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# From Shareholder Value Maximisation to a More Sustainable Stakeholder- Centred Regime? The Evolution of Corporate Governance Since the Global Financial Crisis

Metropolia University of Applied Sciences

Degree Bachelor of Business Administration

Degree Programme International Business and Logistics

Bachelor's Thesis

Date 29 April 2019

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Author Title Number of Pages Date	Envar Begic From Shareholder Value Maximisation to a More Sustainable Stakeholder-Centred Regime? The Evolution of Corporate Governance Since the Global Financial Crisis 35 pages 29 April 2019
Degree	Bachelor of Business Administration
Degree Programme	International Business and Logistics
Instructor/Tutor	Michael Keane, Senior Lecturer
<p>Corporate governance means a system of rules, practices, and processes by which a firm is directed and controlled. Therefore, corporate governance essentially involves balancing the interests of a company's many stakeholders. In other words, it is a system that a company implements to ensure that it serves its governing objective.</p> <p>Governing objective is essentially a statement of what a company is trying to achieve. The definition of the idea of a firm's governing objective can be deduced from different standpoints. Due to the influence of US hegemony in today's market economy, it can be argued, that the dominating approach to define the idea of a company's governing objective is through the goal of maximising the shareholder value. However, due to the financial crisis of 2008, the theoretical underpinnings of the shareholder value maximisation thinking were questioned. This bachelor's thesis consists of a review of literature in relation to the shareholder value maximisation thinking and aims to describe and discuss how the corporate governance thinking in the Western hemisphere market economy is seemingly shifting towards a more sustainable, regional and stakeholder-oriented way of defining a company's governing objective.</p>	
Keywords	Shareholder theory, Stakeholder theory, creating shared value.

## **Introduction**

Corporate governance means a system of rules, practices, and processes by which a firm is directed and controlled (Chen, 2019). Therefore, corporate governance essentially involves balancing the interests of a company's many stakeholders (Chen, 2019). According to Chen (2019), since corporate governance also provides the framework for attaining a company's objectives, it encloses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure. In other words, it is a system that a company implements to ensure that it serves its governing objective. (Mauboussin and Rappaport, 2016).

According to Mauboussin and Rappaport (2016), the governing objective is the key element upon which the organisation builds its culture, communications, and how it allocates capital. In other words, governing objective is essentially a statement of what a company is trying to achieve (Mauboussin and Rappaport, 2016).

The definition of the idea of a firm's governing objective can be deduced from different standpoints. Due to the influence of US hegemony in today's market economy, it can be argued, that the dominating approach to define the idea of a company's governing objective is through the goal of maximising the shareholder value. However, due to the financial crisis of 2008, the theoretical underpinnings of the shareholder value maximisation thinking were questioned.

This bachelor's thesis consists of a review of literature in relation to the shareholder value maximisation thinking and aims to describe and discuss how the corporate governance thinking in the Western hemisphere market economy is seemingly shifting towards a more sustainable, regional and stakeholder-oriented way of defining a company's governing objective.

## **Literature Review and Key Concepts and Terminology**

My research project will be literature based. The research objective is to comprehensively, critically, and objectively collect, analyse and synthesize the current knowledge on the shareholder value theory.

For this project I have researched and reviewed books, peer reviewed articles, grey literature, press reports, and internet-based materials. The main sources are theoretical textbooks and writings, and any available literature on the different ideological theories. In general, the theories described in this paper are well known and have also been discussed prior to this review. Therefore, the references of this review can be accessed through libraries and online databases.

However, I will synthesise the corporate governance theories described later in the paper to the knowledge gained and developed during my studies at Metropolia, especially during the courses of Global Political Economy, Political Economy of Finance, and Finance. Furthermore, I will approach the corporate governance theories outlined later in this paper in International Relations –context, as from my perspective there is an interconnection between US hegemony and corporate governance. Next, I will provide glossary of key concepts and terms used in this review before moving into the literature review part of this project. The aim is to clarify to the reader what is meant with different concepts and terminology, and how those are understood in the context of this literature review.

### **Key Concepts and Terminology**

**Cultural hegemony** is a theory that addresses the relation between culture and power under capitalism (Nicholas, 2017).

**Managerialism Theory** is a theory of corporate governance with that view that the public corporation as a legal entity created by the state for public benefit and run by professional managers seeking to serve not only shareholders but also stakeholders and the public interest (Styre, 2016).

**Profit vs. economic sustainability.** Profit is a financial gain; a firm's income subtracted its expenses. Economic sustainability is one of three integrated parts of sustainability and means that we must use and sustain resources to create long-term sustainable values by proper governance. The two others are environmental and social (Emas, 2015).

**Public Limited company** is a company whose shares are publicly traded on a stock and usually held by a large number of shareholders (Stout, 2012).

**Shareholder** is an owner of shares in a company (Stout, 2012).

**Shareholder Primacy** is a theory of corporate governance with that view that shareholders interest should be assigned priority relative to other stakeholders (Stout, 2012).

**Stakeholder** is any person, social group, organisation that has stake in a business. Stakeholder can be divided into groups: internal- or external stakeholders (Freeman, 1984).

**Stakeholder Theory** is a theory of corporate governance that addresses morals and values in organisational management and emphasises the interests of stakeholders in decision making. There are different variations of the stakeholder theory. For example, Freeman (1984) views all stakeholders initially equal in a business. However, a stakeholder analysis is done to prioritise certain stakeholders in certain conditions.

