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The Social Trajectory of a Finance Professor and the Common Sense of Capital

Marion Fourcade and Rakesh Khurana

Social scientists, like all professionals, like to scrutinize themselves and their neighbors within their preferred disciplinary frame. Economists, for instance, are particularly fond of the economics of their own discipline and have produced a stream of papers about the rankings and performance of individual authors, departments, and journals. For their part, sociologists and political scientists have been partial to relational representations, thinking about their own field and subfields through the prism of dynamic positions and oppositions. Historians and historically inclined scholars, including historians of economics, are often eager to specify how the social sciences' embeddedness in broader political and economic processes (such as colonial expansion, the Great Depression, the Cold War, or the rise of the welfare state) has shaped their intellectual trajectory. The concern, often, is to try to identify where new ideas come from: cumulative knowledge within well organized and paradigmatic disciplines; relational and demographic dynamics within and across fields; and exchanges with or demands from other domains of social life altogether—social movements, business corporations, or government agencies.

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Besides the question of origin is the question of how new ideas manage to diffuse and become institutionalized. Mobilization, institutional innovation, and politics are usually part of the story. People who have an *interest* invest in the game of defending these ideas, and through that process carry them *and themselves* forward. But their effectiveness often depends on more structural conditions, for instance, a crisis opening up a discursive “structure of opportunity,” a favorable distribution of material and symbolic resources, or the need to fill vacancy chains caused by generational turnover or a field’s rapid expansion (White 1970, Bourdieu and Passeron 1979). These are the ingredients that allow challengers and their views to gain ground, settle into orthodoxy and, finally, to become “doxa”—a field’s naturalized and taken-for-granted beliefs about the way the world works.

In this paper we endeavor to reveal the intellectual and social conditions that enabled the emergence and institutionalization of what we call the “neoliberal common sense of capital” in economics and the broader economy—what others have called the “shareholder value” view of the American firm. We focus on the social trajectory of Michael Jensen, a Chicago finance PhD turned Harvard Business School professor. Not that Jensen was the only promoter of this view. We will see that he was part of a much broader, and not necessarily well coordinated, movement that spanned both academia and the corporate world. Jensen’s scientific position was supported by the rise of a generation of corporate raiders aggressively advancing new financial practices and discourses (Heilbron, Verheul, and Quak 2014); these actors, in turn, benefited from the legitimation and support offered by one of the most skilled academic entrepreneurs of the new “financial economics” (Dobbin and Jung 2010).

Thus our empirical narrative seeks to capture the interpenetration among the personal, the institutional, and the ideational—among an individual’s career; the changing institutional dynamics within his field (in this specific case, the relevant transformation is the rise of business schools as major power players within the discipline of economics); and the diffusion of economic theories, management practices, and naturalized ways of looking at the corporation. Jensen’s work, commonly understood as “agency theory,” not only drew inspiration from but actively endorsed, and in some ways enabled, the transformations in corporate management and governance that swept through the corporate world in the last decades of the twentieth century—from the junk bond market in the 1980s to the exponential growth of CEO pay in the 1990s to the share-

holder value management strategies of the 2000s (Khurana 2002; Lazonick and O'Sullivan 2000; Lazonick 2014).

Herein, indeed, lies the second purpose of our paper. The debate about the spread of neoliberal ideas and governance tools has largely centered on the transformations of the state and international institutions (e.g., Krippner 2011), on the one hand, and on the role of actively organized intellectual networks, such as the Mont Pelerin Society, on the other. (e.g., Mirowski and Plehwe 2009) To the extent that whatever happens to corporations is a direct outcome of state policies—e.g., deregulation, loosening of anti-trust regulations, etc.—this line of analysis is necessary. Yet, many transformations in corporate governance travel through different channels and can stay relatively invisible to state actors for a long time. They diffuse primarily through corporate boards, business magazines, consulting firms, and business schools. Nigel Thrift (2005) refers to these channels as “the cultural circuit of capital,” whose business it is to produce a narrative about the purpose of the corporation and justifications for how to make money. The neoliberal reconfiguration of firms is not simply derivative of the neoliberal reconfiguration of states or a by-product of the general diffusion of neoliberal ideas. Rather, we need to identify the specific carriers of that particular transformation in the amorphous space of “business discourse” in America.

Rethinking the Corporation

One of the most cited articles in the entire postwar economics literature was published in 1976 under the title: “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” The paper’s two authors, Michael Jensen and William Meckling, were products of the University of Chicago economics nebulae and both held positions at the University of Rochester business school at the time.¹ Michael Jensen had founded the *Journal of Financial Economics* a few years earlier, and he was still editing this then-minor journal when his joint contribution with Meckling appeared in it. How, then, did this piece, “marginal” from the point of view of academic economics, become so important that by 2005

1. Though Meckling never got a formal degree, he did graduate work in economics at Chicago. Jensen earned a PhD in Economics, Finance and Accounting from the University of Chicago Graduate School of Business in 1968. At the time when “Theory of the Firm” was written, Meckling was the dean of the Graduate School of Management at the University of Rochester, at which Jensen was an Associate Professor.

a prominent critic faulted its authors for unleashing what he saw as rampant corporate amorality and the breakdown of managerial ethics as revealed in a seemingly endless string of corporate scandals (Ghoshal 2005)? To understand this, we have to go back to the individuals who wrote the article, their social trajectory, and the economic and social conditions that enabled their vocabulary and concepts to entrench themselves as the new “common sense” of capital.

As of March 2016, “Theory of the Firm” boasted almost 10,000 citations in the Web of Science and close to 57,000 citations on Google Scholar, a truly staggering number for a single social science paper. The second reason that prompts our interest here is the affinity between the authors’ ideas—defended in this and other related scientific publications—and discourses emanating from the real world of economic governance: the business press, executive boardrooms, and the institutional machineries surrounding American corporations. We will describe the narrative put forward in “Theory of the Firm” before analyzing how the diffusion of these ideas intertwines with the career of their chief promoter: Michael Jensen.

The Academic Career of a Paper

In 2006, Kim, Morse, and Zingales reported that “Theory of the Firm” was the third most cited article in the entire discipline of economics since 1970 (Kim et al. 2006). Four other articles by Michael Jensen made the top 150 most influential economics papers list. The pattern of citation has been enduring, and also cumulative. Until 2009–2010, Jensen’s most prominent publications garnered, on the whole, more citations annually than in the previous year. Figure 1 below reports on the growing prominence of Michael Jensen’s work within social science since 1973, as measured by his ten most cited publications, many of which expand and refine the practical conclusions of the original article.

So what was the message? Quite simply, “Theory of the Firm” argues that corporations always pay “agency costs,” which the authors define as the monitoring and bonding costs that a principal (a firm’s owner, i.e., its shareholders) faces to insure that its agents (i.e., the firm’s managers) act in accordance with that principal’s interests. To these expenditures, Jensen and Meckling add the “residual loss” that comes from “the divergence between the agent’s decisions and those decisions which would maximize the welfare of the principal” (1976, 308). Note that the “welfare of the principal” is maximized only when the stock market capitalization of the

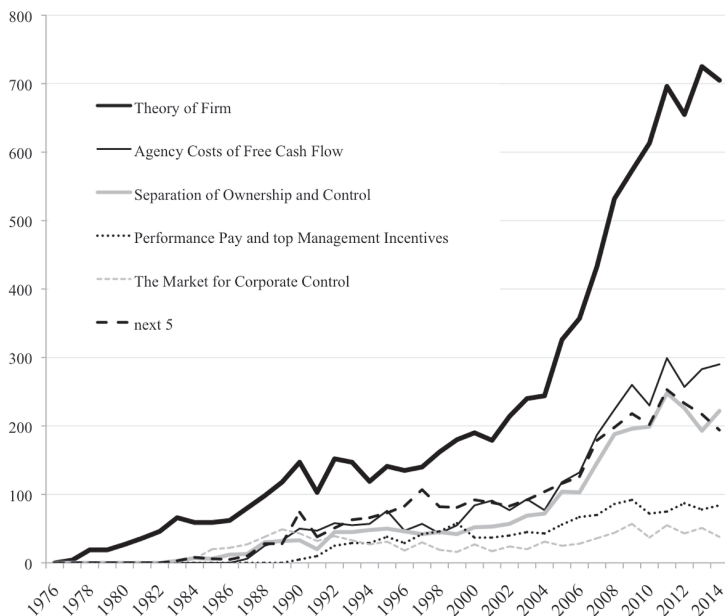


Figure 1 Annual citations of Michael Jensen's work in Social Science Citation Index, 1975–2014

firm is maximized: this is when the shareholders are most satisfied. The welfare of any other stakeholder in the firm—e.g., employees, customers, suppliers—appears irrelevant to this basic goal.

