships among shareholder value creation, stakeholder management, and the firm’s participation in social issues. They find, “Building better relations with primary stakeholders like employees, customers, suppliers, and communities could lead to increased shareholder wealth by helping firms develop intangible, valuable assets which can be sources of competitive advantage” (2001, p. 125). They also find that social contribution beyond that to primary stakeholders destroys shareholder value. Their use of the term stakeholder management is consistent with the dominant view of corporate purpose to be to maximize shareholder wealth.

The majority of the stakeholder literature, often unwittingly, strongly reinforces the status quo of shareholder value theory. Every empirical model designed to link CSP and CFP is an argument implicitly accepting shareholder value theory and relegating stakeholder theory as subordinate.

**Normative Stakeholder Theory**

Normative stakeholder theory is the “fundamental basis” of stakeholder theory (Donaldson & Preston, 1995, p. 68). Normative stakeholder theory assumes that all stakeholders have intrinsic value and no stakeholder has a priority of interests over other stakeholders. The normative aspect has two assumptions that are different from shareholder value theory: relational interest compared
with self-interest and balancing instead of maximizing. A normative aspect of stakeholder theory embraces a view of the corporation balancing the interests of all stakeholders and not maximizing performance for the benefit of the shareholders (Donaldson & Preston, 1995). Margolis and Walsh (2001; 2003) call for expanded agenda for descriptive and normative research. Business as an agent of World Benefit (BAWB) is an example of a research agenda away from trying to prove the economic value of corporate social responsibility. BAWB is a global action research project to generate and forward a dialogue between business and society.

The normative aspects of stakeholder theory account for its difference from shareholder value theory. Normative stakeholder theory provides an alternative explanation of the purpose of the firm and provides a different set of behavioral assumptions. A sense of balancing replaces maximizing and correspondingly, relationship within the environment replaces the individual acting upon the environment. Normative stakeholder theory calls for a view of the firm in broader service to society.

**Implications for Organizational Theory**

Instrumental stakeholder theory is similar to the economic theory of corporate purpose being to maximize shareholder wealth. If merely an extension of economic theory, organizational insights of stakeholder theory only serve to advance the efficiency of wealth generation and miss the other opportunities for organizational theory such as improving the social and environmental consequences of work. Organizational theory needs to play a meaningful role in society in its own right (Bartunek, 2002; Clegg, 2002; Murrell, 2002). How organizations affect the social equity and how social equity is distributed within organizations were central concerns in the emergence of organizational theory from its sociological roots (Hinings & Greenwood, 2002). These questions were supplanted with an increasingly narrower focus toward organizational effectiveness and efficiency. Organizational development and related social sciences must continue to ask the broader societal questions related to organizations and not just serve to make business more effective and efficient (Clegg, 2002; Murrell, 2002). Organizational theory must continue to
address these important questions not only to remain relevant and meaningful, but also if it is to achieve its fullest potential in serving a larger society beyond the status quo of efficiency and effectiveness (Bartunek, 2002; Hinings & Greenwood, 2002). Social constructionist inquiry has the power to unshackle us from the status quo.

**The Social Process of Constructing Reality**

Berger and Luckman (1967) describe social construction as a paradoxical process where humans in community construct social reality and then regard this reality as existing independently of themselves. Reality, produced primarily through language and other forms of communication, then becomes the measurement standard by which people compare themselves in relationship with others.

Many of us have accepted shareholder value theory as some given natural law: “what there is.” Our theories of the firm and its purpose exist from relationship, not from some natural truth or real perspective on the world. Yet, we feel certain of shareholder value as the correct purpose of the firm. We have perhaps lost our awareness that humans invented the story of shareholder value theory. We make sense of the phenomena of our world by telling stories, positing explanations, developing theory. But then, we forget we made up these stories and theories. They do not represent some ultimate truth or given reality. Social Construction describe how humans create their reality, forget they created it, and then measure their accomplishments relative to their creation. However, social construction also offers promise. As we are aware of how our economic and social theories shape our future, we also become aware that inquiry into those can that if we realize that we have invented the stories of our reality, inquiry into those stories can produce an alternate future (Gergen, 1999).

The vast majority of organizational research into corporate social responsibility uses accounting measures such as return on equity, profitability, and change in market value as either the independent or dependent variable in some equation that attempts to show the value created for shareholders by acting in concert with or manipulating other stakeholders. We take it for granted
that a business has to make a profit. Would our outcomes be different if our language of business had a language for reporting measures of joy, fun, challenge, health, well-being, spirituality, environmental beauty, love?

References