**Voice vs. exit-based system.** Voice and exit based systems are forms of corporate control. In a voice-based government control, shareholders and stakeholders have an important function to alert the management in times of dissatisfaction or disagreements. In other words, "voice" refers to an attempt to change, rather than escape, from a dissatisfying situation and can be a constructive response to improve the situation. In an exit-based system, the "exit" refers to the stake- and shareholders attempting to leave the unsatisfactory situation, including leaving the organisation by selling the shares during times of dissatisfaction or disagreements. (Hirschman, 1970).

## **Shareholder Value Theory**

In this part of the literature review, I will describe the underpinnings of the shareholder value theory, its key components, justifications, achievements and possible shortcomings or inefficiencies. The aim is to contextualise the shareholder value thinking in order to explain its positioning in the Western hemisphere's business environment.

### **Free Market Economy – the Underpinnings of Shareholder Value Maximisation Thinking**

Free market economy means that a government imposes no intervention in the market at all and the decisions are taken by individuals and firms (Sloman and Garratt, 2013). In a traditional free market economy, there is one and only one social responsibility of a business, and that is to use its resources and engage in activities designed to maximise profit to its shareholders within the legal framework (Friedman, 1970; 2002). This idea has been widely practised from the late 1970's when Western economic policy shifted from Keynesian to Hayekian economics, or in other words, from a stakeholder voice-based system to a shareholder exit-based system.

Voice and exit based systems are forms of corporate control. The voice of shareholders and equally of other stakeholders, serves the important function to alert the management in times of dissatisfaction or disagreements. The exit of shareholders of a firm alerts the management about dissatisfaction or disagreements more indirectly, through the threat of selling the shares, or "voting with their feet". The voice based corporate control was especially common in Germany and in Japan, where both countries had a low-liquidity system in which it was more difficult to buy and sell shares, and this encouraged the shareholder to make more long-term commitments. In a high-liquidity system, like the one in the Anglo-Saxon countries, it is much easier for shareholders to walk away instead of "taking the fight" and shareholder tend to have a short-term view of their gain of capital. (Pacces, 2015).

The emergence of neoliberalism, a modified form of liberalism tending to favour free market capitalism, was triggered by a combination of slow economic growth combined with a simultaneous increase in both inflation and unemployment, of which is also referred as stagflation (Streeck, 2014). Furthermore, the neoliberal ideology benefitted

from political and academic help to suppress the demands from the society, and especially from the trade unions in opposing the changes from a voice-based system to an exit-based system (Gamble, 1988).

The famous article about the ideology of the shareholder primacy titled the *Theory of the firm: Managerial behavior, agency costs and ownership structure*, which was published in 1976 in the *Journal of Financial Economics* by the economist Michael Jensen and a business school dean William Meckling, describes the shareholders as principals who hire corporate directors and executives to act as the shareholders' agents. The assumption is that shareholders own corporations and that the purpose of corporations is to maximise the shareholder value. The shareholders' interest is only financial, and therefore the directors' (agents) only job is to maximise the wealth of the shareholders (Stout, 2012).

Within the past 20 years, the shareholder primacy has become mainstream thinking as many political leaders, regulators, academics, business leaders and journalists have accepted and embraced the ideology of the shareholder primacy. For example, Francis Fukuyama, an American-Japanese political scientist, in his famous article titled "*The End of History*" (1989), argued that with the collapse of the Soviet Union, the last ideological alternative to liberalism had been eliminated and that the liberal democracy and free market capitalism of the Western hemisphere could be the final form of human governance. Similarly, Hansmann and Kraakman (2000; see also 1997, 1999) argued that the ideology of shareholder primacy had triumphed and was likely to become standard rule of corporate law and practice worldwide, since the alternative models such as the managerialist-oriented, the bank-oriented models or the South East Asian governance model had not gained a global uniformity. However, more and more academics and business professionals have begun to question the empirical and theoretical foundations of the ideology of shareholder primacy. Even Hansmann and Kraakman have revisited the premises of the shareholder primacy more recently (Hansmann and Kraakman, 2013).

The issue that Michael Jensen, Friedrich Hayek, Henry Hansmann, Reinier Kraakman and Milton Freidman raise is that – as typical of neoclassical economists in general – they ignore the existence of externalities. In other words, they ignore the public

consequences of the private transactions they are analysing. In the perfect neoclassical economy, none of the externalities exist due to the logic and the theory of rational choice. There are positive and negative externalities which Milton Friedman acknowledged. The key question is whether the costs of intervening the markets to address the failure, outweigh the benefit outcomes of it. However, in the real world the demand for social justice exists as long as there is social injustice, and in today's world, much of the global social injustice is arising from the social costs of private enterprises (Larson, 2018).

Next in this bachelor's thesis I aim to investigate the theoretical and empirical underpinnings of shareholder value theory further. The aim is to argue that it is not sustainable to pursue shareholder maximisation due to the effects it can cause in the long term.

### **The Rise of the Shareholder Value Thinking**

Already in 1932 Adolf Berle and Gardiner Means, authors of the book titled *The Modern Corporation and Private Property*, called attention to the problems arising from the separation of owners and management in large listed companies. In the final chapter of the book they quote a German industrialist Walther Rathenau at length to the effect that the modern corporation was becoming more like a state, and therefore responsible to a variety of potentially competing interests. Just prior to this publication, Berle had conducted a public debate with law professor E. Merrick Dodd, who argued successfully that corporations were responsible to society at large, rather than simply stakeholders. Berle's book published in 1954, *The 20<sup>th</sup> Century Capitalist Revolution*, confirmed his agreement with Dodd's argument.