The Corporation Is Irrelevant

Today, “Theory of the Firm” seems like quintessential postwar Chicago price theory applied to the governance of corporations. Importantly, though, it was not a natural and straightforward extension in the Chicago view of the world at the time. As Ronald Coase had argued early on (1937), twentieth century economics did not really have a convincing account of the existence of firms; neither, in fact, did it care much about a firm's *internal* workings and outcomes. The discipline represented the corporation as nothing but a production function;² whatever happened within its walls was unexciting for theorists and attracted mostly practically oriented

2. Paul Douglas, the Chicago economist-turned-US senator, developed the functional form known as the “Cobb-Douglas” production function with a colleague from mathematics.

scholars in the institutionalist vein (e.g., Berle and Means 1932). This lack of concern for the allocation of resources *within* corporations was particularly evident at Chicago, where the reigning assumption was that firms only need competitive markets (that is, *external* pressures) to be efficient.

Chicago economists in the 1950s thus had little to say about what we now call “corporate governance,” specifically the processes, structures, and rules that affect the way a firm’s activities are organized and directed (Davis 2010). That was about to change dramatically over the next decade. Characteristically, however, the transformation did not come exactly from within, though part of the impetus was internal to the Chicago tradition. First was the growing empirical acknowledgement—increasingly difficult to brush aside—that modern American corporations had become extremely large and diversified, and were now run by a techno-structure of managers who were insufficiently accountable to stockholders and often driven by imperatives other than profit (Means 1962; Galbraith 2007). The Keynesian mainstream of the profession was simultaneously perturbed and dismissive, but some at Chicago took notice. The question of size, in particular, was at the center of economic debates in the 1960s, pitting George Stigler against Joe Bain and John Kenneth Galbraith.³ Stigler argued that many practices that were previously thought to harm competition—such as incumbents’ cost advantage and economies of scale—were in fact appropriate rewards for successful competitive behavior: hence a large market share does not necessarily imply market power (Baker 2003, 192).

Some Chicago students, however, were skeptical about the pursuit of bigness and the diversification of firms at all costs. They thought it caused managers to behave in an inefficient manner, which decreased the market value of firms and therefore was harmful to the interests of shareholders. Milton Friedman, in fact, articulated a related argument in a premonitory article in the *New York Times Magazine*, titled “The Social Responsibility of Business is to Increase its Profits”:

In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society,

3. John Kenneth Galbraith, of course, was more interested in the *democratic* and monopolistic effects of this transformation.

both those embodied in law and those embodied in ethical custom. (Friedman [1970] 2007, 173–74)

Not that this argument was entirely new: it echoed an exchange from the 1930s between Adolf Berle and E. Merrick Dodd Jr. in the *Harvard Law Review*. In the context of the Great Depression, the debate reflected American public opinion's and law's deep-rooted ambivalence toward the power of corporations (institutionalized in anti-trust legislation and federal regulatory oversight, and culminating in the trust-busting movement of the 1910s). It also illustrated the newer public anxieties about the growing separation of ownership and control, which was creating a class of in-and-out stockholders with limited social and psychological ties to firms.⁴

The government's penchant for acting directly on managers to ensure the viability of the corporation as a national and social institution was a recurring theme throughout the postwar period as well—from the military-industrial complex of the 1950s to the moral suasion of Democratic administrations relying on the discretionary power of corporate managers to stem inflation in the 1960s (Goodwin 1975). Meanwhile, popular management ideas extolled the socially responsible corporation, whose managers could be made to act as promoters of the common good and the welfare of workers and communities (Drucker 1946).

These management ideologies seemed ripe for a critique, however. For one thing, they could be attacked as non-scientific, drawing from sociology (Bell 1971), psychology or philosophy. From the point of view of economics, there was no reason to think that managers were—or ought to be—different kinds of people, driven by any other motive than self-interest. Furthermore, scholars closely associated with Chicago had begun to question the idea that relations within firms are any different from any other market relations: “the firm has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people” (Alchian and Demsetz 1972, 777). Finally, American corporations and their shareholders were not doing so well under the managerial regime. Between 1965 and 1980, the rate of return for publicly traded companies fell from over 12 percent to below

4. In 1932 Berle, a pro-regulation member of Franklin Roosevelt's Brain Trust, was a staunch exponent of the view that managers must have a financial interest in the corporation (he later revised it) and that their behavior must be subject to public accountability. His position thus supported *both* some appropriation of corporate assets by managers, as well as the regulation of their behavior to ensure what has come to be called “corporate social responsibility.”

6 percent (Poterba 1998). In 1974, Yale economist William Nordhaus published an article that puzzled over the “crumbling” of corporate profit margins since 1966 (Nordhaus 1974). The *Zeitgeist* was changing.

The Corporation Doesn’t *Really* Exist

As Michael Jensen tells the story, his and Meckling’s article was the outcome of an assignment they received from fellow Rochester economics professor and libertarian advocate Karl Brunner, for a seminar he was running in Interlaken, Switzerland that brought together scholars from east and west:

In 1971 Karl asked Bill and I to give a paper on the social responsibility of business. And Milton Friedman had written his *New York Times Magazine* piece that—I don’t remember the title, but it was something like “the social responsibility in business was to maximize profits”. . . And so Bill and I didn’t really—we weren’t wild about it, but we accepted the job and so I thought about it as maybe a pedagogical piece that did some of what Milton had done, but did it in a little bit different way for the Communists and the Marxists. And so we started to write this paper and the farther we got down that road now in the context of what we’d been doing in the classroom, we finally realized we didn’t have anything whatsoever to say about social responsibility of business in the way we were thinking about it before. But that what we were absolutely certain of was that competition in the way I had been trained and Bill had been trained in Chicago wasn’t going to ensure that the value of the firm got maximized. . . . I remember we gave our first version of it at Rochester, before we went to Interlaken, in May. These are all our friends now, but a lot of them had come from Chicago. They hated it. They ran us out on a rail. . . . They accused us of being dead wrong. And they were really mad at us. (Michael Jensen, interviewed by Rakesh Khurana, April 2005; also see Jensen and Walkling 2011 for a very similar narrative.)

The first formulation of agency theory departed from the Chicago dogma in that it argued that the separation of ownership and control creates agency problems that competitive markets *among firms* are unable to solve. The solution, paradoxically, was to “theorize away” the corporation (Bratton 1989, 1499), to dissolve its boundaries into the market by treating, and indeed reshaping, it as a nexus of contracts between individuals.