In the period between 1930s and 1970s the managerialist view dominated the corporate governance. In general, the managerialists view that the public corporation as a legal entity created by the state for public benefit, and of which is run by professional managers seeking to serve not only shareholders but also stakeholders and the public interest, was prominent. The idea that a public corporation should be run according to the shareholder value was reaffirmed in Berle's book in 1954, even though he did acknowledge Dodd's argument in the very same book.

Managerialist theories of the firm developed by authors such as Oliver E. Williamson and Robin Marris retained the rational self-interest and maximising assumptions of neoclassical economics. In so doing, they offered theoretical justification for the criticism of corporate executives as exploiting their position at the expense of shareholders, who were assumed to be the ultimate “owners” of the corporation and therefore the wronged party. Conglomerate diversification could be justified on the basis of the application of superior management techniques, as celebrated by Alfred D. Chandler’s major works and exemplified by companies like ITT, but when financial results failed to keep pace with investor expectations, the ground was already prepared for a reassertion of owner primacy, despite the ambiguous status of the ownership in question. The simplicity of the argument was both its chief strength and the source of much of its appeal. (Stout, 2012).

In 1970, Milton Friedman published the famous article “*The Social Responsibility of Business Is to Increase its Profits*” where he argued that managers had a moral responsibility to act always in best interest of the shareholders and that was to maximise the shareholder value. In this article, he explicitly described managers as agents acting on *behalf* of the principals, the shareholders. However, it was Michael Jensen and William Meckling in 1976 that developed the shareholder theory that we know today. (Stout, 2014). Friedman’s article was not an academic paper, but rather an opinion statement. What Jensen and Meckling did was they translated Friedman’s article into the mathematical language of economics (Kinsley & Clarke, 2009; Dunn and Burton, 2006). The article of Jensen and Meckling also explained how the personal interests of the managers (agents) should be aligned with those of shareholders (principals). The idea was that the stock compensation and options would turn the managers into part-owners of the firm and so protect the other part-owners, the shareholders, against the firm wasting cash on corporate jets, new headquarters or increasing the wages for the workers. Managers would act like owners. They would focus on doing the correct thing, namely maximising the shareholder value and in the process be well compensated for doing so. (Denning, 2017).

Shareholder value doctrine quickly established itself as a new pillar of corporate governance and was embraced politically by Ronald Reagan and Margaret Thatcher. They championed the idea that the business should go back to its basics and that was to make money. This would guarantee prosperity for the economy including for all the other stakeholders, such as the workers. In the begin of 2000s, shareholder value primacy had gained such a foothold that Henry Hansmann and Reinier Kraakman proclaimed that it would become the universal rule of corporate law and practice, especially since other models had apparently failed. Next, I will describe the shareholder theory itself.

### **The Shareholder Theory**

The shareholder theory focuses on the relationship between a principal (shareholders) and the agent (management) who is supposedly looking after the interests of the shareholders. If management does not act according to the owners' preferences, a principal-agent problem occurs. The idea of the shareholder theory is that shareholders need to spend time and resources to exercise control of the management, thereby incurring in agency costs. The company law rules should be framed so that it becomes possible for shareholders to control management and so that this can be done at the lowest possible cost. The separation of owners and management leads to asymmetric information. The principals (shareholders) do not possess the same information about the company as the agents (management).

Jensen and Meckling (1976) pointed out that large companies run the risk that corporate management acts opportunistically, in other words, try to protect their own interests at the expense of the interests of the company (the shareholders) (Krüger, 2003; Hansmann, 2000). The quarterly economy (or reporting system) is intended to hold executives to account. It represents a major agency cost because it requires the preparation of a lot of financial information on a regular basis, reporting on recent performance and updating forecasts. The intention is to ensure that executives serve the shareholder interest rather than their own.

There are three basic assumptions underlying the principal/agent approach of the shareholder theory. These are presented below.

1. Shareholders own the corporation.
2. Shareholders are the residual claimants. This means that shareholders will receive all the profits left over after a company's contractual obligations to its stakeholder have been satisfied.
3. Shareholders are principals who hire directors and executives to act as their agents.

According to the third assumption of the shareholder theory, the shareholders are principals who hire directors and executives as to act as their agents. However, in economics, a principal-agent problem occurs when the agent is able to make decisions and take actions that impact the principal, on the behalf of the principal (Eisenhardt, 1989). Therefore, the principal-agent problem exists in conditions where the agents are motivated to act in their own best interests, and of which are contradictory to those of their principals (Eisenhardt, 1989).

Problems may occur when the two parties have different interests and asymmetric information. In models that assume the rational self-interest of all actors, the agency problem is inevitable whenever there is a division of labour, which capitalises on the economies of scale achieved by specialisation, but which has the cost of asymmetric information, leading to the possible problems of adverse selection and moral hazard (Holmström, 1979). Aligning executive interests with those of shareholders by giving executives incentives to focus mainly on the share price is intended to reduce or even eliminate this problem of moral hazard.

Next in this section, I will describe how the US hegemony has enabled flourishing conditions for the principal-agent problems to occur, and by doing so, I aim to illustrate how the shareholder value thinking way is not an effective approach to define the idea of corporate governance objective. I will begin this section with a brief outline of the history of academic economics, as this development has contributed to the raise of popularity of unregulated markets –thinking (Johnson, 2000).