The questions of hierarchy, which preoccupied a whole generation of anti-managerialist writers, and of organizational form thus became simply irrelevant. As Jensen and Meckling put it,

The private corporation or firm is simply one form of *legal fiction*, which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. (Jensen and Meckling 1976, 311)

This view had two important implications: First, if the firm is like a market, then the usual concerns about corporate monopoly are irrelevant: “a large, monopolistic corporation is no longer a problem for the functioning of the market because it is *actually* and *merely* a group of individuals contracting with one another, not a massive and powerful entity in its own right” (Bratton 1989, 1499). In the neoliberal imaginary, contracts are not *social* artifacts bound by technology, law, and the distribution of power (Suchman 2003). They are only expressing the freedom and maximizing behavior of interacting individuals. Mediated by the individualistic metaphor of the free contract, the rhetoric and epistemic of the market might actually *and legitimately* sustain a social order in which large, even monopolistic, business formations reign supreme (Van Horn and Mirowski 2009; Nik-Khah 2011; Van Horn 2011; Birch 2016). Consequently the firm is not a social entity. There is no collective project, no commonality of purpose or solidarity among the actors, no fiduciary duty, no coordination necessary beyond that which enhances the firm’s value for its owners—the shareholders. If the whole turns out to be less valuable than the sum of the parts, then so be it! Shareholders have every right to sell the pieces for a profit. And they ought to have the right to demand that every unit within the firm help maximize shareholder value.

Jensen, Meckling, and their colleagues (including Jensen’s thesis adviser at Chicago, Eugene Fama) advocated for three corporate governance changes that would help reach the goal of shareholder value maximization: monitoring managerial performance, providing comprehensive economic incentives, and promoting an active market for corporate control, i.e., relying on external actions (such as hostile takeovers) to discipline corporate executives in underperforming firms. Monitoring managerial behavior involves the deployment of accounting practices, internal control systems, and the appointment of a professional board of directors whose

members operate in the stockholders' interest by virtue of their need to maintain their personal reputations. The alignment of incentives involves remunerating management in the form of company stock and stock options, so that managers, being turned into shareholders, will have the interests of owners at heart: self-interested employees will maximize shareholder value as a by-product of maximizing their own material gain. Importantly, two friends and co-authors of Jensen, Black and Scholes (1973), had just derived a valuation formula for such options, which was about to become enormously influential in the financial world (MacKenzie 2006). As options exchanges, powered by the new technique, started to thrive, the practice of remunerating managers (and other employees, particularly in the new economy) with stock options generalized, too.⁵ In a world of salaried managers, this was nothing short of a small revolution.⁶ Finally, the market for corporate control was said to lead to stock prices reflecting firm fundamentals, and to ensure that poorly performing "insider CEOs" will be threatened and ultimately replaced by efficiency and profit-oriented "outsider CEOs."

As Lazonick and O'Sullivan (2000) have shown, the extolling of shareholder value came, in practice, to be associated with the downsizing of the labor force and an exponential rise in executive compensation. These trends came under fire during the 1980s, and were perceived as mounting evidence of corporate greed (see Appendix 1, which documents the rapid rise—or return—of these themes and language, using Google's Ngram Viewer). To agency theorists, however, the new practices not only appeared scientifically more valid; they were inherently good, and corresponded to deeply held values and beliefs about how the world should work. By forcing managers to reveal the truth about corporations, the recommendations of agency theory would, they believed, help prevent self-serving and unethical behaviors:

The following three things played a huge role in who Bill and I were and are. One is freedom of the individual. And what we were in life was all about creating a world in which individuals could be as free as pos-

5. The number of US employees holding options rose from one million in 1992 to between seven and ten million in 2000 (Hall and Murphy 2003, 53).

6. Besides the original 1976 paper, this argument was developed prominently in Eugene F. Fama, "Agency Problems and the Theory of the Firm," *Journal of Political Economy* 88, no. 2 (1980), and in Eugene F. Fama and Michael C. Jensen, "Separation of Ownership and Control," *Journal of Law and Economics* 26, no. 2 (1983).

sible. . . . The second thing was we detest waste. And we were devoted to creating a world in which efficiency reigns, efficiency in the economic sense. And the third thing was—and it took me years, a number of years later, to really formally recognize it—was that we both were devoted to creating a world in which honesty and integrity reigned supreme. (Michael Jensen interviewed by Rakesh Khurana, April 2005; also see Jensen and Walking 2011)

The Social Trajectory of a Finance Professor

But how did the argument become the common sense of financial economics and beyond? To understand this, we need to go back to two intertwined structural transformations within the fields of economics and higher education. Jensen, Meckling, and most of the people who developed agency theory in accounting, finance, and economics were not mainstream economists—they were not even traditional economists in an institutional sense. Rather, they were the products—and in many ways the foot soldiers—of a new kind of institution: the scientific business school.

The Ford Foundation and the Emergence of the Scientific Business School

Until recently, scholars rarely paid attention to business schools as important sites of *disciplinary* training. And to some extent, they were right to do so: first, business schools, particularly in the 1960s, trained much smaller numbers of doctoral students than regular departments; second, they typically trained them in business disciplines (dominated by practitioners of accounting, management, and finance) rather than in the traditional social sciences; and third, disciplinary social scientists looked down on business schools as places of employment. For economics PhDs, business schools were near the bottom of the academic job market pecking order.

Things have changed dramatically since then, of course. Today's economists often covet business school jobs, particularly at top institutions, because they pay so much better and often involve lighter teaching loads and more generous research support than regular economics departments. Business schools have moved aggressively into the regular economics job market; consequently, the boundary between the kinds of economists who populate arts and science departments and those who populate business schools has eroded significantly.

The scientific business school emerged in the late 1950s, when the Ford Foundation diverted its vast resources away from controversial social questions and toward the education of a new generation of corporate elites. Foundation officials had become convinced that training in the so-called “behavioral sciences” would help managers organize production more efficiently and avoid conflicts with labor (Khurana 2007; Fourcade and Khurana 2013). The foundation established a grant program to support institutions that demonstrated their commitment to curricular reform. Among the successful applicants, two schools in particular stood out for their project to ground business education in science: the Graduate School of Industrial Administration (GSIA) at Carnegie-Tech, and the Graduate School of Business at the University of Chicago (Chicago GSB). The GSIA supported an integrated, interdisciplinary model rooted in engineering, while the Chicago GSB was much more aggressive in its promotion of economics as the core discipline around which the reform of business training should take place.

W. Allen Wallis, the dean of the Chicago GSB from 1956 to 1962, crafted the new institutional strategy. Wallis was a Columbia-trained statistician, but he had spent time in the Chicago economics department during the 1930s, where he had forged a life-long friendship with two fellow students, Milton Friedman and George Stigler. It is Friedman, indeed, who helped recruit him to the University of Chicago to found the Department of Statistics after the war. Like Friedman, Wallis was also a bona fide neoliberal: a member of the Mont Pelerin Society, he was later appointed undersecretary of state for economic affairs under Ronald Reagan and finished his career at the American Enterprise Institute.

Once at the helm of the GSB, Wallis proceeded to upgrade the school’s research profile. The reformed GSB drew upon disciplinary faculty who were working in areas most closely related to business—statistics, accounting, law, but especially economics. Supported by the Ford Foundation, the transformation was swift: Between 1957 and 1963, the number of doctoral candidates in the school’s programs increased from 18 to 70. Faculty ranks swelled to 70 members, with only 11 of the pre-Ford-reform faculty. Of the 51 faculty in 1959, 22 had a PhD in economics (Whitley 1986). The trend continued into the 1960s with the next dean, economist George Schultz. According to our own calculations, in 2008, 62 percent of the faculty at the renamed Chicago Booth School of Business held a PhD in economics or finance; furthermore, at 71 members this group was more than twice as large as the economics department in the university’s arts and sciences division.

A large proportion of the new recruits in the early 1960s held a joint appointment with the economics department, making the business school a de facto extension of that department, if not (given its size) a second economics department located at the university. Allen Wallis explained the policy by flatly stating that: “if a person wasn’t good enough in his field to be welcome in the appropriate department, we did not want him either” (Olkin 1991, 136). PhD students at the GSB were required to take classes from the department’s heavyweights—macroeconomics with Milton Friedman, microeconomics with Gary Becker. Such a close integration helped forge a certain unity within the Chicago approach, and strengthened its strategy of scientific legitimation vis-à-vis the broader field of economics, which was often perceived as hostile.

Corporate interests in the local business community also supported this organizational revamping. The school’s Associates Program enrolled the financial commitment of a hundred corporations. The banking giant Merrill Lynch was interested in the development of empirical financial knowledge, and it committed resources to the establishment and maintenance of a unique financial database at James Lorie’s Center for Research on Security Prices. Additional funding came from private, often conservative foundations, which George Stigler, in particular, pursued assiduously. These considerable institutional resources helped Stigler—together with Milton Friedman (his colleague in the economics department) and Aaron Director (at the law school, an institution that also benefited from the Ford Foundation largesse)—push forward an intellectual program that sought to transform prevailing views about government, markets, and corporations. Together with his GSB colleagues Sam Pelzman and Merton Miller, Stigler helped provide a rationale for the movement of deregulation that took place in the 1980s and to support the benign view of antitrust defended by much of the Chicago-originated law and economics scholarship, according to which “only explicit price fixing and very large horizontal mergers (mergers to monopoly) were worthy of serious concern” (Posner 1979, 933; also see Nik-Khah 2011).

Perhaps the most visible consequence of the institutionalization of a powerful economics core within American business schools, and at the Chicago GSB in particular, was the transformation of the field of finance, traditionally dominated by qualitative practitioners (chartists and financial analysts), into “financial economics” during the 1960s. This evolution was hugely consequential for the future of financial technologies and practices, enabling the rise of financial engineering (MacKenzie 2006), as well as for the subsequent trajectories of both fields. Building on modern

probability theory and the formalization of stochastic processes, the academic and worldly practice of finance was scientized; conversely, the scientific practice of economics was transformed by the application of a financial lens.

According to Mehrling (2005, 82) modern finance theory arguably originates in the desire to make theoretical sense of a statistically “startling fact”: if you graph the price of a stock over time, it will look no different than a series tracking cumulative coin flips. In other words, it is impossible to game the market. It is through this “no arbitrage” condition that the empirical phenomenon of random stock price fluctuations would be connected to the notion of equilibrium in economic theory (Jovanovic 2008, 223–24). Later reframed as the “efficient capital markets hypothesis,” or, for short, efficient markets hypothesis (EMH) by Eugene Fama, the theory posits that, if agents are risk-neutral, the prices of securities always perfectly reflect all known information; consequently, a firm’s stock price is the best reflector of that firm’s fundamental economic value. Only new information can impact stock prices, and to the extent that new information emerges randomly, then the movement of stock prices is, indeed, a “random walk” (Fama 1970). The rates of return on all assets are equal to the rate of return on the risk-free asset. By relying simultaneously on empirical fact and economic theory, the EMH provided both a definition of market efficiency and a description of the world in which financial markets were, indeed, efficient.

Other financial economists immediately critiqued both the statistical interpretation of the phenomenon and its theoretical explanation. The concept of efficient markets is merely an idealization, they argued. In practice, rates of asset returns differ and agents are risk averse. This perspective was embodied in an alternative, more practically oriented, approach: the capital asset pricing model (CAPM), which connected asset risk and return in a mathematically tractable way. With some important exceptions, the leaders and promoters of the CAPM were primarily located on the US east coast, and specifically in the Cambridge, Massachusetts, intellectual community that spanned MIT, Harvard Business School, and the management consulting firm with MIT roots, Arthur D. Little.⁷

The EMH and the CAPM had much in common, as well. The two approaches co-evolved in the 1960s and 1970s through constant intellec-

7. The most tireless advocate of the approach, Fischer Black, bridged both the academic world and the world of practice at Arthur D. Little, then the University of Chicago (where he came as Ford foundation professor in 1971), MIT, and, finally, Goldman Sachs.

tual exchanges and overlapping social networks, and they have arguably converged since then (Mehrling 2005). But it is the EMH version of price efficiency, not the CAPM, which truly captured the imagination of the later generations of finance academics (Polillo 2015). First, it offered a convenient mathematical foundation with a clear economic meaning, opening up new scientific possibilities, and propping up a cottage industry of academic papers:

The assumption that the ECMH is true makes it possible to do a lot of interesting and fun things in financial economics and corporate law. . . . It is a highly useful tool and even though its strict truth cannot be defended any longer without substantial supplementation, we do not have as yet a single better story of how prices are set or what constitutes fundamental value of a security. More realism tends to overwhelm us. (Allen 2003, 558)

Second, not only did the EMH fit quite naturally into Chicago's signature approach to economics—free-market-oriented and interested in the predictive power of the theory over the realism of assumptions—it was promoted in a voluntaristic manner as a key element of the Chicago “brand” (Mehrling 2016). Third, unlike the CAPM, which repeatedly failed empirical tests, the EMH *appeared* to be empirically irrefutable, even though much of that irrefutability was rooted in the low power of statistical tests.⁸ Fama's reliance on standard econometric techniques, in fact, helped Chicago to discredit CAPM, “build bridges with others,” and tie scholars into a coherent social network (Polillo 2015, 30). Finally, the approach was practically useful. Here was a way to talk about value—“fundamental value”—that completely sidestepped the elusiveness of the concept, and seemed to offer instead an “objective, useful and safe” standard in the form of a stock price that incorporates all publicly available information (Allen 2003, 558).

From Chicago to Rochester

One way to interpret agency theory as a product of the finance revolution has precisely to do with the financial markets' efficiency at pricing the value of a firm (in spite of their different assumptions on agents' risk

8. In an important critique, Lawrence Summers (1986) shows that statistical tests have very low power to reject alternative theories to the ECMH, but this should not be taken to mean that the hypothesis must be accepted as valid.

aversion and preferences; both EMH and CAPM agree on that). Jensen and Meckling show that value is not simply revealed by this process. It can also be created. By using stock prices to convey a signal to corporate managers, shareholders can direct them to squeeze out firm inefficiencies. In other words, and paraphrasing Donald MacKenzie's (2006) paraphrasing of Milton Friedman, shareholder value is not simply like a *camera* taking a snapshot of what the firm is worth. It is also an *engine* to help generate that worth, by making the firm more efficient and aligning the behavior of managers with the interests of their principals—that is, bringing them ever closer to the ideal rational agent.

The connections among the modern finance theorists (both EMH and CAPM) were not simply intellectual of course. Michael Jensen studied with and then under Eugene Fama at the Chicago GSB (they were similar in age, and Fama was hired directly from the Chicago school's graduate program) and collaborated closely with him. The affinity is clear, but we still need to explain the intellectual trajectory. Even at Chicago, the practical problems of corporations seemed trivial and not much worth an economist's time. Chicago scholars were interested in economics and markets first, and looked down upon the practical problems internal to firms. And thus aside from providing a rationale for deregulation, Chicago faculty had very few prescriptions to offer American corporations—as they did governments, incidentally. As we suggested earlier, Stigler's standard line—that competitive pressures would keep firms on their feet—made Chicago-originated price theory somewhat irrelevant to the question of how corporations should be managed. This was the paradox of a business school science that had little to teach business. Even Fama's EMH seemed, at least in the initial formulation, to have little practical advice to offer, since stock returns are unpredictable and thus markets cannot consistently be gamed.⁹ One of Jensen's first published papers, written while a graduate student at the University of Chicago, showed—much to the chagrin of professional portfolio managers but consistent with Fama's theory—that mutual funds performed no better than the market¹⁰ (Jensen 1968).