## **The US Hegemony Enabling the Flourishing of the Shareholder Value Maximisation Thinking**

Academic economics used to be a part of the department of social sciences. Just like political science or sociology until the late 1950s, academic economics were engaged in a non-experimental, often speculative qualitative research on how individuals, groups, markets or national economies behaved under different situations and conditions. Academic economists concerned themselves with questions related to employment, growth, price stability, finance, labour, and other socioeconomic topics. However, as socioeconomic research became an ideological counterweight to Soviet Marxism during the 1950s, academic economists aimed and succeeded to extract the field of academic economics from a form of a qualitative social science and re-design it as hard quantitative discipline and science. (Johnson, 2000). Gradually, academic economists began to express themselves less in words and more in mathematical postulates that were divorced from qualitative, descriptive empirical research (Johnson, 2000). The new mainstream economists tried to show through deductive reasoning expressed by mathematical formulas that resources could most efficiently be allocated through an unregulated market (Johnson, 2000).

Soviet Marxism sparking of a change in the development of the field of economics and later the collapse of Soviet Union has both contributed to the rise of free market economy -thinking. With the collapse of Soviet Union, the United States were free to roam the globe. Two of the most influential articles in the field of global political economy written after the end of the Cold War were Francis Fukuyama's *The End of History* in 1989, and Charles Krauthammer's *The Unipolar Moment* in 1990.

Fukuyama (1989) was arguing that the US had spent the first part of the twentieth century on defeating fascism and the second part defeating the communism, and now what was left to do was to spread liberal democracy across globe. Krauthammer (1990) on the other side, was arguing that it was a unique moment in the world history and that the US, now by far was the strongest military power in the world, should seize the moment for its benefit and reshape the world for its own interests. In other words, Fukuyama is stating that the US now had a wind at their back to pursue their own interests whilst Krauthammer is likeminded-wise highlighting that the US had an

opportunity to facilitate the process of reshaping the world in an image of the United States. When combining the arguments of Fukuyama (1989) and Krauthammer (1990), one ends up with a recipe to achieve liberal hegemony.

According to Mearsheimer (2018), liberal hegemony consists of three components or missions. These are:

1. Spread liberal democracy across the globe.
2. Integrate more and more countries into the open international economy.
3. Integrate more countries into international institutions.

To demonstrate the significance and the dimensions of liberal hegemony in economics and to outline its relationship to the shareholder value thinking, I will briefly describe the meaning of the word “hegemon”. The word hegemon arises from the classical Greece, where the term was used to refer to a city state who held political and military power. However, not only is the United States a hegemon in these traditional senses, but nowadays the United States holds a position also as a cultural hegemon. A “cultural hegemon” is a term developed by Antonio Gramsci, who described how the capitalist elites control the masses not only by physical power but also through cultural domination. Cultural hegemony is therefore used within and beneath a cultural context, where a dominant group uses culture in its different embodiments to legitimise its dominance. (Nicholas, 2017).

Due to the hegemony of the United States in the aspects of politic, military and culture they were able to influence the corporate governance culture around the world. Especially in the last 25 years, not only had USA defeated Soviet Union, but it was also increasing its lead over Japan and the other Tiger economies – thereby legitimising the dominance of the shareholder maximisation as the foremost corporate governance model in the capitalist society.

William I. Robinson, in this book *Global Capitalism and the Crisis of Humanity* in 2014, argues that we need to abandon the state-centric view to understand the global forces that shape global politics and economics. According to Robinson, a network of corporate leaders, globalising politicians, and technical and communications

professionals make up a power elite. The interest of the power elite lies in the advancing of capitalism globally rather than in the wellbeing of a society. My argument is that the shareholder value doctrine in practice has indeed been used to justify the appropriation of earnings by shareholders and their manager-agents at the expense of labour, whose share the income generated by the business has stagnated or even fallen during the last 40 years (Piketty, 2014).

The gap between rich and poor is getting wider rather than narrowing, revealing the world as a very unequal place (Piketty, 2014). Income inequality refers to the extent to which various measures of economic wellbeing (such as wealth, income or consumption) among individuals in a group are in disproportion (Piketty, 2014).

The widening gap of economic inequality can be modelled according to game theory (*Four Horsemen*, 2012). In economic games (or in a zero-sum game situation) each participant's gain (or loss) of utility is exactly balanced by the losses (or gains) of the utility of the other participant(s). If the total gains of the participants are added up and the total losses are subtracted, they will sum to zero. According to the zero-sum game thinking on economic inequality, the same players have been succeeding more often, resulting in a widened gap between the rich and the poor. It is not the existence of the gap that is seen as a problem but rather the size of it.

Economic inequalities are seen as being a vital part of the operation of the price mechanism. According to free market capitalist view, people should be paid according to the labour market's monetary evaluation of their abilities. People with higher skills and experience should, rightly, receive the full monetary equivalent of their greater value (Dawson et al., 2006). Economists, however, are concerned that widening income disparities may have damaging side effects. (Streeck, 2014; Piketty 2014). This is also Keynes' critical point: widening inequality results in increased poverty of which reduces aggregate demand and so depresses the economy. This is a vicious circle, of which makes the situation increasingly worse. (Mann, 2017). Therefore, by purely paying attention to shareholder value maximisation, companies indirectly create economic inequalities. For instance, company cannot sustainably move production to a low-cost labour country and assume to sell the very same product in the original production location. This offshore policy has recently begun to receive political backlash. After the election of Donald Trump and his "America first" -policy and the

open hostility to manufacturing companies that have transferred their production abroad expressed by the introduction of tariffs, the political message to the companies is that they must contribute to the local economy, and especially so with the labour force. (Tucker, 2016). This may signal that there are other factors to be considered than mere shareholder value maximisation in defining governance objectives even in a capitalist society such as the US.