9. Fama's approach, however, inspired a GSB student—David Booth—to set up a financial investment firm, Dimensional Fund Advisors, where Fama also serves as a close consultant. In 2008, Booth donated \$300 million to the Chicago business school, which was thereby renamed in his honor.

10. Consistent with the CAPM approach, this suggested that mutual funds should not cherry pick stocks—holding the market is the best strategy.

The less public, more silent revolution, however, was taking place in classrooms—and it owed much to the reconfiguration of higher education brought about by the ongoing expansion of business schools. In 1963, shortly after launching the first phase of the curricular reforms at the Chicago GSB, Allen Wallis was persuaded to accept the presidency of the University of Rochester—a job he would hold for twenty years. Once there, his first move was to start a business school in the Chicago mold, drawing on financial support from the local business community. Wallis hired William Meckling, a former Chicago economics doctoral student and fellow Mont Pelerin Society member, as dean of the new institution, and together they began to assemble a critical mass of University of Chicago-trained young economists to teach business subjects. Between 1970 and 1995, fourteen of the faculty members hired at the Rochester/Simon School of Business had obtained their PhD at the University of Chicago. The next institution, Carnegie Mellon, contributed only four. Meckling himself remained dean for nineteen years, profoundly shaping the institution. A former student recalled that:

There was a deep connection with the Chicago economics department. . . . That's where the real Jesus lived. In Chicago. And everybody else was sort of, just wanted to be like Chicago. . . . You know, Friedman's notes were what our qualifying exams were formed from. . . . Basically a paper version of Friedman's notes that I just carried around with me wherever I went. That's what you did. There it is, still right there. They're right here. [taking document] I mean, the idea that you would be without this document. How could you move without this document, right? This is like, this is how you learned price theory. What else is there?

Question: So this is basically like a course book?

Answer: Well. . . it's like his type-written notes. Friedman's type-written class notes. (Anonymous interviewed by Khurana, November 2010)

The quote expresses vividly the intellectual and emotional bonds between the two institutions. Rochester was a satellite of Chicago, and it was perhaps the most zealous and loyal satellite. At the same time, the distance from Chicago, as well as the specific demands that the school faced from its patrons and publics, were a source of autonomy, and helped spur a reorientation of the research framework. The Rochester area was the second largest economic region in New York State. Major companies had their headquarters (Eastman Kodak and Bausch and Lomb) or significant operations (Xerox, IBM, and Corning) in the area. The University of

Rochester was “flush with capital”: it had the third largest endowment in the country throughout much of the 1960s, thanks to the support of local patrons (Amadae and de Mesquita 1999, 279).¹¹ The business school itself was a pioneer in the development of a successful—and lucrative—executives’ program.

After obtaining their degrees, Rochester business school graduates were destined to feed into the local industrial basin. But the dry price theory inherited from Chicago lectures (upon which the new scientific business school curriculum was built) did not appeal much to them, and they insisted that their teachers be practice oriented. From below, the faculty thus faced the pressure to be directly relevant; from above, they still had to be scientists (they were Chicago students after all). Furthermore, they were acutely aware of their peripheral position in the broader field of economics. They were young and the school was brand new (the first Rochester MBA degree was awarded in 1962). Indeed, in the interview with the second author, Jensen had no problem acknowledging that it was then “a third-rate place.” Most of the newly hired had gotten their PhDs from the Chicago business school—rather than the economics department—an oddity at the time and certainly a mark of lesser status. Their scientific papers were going nowhere: even the Chicago-dominated *Journal of Political Economy* would not publish them. Fama was a strong supporter, but he, too, was somewhat isolated; perhaps the fact that he had been educated at the GSB, in economics and finance, continued to act as an invisible, but nonetheless real, status barrier.

Sociologist Pierre Bourdieu has suggested that newcomers in a field who are “outside the beaten tracks cannot ‘beat the dominant at their own game’ unless they make *additional, strictly scientific investments* from which they cannot expect high profits, at least in the short run, since the whole logic of the system is against them” (1975, 30, emphasis added). On the symbolic front, Rochester scholars mobilized scientific institutions and language in a deliberate manner. “Positive” theories sprung up in political science around William Riker and in accounting around Watts and Zimmermann, durably impacting both fields and entrenching the influence of economics within them. Echoing Milton Friedman’s (1953) article on “the methodology of positive economics,” the accountants contrasted their own approach, dubbed “positive,” to older, less scientific

11. This did not last: much of the University of Rochester’s endowment was in stock from Kodak (the university was founded thanks to the bequest of George Eastman, founder of Kodak Eastman) and other local companies. However, this capital shrunk as a result of the changing economic climate of the 1980s, forcing the university to downsize severely.

ones, called “normative.” Jensen similarly described the shift in finance theory as one from “*normative* questions such as ‘What should investment, financing, or dividend policies, be?’ to *positive* theories addressing questions such as ‘What are the effects of alternative investment, financing, or dividend policies on the value of the firm?’” (Jensen 1984, 2, emphasis added). Like Friedman, both groups anchored their disciplinary claims in the view that free markets are generally efficient and, in a prediction-oriented methodology, focused on shareholder value.

Institutional investments complemented intellectual ones. In the 1970s, Rochester scholars established new scholarly reviews in economics, finance and accounting: *The Journal of Accounting and Economics* (JA&E), *The Journal of Financial Economics* (JFE), the *Journal of Monetary Economics*, and the Carnegie-Rochester conferences series in public policy¹² were all originated and edited there. The journals created new scientific circuits for the rapidly expanding fields, and served as vehicles for the new approaches to macroeconomics, financial economics, and accounting: Rochester faculty and students built their academic reputation in part through these publications. For instance, 16 percent of the articles in the JFE and 23 percent of the articles in the JA&E between 1970 and 2012 had at least one Rochester affiliate as author. In other major journals in finance or accounting, by contrast, Rochester’s presence never reached beyond 5 percent. The Rochester journals also helped cultivate the connection with Chicago (and Carnegie-Mellon), particularly in their first two decades of existence. Among all the papers published in the JFE since its founding (in 1974) to 2006, Chicago authors have published the most (123), followed by University of Rochester faculty (114).¹³ Interestingly, Harvard becomes the dominant player after 2000. Finally, if we look at PhD of origin (Fig. 2), then the preponderance of the Chicago-Rochester group is even more overwhelming, accounting for close to 50 percent of the top 40 publishing authors in the journal.

These disciplinary strategies would prove, in the end, effective in helping their authors claim—or reclaim—an edge vis-à-vis the mainstream in economics, as well as their Chicago forebears, with whom they entertained a complex relationship, simultaneously deferential and competitive. Operating on the symbolic (and paradigmatic) edges of the economics

12. The Carnegie-Rochester conference series, started by Karl Brunner, has become famous for publishing the “Lucas critique” of econometrics in its first issue.

13. Eugene Fama, in particular, co-authored extensively with Rochester faculty and students. Also see the useful data reported by the *Journal of Financial Economics* website at http://jfe.rochester.edu/Decade_inst.pdf.

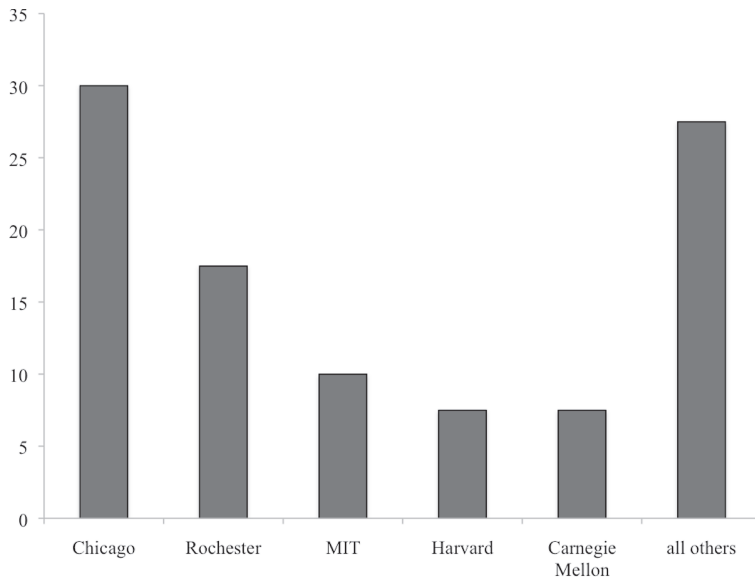


Figure 2 PhD origins of the top 40 publishing authors in the *Journal of Financial Economics*, 1974–2006. (percentages)

profession, the Rochester scholars sought, consciously or unconsciously, to bridge their distance from the center of the field by engaging in forms of scientific activism and by enrolling allies from outside of academia. The money started to come in, too. In 1986, former secretary of the treasury (under Ford) and leverage buy-out investor William E. Simon coordinated, together with conservative foundations, a major donation of \$15 million (the school's endowment before that was \$3 million). Grateful, the school renamed itself after him. In an interview with the *New York Times*, "Simon said that he agreed to donate and raise money for Rochester because he strongly believes in the business school's staunch free-market philosophy and its grounding in economic analysis" (Schmitt 1986). From 1977 until his death in 2000, Simon was president of the very conservative John M. Olin Foundation, the foundation most responsible for funneling funds to conservative scholars in American universities, in order to build a pro-free-market counter-intelligentsia (Mayer 2016). He practiced this advocacy himself: in several book-length pamphlets Simon called for would-be philanthropists to rush their millions to help the cause of "liberty" and for businesses to truly implement free-market capitalism (1978, 230–31).

If it had only been about the science, the theories marshaled out of Chicago and closely related institutions, like Rochester, might have remained "pretty, polite techniques for a well-paneled boardroom," (Keynes 1937)

with little relevance to politics and little purchase on the world. But we would not be talking about a neoliberal revolution if that had been the case. Of course, what happened is that economists in the Chicago orbit, and philosophical acolytes in the conservative movement, became allies in an effort to push back against the greedy hand of government.¹⁴ Chicago scholars, Friedman first among them, voiced their views on many questions of public interest, from the draft to rent control to anti-poverty policies. Supported by conservative foundations, they published bestsellers, wrote in the business and general press, helped set up think tanks (Mitchell 2007; Mirowski and Plehwe 2009; Van Horn, Mirowski, and Stapleford 2011), and lobbied public authorities (MacKenzie 2006). Friedman himself produced a pedagogical series for American public television. And they successfully enrolled political and economic allies in the process. Indeed, some (Allen Wallis, George Schultz, and countless students of theirs) heard the call when Ronald Reagan was elected and moved to Washington.

What gave particular visibility and influence to agency theory, in particular, was that its promoters made considerable efforts to disseminate their ideas and findings beyond traditional academic channels—into the classroom and the wider world of practice. Unlike their more purist disciplinary brethren, the new finance scholars cultivated their connections to the markets, as principals in or consultants to private firms, and agency theorists were no exception (Fox 2011). There was a missionary zeal about the whole enterprise: appearing relevant to practitioners—e.g., corporate boards and asset managers—was a powerful source of legitimation, particularly vindicated in the increasingly assertive business school field. Relevance, however, was not enough. Agency theorists wanted to change people's minds and practices. As Jensen put it in his course material, those who taught the course subscribed to the idea that *real learning leads to (and is evidenced by) changes in behavior*. This belief has remained an important philosophical underpinning of the O and M [Organization and Management] group at Harvard. As the instructors put it in their course material, "We do not just teach; we are devoted to making a difference in peoples' lives." But a change in behavior almost always means giving up an associated way of thinking, and giving up a way of thinking is almost always a painful process (Jensen et al., 1997, 6).

The core course Jensen and Meckling developed around agency theory, Coordination, Control and the Management of Organizations (more popularly known as CCMO), became the most successful elective course at Rochester business school. It came to be seen as so central to the school's

14. On "state-phobia" as a uniting theme in neoliberal thought, see Foucault 2008, 75–76.

identity that the dean later turned it into a requirement of the MBA curriculum (Jensen et al. 1997). Originally started as an attempt to teach price theory to business students, the course quickly evolved into an overarching framework applicable to a wide range of phenomena, including human resource management, labor economics, organizational behavior, finance, governance, and corporate control. The course consisted of three modules. The first module introduced students to the foundational papers around the problems of agency and agency costs. The second module applied this framework to a variety of organizational situations and problems found inside organizations, including incentive systems and budgeting systems. The third module applied the constructs of agency theory and agency costs to examining corporate governance more broadly and the impact of capital markets, debt structures, and takeovers in disciplining managers and restoring efficiency.

From Rochester to Harvard, and on to the World

Places higher up in the business school status order started taking notice of the changes in tone and philosophy. In 1984, Michael Jensen moved to Harvard Business School, first at half time and then full time. His relocation to the (still) most powerful institution in the field of business education was not without costs, however. To the world he came from, he looked like the prodigal son who forgets his true origins. By accepting a position at Harvard, Jensen revealed a “practical” habitus that was much less appealing to his economics brethren, who sought to remain scientifically pure. His Rochester colleague and long-time associate Bill Meckling, for instance, saw the move as a sell-out. Some people in the Chicago crowd were even more negative, also faulting him for messing with the world.

But Harvard Business School was a real consecration vis-à-vis the practical world of business.¹⁵ It offered something new, an influential public platform from which to broadcast one’s ideas toward finance practitioners, to purge them of their unscientific beliefs and practices (Jovanovic 2008, 221). The classroom, once again, was the pivotal institution. During Jensen’s tenure at Harvard Business School (1985–2000), the CCMO course went from enrolling a few hundred students to over six hundred, or more than two-thirds of each year’s MBA cohort (see Fig. 3). Harvard, furthermore, provided closer connections to the corporate world through

15. Note that Jensen’s friend Fischer Black had left MIT and taken a position with Goldman Sachs at about the same time (Figlewski 1995, 95).

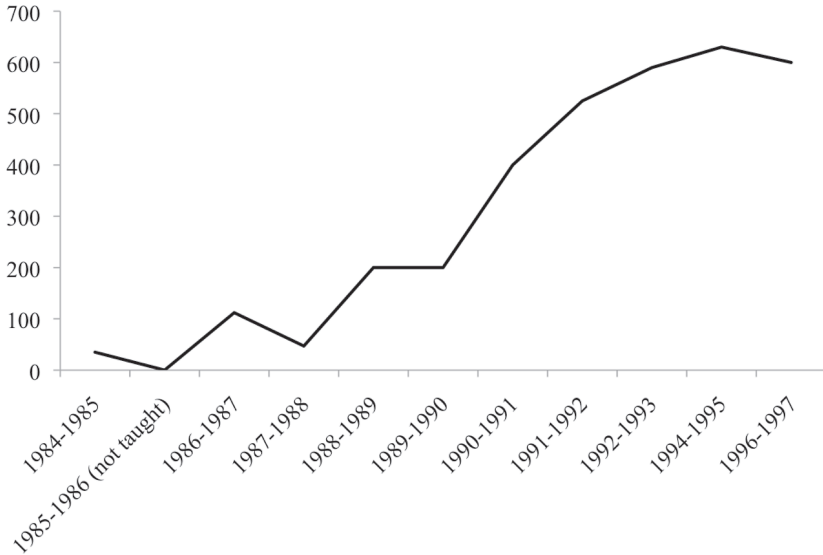


Figure 3 Enrollments in the CCMO course, Harvard Business School, 1985–1997.