The assumptions underlying the shareholder value maximisation thinking can also be questioned from a legal perspective, as is done by Lynn Stout (2012). She approaches these assumptions from a corporate law perspective. Next, I will describe the corporate law on the shareholder wealth.

### **Corporate Law on Shareholder Wealth**

The idea that corporate law requires directors and executives to maximise shareholder wealth is not valid according to law professor Lynn Stout (2012). She states that there is no solid legal support for the claim that the directors and executives in the U.S. public corporations have a legal obligation to maximise shareholders' wealth. Furthermore, and crucially, from a legal perspective, shareholders do not and cannot own a corporation. Corporations, like humans, are independent legal entities that own themselves. Shareholders own shares of the company and a share of stock is a contract between the shareholder and the corporation that gives the shareholder very limited rights under certain circumstances. The stockholder is per se not different from other stakeholders, for example, bondholders or employees. Therefore, all stakeholders have a contractual relationship with the corporation. (Stout, 2012).

The idea that the shareholders are residual claimants stems from the bankruptcy law where courts distribute the assets of liquidated companies. In a case of bankruptcy, the shareholders get paid last, and only after the claims of employees, debtholders and others debtor have been paid first. As Stout (2012) importantly points out, there is a difference between living and dead companies. Shareholders cannot get money out of functional corporations unless certain conditions are fulfilled. It is only the

company's board of directors that have the legal authority to declare dividends to shareholders when the company is doing well enough financially, and if there are sufficient retained earnings or operational profit. However, even if the financial goals are fulfilled, the board of directors can still refuse to pay dividends out to the shareholders. Since the retained earnings or operational profit are an accounting term, directors have a direct influence on paying dividends to the shareholders - as they can to a certain degree - control the expenses. (Stout, 2012; Hansmann, 2000). From the legal perspective, there are no statutes that require firms be run to maximise profits or share prices (Stout, 2012).

### **The Achievements of the Shareholder Value Theory**

Even though there is no US law requiring firms to be run in order to maximise profits or share prices, the shareholder value maximisation way of thinking towards defining a firm's corporate governance objective has been popular for decades. Much of its achievements and popularity among business influencers can be attributed to the simplicity of its core idea: maximizing the share value. "Shareholder's interests" can be used as a simple justification for the decisions made by the management. The shareholder value maximisation thinking also offers a simple measurement of a firm's performance in an otherwise complex environment. The share price can be used as an indicator of a firm's success. Thereby, it becomes a standard measurement of the executive's performance. In other words, the executives have a clear objective, and that is to increase the share price and the shareholders have a tool to measure the performance of the executives. This potentially leads to more short-term thinking and behaviours and actions related to that. To put differently, managers and executives are less likely to be engaged in long-term strategical planning due to the fact that they are emphasising the current value of the shares. Managers and executives might also be fearing for shareholder activism. To meet the quarterly targets, the executives might also use financial speculation or calculative editing of account statements to boost the share prize. An example of this is the case of Jack Welch from GE. A firm's leaders focus on the share price is so dominant that the other stakeholders' demands are pushed aside. After his retirement, Jack Welch stated that the shareholder value maximisation was the "dumbest idea in the word". The reason for that is that the corporate executives have incentives to focus more of their attention on the

expectations market instead of managing the company by producing real products and services. (Denning, 2011).

However, the definition of the idea of a firm's governing objective can be deducted from other perspectives than through the goal of maximising the shareholder value. Next, I will describe another alternative to the shareholder value theory - the stakeholder value theory – through which the idea of a firm's governing objective is defined from a different point of view. In the next chapter, I will describe the underpinnings of the stakeholder value theory, its key components, justifications, achievements and possible shortcomings or inefficiencies.

## **The Stakeholder Theory**

The stakeholder theory approaches the definition of a company's governance objective from a different viewpoint compared to the shareholder value theory. Whilst in the shareholder maximisation thinking the core idea of a firm's target is to maximise shareholder value, the stakeholder value theory advocates that the company balance the interests of all stakeholders. Despite the hegemony of the United States, the stakeholder way of defining a firm's governing objective is relatively common in countries operating under civil law, including France, Germany, and Japan (Mauboussin and Rappaport, 2016). In this part of the literature review, I will describe the underpinnings of the stakeholder theory, its key components, justifications, achievements and possible shortcomings or inefficiencies.

## **The Stakeholder Model**

There are many different definitions of the stakeholder theory. Swayne, Duncan and Ginter (2006) in *Strategic Management of Health Care Organizations*, defined the theory's stakeholders as organisations, groups and individuals that have an interest or a "stake" in the success of the organisation. R. Edward Freeman approaches the theory with a broader definition of a stakeholder, and in his book titled *A Stakeholder Approach* (1984) he defined a stakeholder as any group or an individual who can affect or is affected by achievement of the organisation's objective.

Freeman attributes the stemming of the concept of the stakeholder theory to Igor Ansoff and Robert Stewart. The point of the stakeholder theory is to understand which groups of stakeholders are important to the value creation process within a business. The group of stakeholders are different from business to business. However, the theory is building on the following two principles:

1. Mutual rights: the company including its management should not violate other stakeholders' legitimate rights.
2. Mutual impact: the company, including its management, is responsible for the effect of its actions on other stakeholders.

The two principles may seem a little farfetched if the other stakeholders' legitimate rights are not defined correctly. Companies have already a large number of obligations under legislation, and it is hard to imagine that they will voluntarily take on additional commitments, especially if they will lose competitiveness as a result. Next, I will describe how the stakeholders can be identified.

### **Identifying and Categorising Stakeholders**

Identifying and categorising the stakeholders are crucial in the stakeholder theory. According to Freeman, an individual or a group is considered a stakeholder of a company if certain characteristics apply. There are minimum three characteristics that applies to a stakeholder (Freeman, 2009):

1. The actor has the potential to be positively or negatively affected by the organisational activities and/or is concerned about the organisation's impact on his or her or others' well-being,
2. The actor can withdraw or grant resources needed for organisational activities.
3. The actor is valued by the organisational culture.

Swayne, Duncan and Ginter (2009) argue that stakeholders can be categorised into three groups

1. Internal
2. Interface
3. External

A stakeholder analysis is important for every organisation since the company makes critical decisions based on the results of the analysis. If not done carefully, the shortcomings in the stakeholder analysis can have undesired outcomes. For example, Barbara Tuchman (1984) in her sobering history *The March of Folly: From Troy to Vietnam* recounts a series of disastrous misadventures that followed in the footsteps of ignoring the interests of, and the information held by, the key stakeholders. She concludes: "Three outstanding attitudes -obliviousness to the growing disaffection of

constituents, primacy of self-aggrandisement, and the illusion of invulnerable status - are persistent aspects of folly". (Bryson, 2003, p.5). In the next section, I will describe some of the achievements of the stakeholder theory and its main critique.

### **Achievements and the Critique of Stakeholder Theory**

Although the stakeholder theory has not gained such a strong foothold as the shareholder theory, it has its achievements. The stakeholder theory does not attempt to identify a single governing objective for a company. This means that it fundamentally is more complex compared to the shareholder theory. The complexity of the stakeholder theory can be regarded both as its strength and as its weakness. The shareholder value theory is simple by comparison, as everyone is focused on achieving the same goal. The simplicity is not a justification by itself, but it is appealing to many people simply because it is timesaving. In other words, this means that the stakeholder theory advocates must work harder to convince its audience.

The stakeholder theory aims to take other objects such as suitability into consideration and is seeking to create a transparent and efficient relationship with all stakeholders. Furthermore, due to the clear governance objective to benefit all the stakeholders, the stakeholder theory aims to combine economy with ethics. At the end, a stakeholder's contribution towards the company will directly impact the company's performance and wealth, and as a result, if executives consider all the stakeholders, the entire company will stand to benefit from it. The strategical goal is therefore to enrich the community.

An example of the stakeholder theory's achievement in practise is Japan's post WWII economic recovery, since the country's economic recovery was largely build on the stakeholder theory. Japan's economy was organised so that it initially served the producers rather than the consumers. The labour harmony was encouraged and industries were built on maximising the highest labour input. The ultimate goal was to enrich Japan, and thereby the Japanese people. Currently China is applying a similar strategy to the Japanese. (Johnson, 2000).

Achievement examples can also be found in Europe. For example, Germany's five leading lenders control less than half of the total banking market compared to France for instance (85%, FT, 2018). The stakeholder model is the preferred corporate governance model in Germany, and it is quite visible in the German banking system. The local banks are working closely together with local firms, not only to enrich themselves but also the local region. Local, regional and municipality own banks are dominating the banking industry in Germany, because under local control, they do not face the pressure to maximise shareholder value nor to pay large dividends to the shareholders. Especially in Germany, the local banks are known for their contributions to the local economy.

Despite its achievements, the stakeholder theory is not without its critique. Its opponents criticise the stakeholder theory for being a current embodiment of socialism, a concept that has existed before but did not stand the test of time. A beautiful idea that does not perhaps work in practise. (Jensen, 2001). The critique of the stakeholder theory or social responsibility being labelled as "socialism" was also a feature of Milton Friedman's NYT 1970 article on the social responsibility of a business. Friedman's argument was that a corporate executive was an employee of the shareholder and therefore directly responsible to them. The business should be governed according to the shareholders wishes, which generally was to make as much profit as possible without the breach of basic rules of the society. If the corporate executive directed capital to social responsibility or to other stakeholders, he would act as a principal and not as an agent. In other words, the executive would be spending the shareholder's money to benefit the stakeholders and therefore "implementing socialism".

The most voiced out criticism of the stakeholder theory is that balancing stakeholder interests cannot serve as a company's singular governing objective because it not possible to simultaneously satisfy the interests of all the stakeholders (Mauboussin and Rappaport, 2016; Jensen, 2001; Sternberg, 2000). The question under debate is then that how can a company with the applied stakeholder theory be able to make the necessary trade-offs among the different stakeholders (Jensen, 2001; Stenrberg, 2000). Sternberg (2000) and Jensen (2001) also criticise the stakeholder theory for not addressing the shareholder's rights or property rights. In addition, Jensen (2001)

argues that it is only possible to maximise value in one dimension. He states that in a society without externalities and monopolies, the welfare of the entire community will be maximised when companies individually try to maximise their value. This is a classical microeconomics theory. At the same time, Jensen (2001) criticises the fact that management in companies using stakeholder theory has no clear boundaries of the balance between the different stakeholders, and that therefore gives the executive board far too much power, which can be exploited for its own gain.