* no classes taught in 1985–6. Source: Jensen et al. 1997, p. 170.

the weight given to case studies (Jensen started writing cases in the early 1990s), their worldwide diffusion through the Harvard publishing machine, and through executive education programs with prominent companies (Jensen and Walkling 2011, 10).

The press was the other vehicle. Harvard, again, was at the core of the diffusion process, as agency theorists marshaled their ideas in the influential *Harvard Business Review* (HBR). It is in the pages of the review that Jensen, for instance, came out forcefully in favor of takeovers (Jensen 1984), stock options for CEOs (Jensen and Murphy 1990; also see Murphy 1986); and private equity (Jensen 1989). Meanwhile, the Harvard position gave agency theorists more authority in national newspapers, such as the *New York Times*, the *Washington Post* and the *Wall Street Journal*. Using dramatic examples, they explained the changing business environment and offered concrete prescriptions to improve corporate profitability, all of which had to do with properly aligning managerial incentives.

To be sure, corporate raiders had *initiated* the new rationale and corresponding practices (Heilbron, Verheul and Quak 2014). But they were not popular, often described as lone wolves coming out of nowhere, leaving vulnerable corporations in shambles. In 1985, T. Boone Pickens made the cover of *Time* magazine, portrayed as a poker player. The raiders elicited

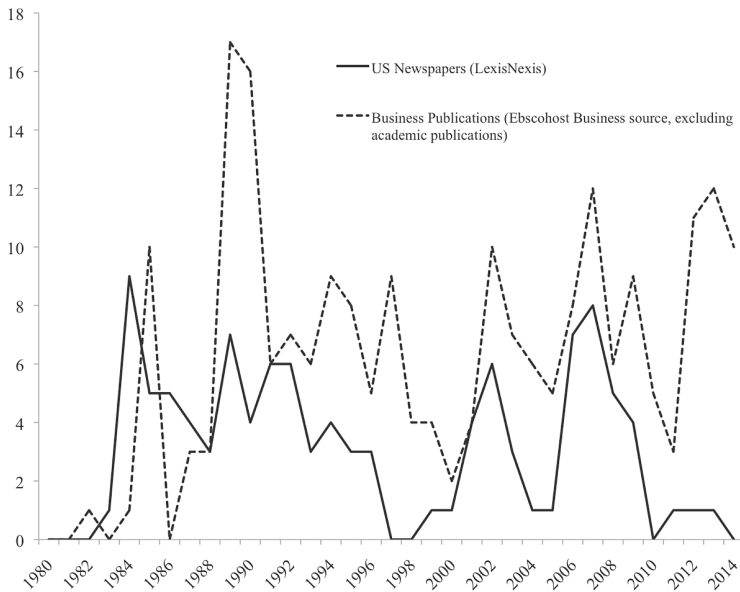


Figure 4 Citations of Michael Jensen in US media

a mix of fascination and fear. Agency theorists explained that the dread they inspired was actually a good thing. It was the best way to discipline supposedly wasteful managers. They argued that the deregulation that enabled hostile takeovers had resulted in a more efficient allocation of the rights to control corporate assets. Managers who were unable to run their companies efficiently, as measured primarily by the firm's stock price, should suffer the consequences in the form of a takeover; the prosperity of takeover entrepreneurs and imaginative investment bankers was a sign that there was value to be unlocked from American corporations.¹⁶ Jensen himself described T. Boone Pickens not as a financial speculator but as an “inventor” whose insights into improving a firm's value were intellectual property, the value of which should rightly accrue to its originator (Jensen 1987). Pickens, for his part, reportedly handed out copies of Jensen's famous *Harvard Business Review* article defending takeovers.¹⁷ Jensen also defended Pickens's business strategy against his critics and criticized an adverse legal decision by the Delaware Supreme Court (Jensen 1985).

16. See Jensen and Ruback (1983) for a review of the agency literature on this topic.

17. See Jensen (1984). Part of Jensen's argument in this article was that those who were against takeovers engaged in “folklore,” whereas his views were grounded in “science.”

The same year, he extolled takeover activities as beneficial to society in Congressional hearings, citing higher stock prices as evidence (Vise 1985). Finally, he was not shy about writing for or speaking to the general news media or specialized business magazines. Figure 4 below reports on citations of Jensen in both, showing his rising presence in the general press in the early 1980s, and in the business media in the later part of the decade and into the 1990s.

As Hirsch (1986), Scherer (1988a, b), and Dobbin and Zorn (2005) have argued, the real impact of agency theory was cultural: its promoters were able to back up a nascent market for corporate control with their authoritative voice, helping shareholder value triumph as the new measuring rod of corporate performance. Jensen and Meckling, Scherer writes, “[changed] the semantics—from the ‘separation of ownership and control’ of Berle and Means, with its ominous negative ring, to the much better sounding challenge of securing the optimal relationship between principals (stockholders) and agents (managers)” (Scherer 1988b).

The figures below (Fig. 5 and 6) report the rapid rise in mentions of the terms “shareholder value” in academic journals and in major business and news sources. The data demonstrate the leading role played by the *Wall Street Journal* in the very early years and the *Financial Times* at the peak (on this point, also see Heilbron, Verheul, and Quak 2014). It also shows a striking pattern of diffusion, with a salient inflexion point around 1985 (which, incidentally, is the year that Jensen came to Harvard Business School). The explicit connections between the two movements (the academic and the practical) became apparent around the same time to observers. For instance, a 1985 article in *Institutional Investor* remarked that Jensen “has come out in favor of corporate raiders and greenmailers to the point of developing an economic rationale for takeovers”:

Jensen, Jarrell, Ruback, and a coterie of other researchers, mostly like-minded Chicago or Rochester alums, have a new tune for the pundits and pear-shaped executives who agitate for a return to the days of genteel board luncheons and smaller block trades. They sing loud, and Jensen the loudest. Their stage is Jensen’s research center, which funds conferences and such studies as “Antimerger Policy and Stockholder Returns: A Re-Examination of the Market Power Hypothesis,” “Take-Over Defenses via Corporate Charter Amendments and Their Effects on Stockholder Welfare” and “Raiders or Saviors?: The Evidence on Six Controversial Investors.” Their fan-club newsletter is Jensen’s *Journal of Financial Economics*, which publishes much of this research. (VerMuelen 1985, 75)