For example, a director who has relations with a particular stakeholder or stakeholder group, possibly even a stakeholder in the company, may give unfair advantage to particular stakeholders beyond the other stakeholders as long as there is no guidance as to how the weighing relationship is between the various stakeholders. Ultimately, Jensen (2001) believes that the stakeholder theory does not act as an alternative to the shareholder primacy as this theory, unlike the shareholder primacy, does not provide the answer to all questions about what to maximise and how it should happen. However, Jensen's critique is fundamentally inconsistent since he is constantly advocating the supremacy of the shareholder interest, in other words, one stakeholder over all others. The strategical goal of the stakeholder theory is however to enrich the community. Jensen (2001) does however recognise that the shareholder value maximisation thinking must be supplemented with the rights of other stakeholders. He acknowledges that it is impossible to maximise the shareholder value if the management chooses to ignore the other stakeholders of the company. In the next chapter, I will describe a compromise solution called the creating shared value model.

## **Creating Shared Value (CSV) – Seeking for a Sustainable Solution?**

After the financial crisis of 2008, the financial sector and the idea of shareholder value began to track headwind. Much of the sector's trouble can be attributed to the maximising the shareholder value -idea, especially if a company's governing objective and goal was seen to be to maximise short-term earnings to increase the day's stock price (Mauboussin and Rappaport, 2016). Porter and Kramer (2006) began to revise the shareholder theory as they evaluated it was not a sustainable solution after the crisis, but perhaps identified the financial markets to be too capitalist to conform to the stakeholder value way of defining the company's governing objective.

Porter and Kramer (2006) aimed to create a model of which applied the capitalist system and of which would address to the issues in society such as hunger, environment, health and water. This is called the creating shared value model (Porter and Kramer, 2006). According to Porter and Kramer (2006), with the creating share value idea, they are rethinking capitalism, not redistributing value. The concept of creating shared value (CSV) was introduced in 2006 and was further developed in 2011. Porter and Kramer (2006, 2011) understood that Friedman's theory of how to conduct business was not sustainable for a society, and in the long run it would be destructive for everybody. They argued that the economic system had evolved to narrow the scope of economic value, and firms are beginning to be perceived to make huge profit at the expense of the community and not making profit that would benefit the whole community.

As a result, the society has begun to view the firms as a source of problems within it. The mind-set of politicians and the general public has shifted towards more control, regulation and taxes presented to the companies. Politicians have difficulties in pursuing business friendly policies because the political environment forces them to be more tough on them. However, businesses and societies need each other in order to grow. Porter and Kramer also acknowledged that corporate governance was just about maximising the shareholder value, and the simplification and narrow focus have resulted in unethical choices in pursuing the maximisation of the shareholder value. Society is therefore questioning all the profit companies have made, as simultaneously

the people are being impoverished. Companies should seek long term and sustainable solutions in order to make profit so that the profit of the company is not created at the expense of the society (Porter and Kramer, 2011).

The concept of CSV focuses on the connections between societal and economic progress. A business needs a successful community and a community needs successful businesses. This interdependence between them would create economic value in a way that also creates value for society by addressing its needs and challenges and at same time generates growth for the business. CSV's main emphasis is on creating economic value by creating societal value. The idea is to expand the total pool of economic and social value. In other words, the term social value is referring to creating societal value in the form of progress in social issues and economic value on a financial statement. Therefore, CSV is using capitalism to address societal issues (Pfitzer, 2013; Bocksette 2013).

Creating shared value idea resembles corporate social responsibility (CSR) in many aspects. According to Porter and Kramer (2011) there is a distinction, however. In corporate social responsibility, companies make profit and then assign some of that to advance wellbeing in many of its ways. In creating shared value – according to Porter and Kramer (2006, 2011) - companies work together with the stakeholders to create shared value. Whether this is the reality is debatable. CSV claims to apply new theory suggesting companies to alter their strategy by valuing the society and its economic life with long term goals. In terms of an ideology, the corporate social responsibility is relatively similar.

In Porter's and Kramer's CSV capitalism is applied to benefit the stakeholders. However, the concept of stakeholders in their model is not new. Freeman (1984) attributes the stemming of the stakeholder concept to Igor Ansoff and Robert Stewart. Therefore, the main difference between CSV and CSR seems to lie in the thinking and in the philosophical approach to social responsibility as opposed to action (Lapina, 2012). Publicly owned corporations are "owned" by shareholders and directed by their agents (managers). The managers as humans are directed by self-interest. In other words, at the end of the fiscal year what the managers really want are profits. Hence,

one could argue that they see the CSV concept as an opportunity to maximise their profits or stock price. (Lapina, 2012).

Crane, et al., (2016) argue that Porter's and Kramer's CSV concept is a marketing tool that potentially aims to increase a company's profits. Porter and Kramer view business and capitalism as systems of competition for resources. Freeman (2010) views CSV as a tool to achieve competitive advantage. He raises a question whether we are living in an era of "woke" capitalism in which companies pretend to care about social justice and externalities to sell products to people and thereby increase their profit. In addition to that, Friedman (2002) questions if a firm's local investments and societal contributions can indeed be attributed to social responsibility at all in instances where the motivation for contributions is sparked by a company's self-interest. An example of this would be investments on infrastructure to enable smoother logistics.

CSV and CSR are ideologies that are inserted in a product or a corporation. The idea is to maximise the profit by selling an ideology rather than a product of which would cause a guilty conscience to the consumer (Zizek, 2012). The concepts could therefore be used to achieve a competitive advantage. However, where CSR can be cynical public relations, it may also reflect a recognition by CEOs and others that the current situation is not sustainable. According to a FT article by Edgecliffe-Johnson (2019), growing numbers of business leaders are now "willing to do things that are not in their best short-term interests but are in the best interests of their company and country long-term".

In the article, Edgecliffe-Johnson is highlighting the crisis of legitimacy in capitalism and the growing sense of dissatisfaction and discontent that seems to be spreading. The question under the debate is where does the dissatisfaction and discontent stem from. Business leaders are voicing out concerns over the shortcomings of capitalism, and how even the capitalist themselves think "capitalism is broken" by leaving so many people behind. Alternatively, other capitalists mentioned on the article share their fear of "some form of revolution". What really scares some of the capitalists then is the data showing younger people being increasingly comfortable with socialism as a way of organising the economy. For example, in 2010, 68% of young Americans had a positive view of capitalism. Last year however, the percent had fallen to 45. From this

perspective, the motivation to reform capitalism would spark from the opportunity to initiate the change from the capitalist viewpoint rather than to wait for the change to be forced on them. In other words, the business leaders could reform capitalism themselves or have it reformed for them through political measures and the pressures of an angry public. According to Edgecliff-Johnson (2019) the question now is whether companies will take more meaningful action at a short-term cost to save what has been cited as the most successful economic system the world has ever seen. (Edgecliff-Johnson, 2019). The more attention given to CSV by the international mainstream media, the business schools, and several CEO roundtables at Davos, the more awareness will the important societal values and inequalities arise and therefore contribute to finding a sustainable solution. (Crane, 2014).

## Conclusion

This bachelor's thesis consists of a review of literature on the shareholder value maximisation thinking. My aim has been to describe and to discuss how in the Western hemisphere the corporate governance objective(s) are defined and to provide some theoretical and ideological background information to offer an explanation for such definitions.

The financial crisis of 2008 sparked a discussion around the shareholder value maximisation idea, especially around the topic of whether the maximising share price is a sustainable goal for a company in the longer term. An alternative way for a company to define its governance goals is through the stakeholder model, however, given the US hegemony and strong capitalist economic system of the United States, it has not caught the breeze under its wings in the US. The financial crisis of 2008 demonstrated however, that the shareholder value maximisation thinking as it was known at the time was not sustainable way of governing a company. A compromise solution, the creating shared value –approach emerged. The creating shared value model is to an extent a compromise solution between the shareholder and the stakeholder approaches to corporate governance.

The main assumption of the shareholder value maximisation thinking is that the owning the shares of a company equals owning the firm. In this thesis I have described however, that according to the corporate law, this assumption is false. From a legal perspective, corporations are legal entities that own themselves just as human beings own themselves (Stout, 2012). In other words, a shareholder owns a share of stock. A share of stock is in turn simply a contract between the shareholder and a corporation. That contract gives the shareholder limited rights under limited conditions (Stout, 2012). This means that relationship between the shareholder and the company is a contractual one. Therefore, a shareholder – from legal perspective – has the same contractual legal rights as some other company stakeholders such suppliers, employees, debtholders and so on. However, some other stakeholders are more difficult to justify as equal on this basis, where there is no legal binding contract. Part of the problem lies with the culture (or cult) of liquidity, which is elevated to supreme status in Anglo-American capital markets, privileging exit over voice and encouraging

the reduction of assets to cash (net present value). In other words, “maximising the shareholder” value as a justification for executive decisions is too simplified as the firms are not legally committed to that.

In this thesis, I have described how the shareholder primacy ideology has developed in the past decades and through the development of the science of economy and interaction of ideologies. The shareholder value maximisation thinking was beginning to trend with Jensen’s and Meckling’s article being published in 1976. Prior to that, corporate governance was reflecting more of the stakeholder theory. Interestingly, Roger Martin (2011) has shown and calculated that between the years of 1933 and 1976, the shareholders who invested in S&P500 got a real compounded average annual return of 7,5%. After 1976 until today however, the average has been 6 percent. This suggests, that in terms of sustainable corporate governance, the stakeholder approach to defining the governance objectives is indeed financially more justified. Martin also shows that with the stakeholder theory model the share prices have been more stable and therefore predictable compared to the share prices of companies pursuing the shareholder value maximisation. Predictability of share prices create more stable economy. (Martin, 2011). Stable economy promotes welfare.

Shareholder value maximisation thinking is deep rooted in Anglo-American capitalist economy and due to the US hegemony it has major global significance. The financial crisis of 2008 however, brought its assumptions under critique. The stakeholder approach might at the moment seem too socialistic to the most devoted capitalists, however, stakeholders’ prosperity unquestionably benefits the company and the society as a whole in the long term. In other words, a firm’s success depends on long-term relationships with each of its stakeholders (Mauboussin and Rappaport, 2016). Therefore, lengthening the investment time horizon benefits the shareholders as well as stakeholders.

Porter and Kramer (2011) in their CSV model offer a compromise solution to defining a company’s governing objectives through the interests of both shareholders and stakeholders. They introduce the CSV as redesigning capitalism. As described in this thesis, the moment CSV appears to be capitalism renamed rather than redesigned as CSV is aiming at selling an idea of social responsibility to the consumers in order to

increase the share price. However, bringing the societal and global issues to daylight and under debate from other angles than mere corporate social responsibility or good will, they are raising awareness about sustainable economy and inequality. This is a step towards a more sustainable solution in the future and perhaps a step for a capitalist hegemon society to begin to open up towards genuinely more stakeholder oriented corporate governance way of defining its governing objectives.

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