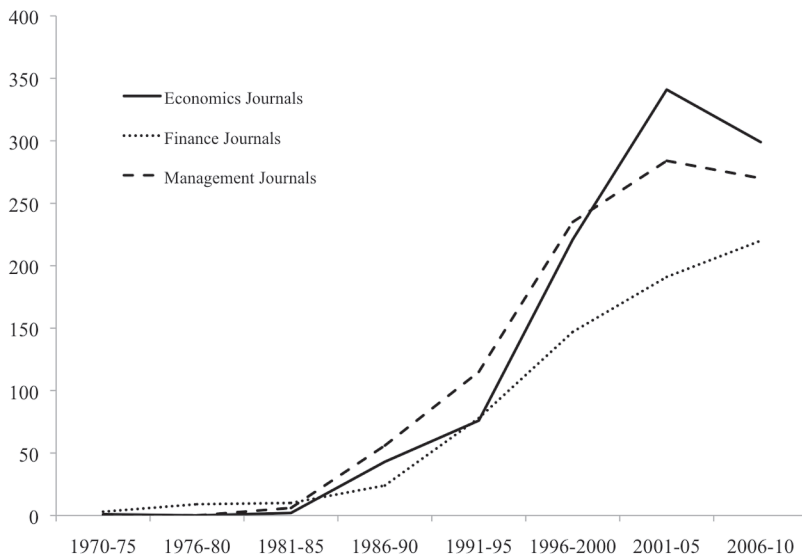


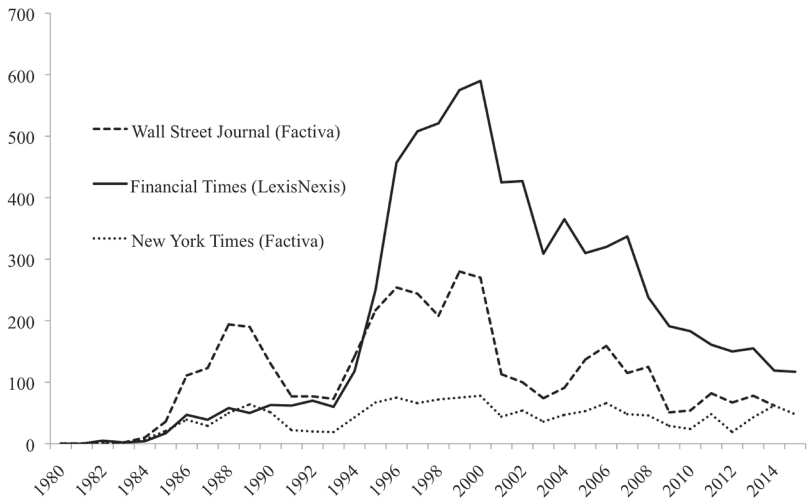
Figure 5 Mentions of the term “shareholder value” in selected academic literatures, 1970–2010. Source: JSTOR.

But the fastest growth in popularity, both within academic fields and in the business press, comes in the 1990s.¹⁸

Agency theorists, in short, helped “plant the idea that the most important people in any company are not the employees or the managers but the owners—the stockholders and bondholders” (Cassidy 2002). In less than twenty years, shareholder value entered the everyday language of business. Its generation became the established purpose of a corporation’s existence and activities and the lingua franca of investors. Using the language of shareholder capitalism, financial analysts, money managers, institutional investors, and hedge funds (in the 2000s) advocated for the expansion of shareholder rights and the removal of restraints on their own behavior.¹⁹ With their coffers overflowing with pension funds and

18. We used Factiva to search the *Wall Street Journal* and *New York Times* (largely because the *Wall Street Journal* is not accessible via LexisNexis) but we found that Factiva generated a lot of duplicates for the *Financial Times* (because it searches multiple editions and thus “finds” the same article more than once), so we used LexisNexis to search the *Financial Times*.

19. In 1952, less than 10 percent of US equity was owned by institutional investors. This share reached 30 percent in 1976. By 2006, it exceeded 70 percent (Gillan and Stuart 2007, 57).



Figures 6a and b. Mentions of the terms “Shareholder Value” in major news and business sources (Factiva) and, below, in selected news sources (Factiva and LexisNexis), 1980–2014.

401K dollars, and under pressure (and financial inducement) to deliver higher-than-average returns, institutional investors, in particular, promoted shareholder value as a practice that was in the best interest of US companies—and thus in the interest of workers, too (Drucker 1986; Dobbin and Zorn 2005; Davis 2009).

It is uncertain that shareholder activism succeeded in improving the performance of US firms in the end (Gillan and Stark 2007). What is clearer is that, contrary to the promises of the movement, workers and pensioners did not gain much from these actions (Fligstein and Shin 2004). Despite the anti-managerial rhetoric, managers were the main beneficiaries (Goldstein 2012). The compensation packages of corporate executives went through the roof in the 1990s, fueling a massive increase in social inequalities (Piketty and Saez 2003). The ratio of CEO to worker pay rose from 30:1 to over 400:1 in 2000. The largest proportion of the growth was attributable to a shift from salary to equity in executive compensation (see, e.g., Murphy 2012)—a shift directly traceable to the arguments promoted by agency theorists through the twenty preceding years. In 1984, while still at the University of Rochester business school, Jensen and his young colleague Kevin J. Murphy had organized a conference on executive pay, the main conclusions of which they disseminated in business publications and in a *New York Times* editorial titled “The Flap over Executive Pay: Beware the Self-Serving Critics”:

Shareholders, taxpayers, consumers and voters must be wary of wolves dressed in sheepskin currently attacking executive compensation to achieve their own ends. Many assert that executives are overpaid and paid in a way that is independent of performance. Noteworthy is the lack of accusation of fraud or illegal behavior. Most important, the attack has excited little support on the part of shareholders, who, after all, pay the bill. Shareholders recognize that there is no issue, a conclusion supported by the best scientific evidence currently available. The consensus of more than 60 leading academicians at a recent University of Rochester conference was that executive salaries are determined by the market, and that changes in compensation are strongly related to company performance. Moreover, no one expressed concern that compensation was “too high.” (Jensen and Murphy 1984)

Epilogue

As late as 1990, the Business Roundtable, a leading business organization, still officially adhered to a traditional “stakeholder” view of the corporation, embedded in its official statement on corporate governance:

Corporations are chartered to serve both their shareholders and society as a whole. The interests of the shareholders are primarily measured in terms of economic return over time. The interests of others in society (other stakeholders) are defined by their relationship to the corporation. . . .

The central corporate governance point to be made about a corporation’s stakeholders beyond the shareholder is that they are vital to the long-term successful economic performance of the corporation. Some argue that only the interests of the shareholders should be considered by directors. The thrust of history and law strongly supports the broader view of the directors’ responsibility to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation or to the long-term interests of its shareholders.

By 1997 however, this language had been swept away. The views defended by agency theorists and now widely institutionalized in the management practices and pay structures of American corporations had become the organization’s new *lingua franca*, the new *common sense of capital* in the neoliberalized corporation:

In the Business Roundtable’s view, the paramount duty of management and of boards of directors is to the corporation’s stockholders; the interests of other stakeholders are relevant as a derivative of the duty to the stockholders. The notion that the board must somehow balance the interests of other stakeholders fundamentally misconstrues the role of directors. It is, moreover, an unworkable notion because it would leave the board with no criterion for resolving conflicts between the interests of stockholders and of other stakeholders or among different groups of stakeholders. (Business Roundtable 1997)

The conversion looked complete. The shareholder-maximization imperative advocated by agency theorists, corporate raiders, CEOs and the shareholder movement was taken for granted. Firms were increasingly evaluated on the basis not of returns on investments but returns on equity

(Levy 2014). New accounting methods (fair value or mark-to-market accounting, also developed at Rochester business school) sustained these new profit calculations and helped valorize strategies of growth based on debt-fueled asset purchases. Contrary to expectations, executive pay had remained disconnected from stock market performance, as tightly networked corporate board members had each other's backs (Khurana 2002). Derivative shareholder value management recipes, such as companies buying back their own stock to pump up prices, often diverted available cash from more productive uses.

Critiques mounted. By the early 2000s, a wave of corporate scandals (Enron and WorldCom among others) put many of the recommendations of agency theory into question, prompting its authors to argue that they had been misused and misunderstood. This may have been true: in an article titled "The Misapplication of Mr. Michael Jensen," Dobbin and Jung (2010; also see Jung and Dobbin 2014) suggest that agency theorists had failed to anticipate how their prescriptions would interact with the incentive structure faced by the most important actors in the financial markets, namely institutional investors. Instead of increasing efficiency, the uneven implementation of these prescriptions had translated into excessive risk-taking, untempered by adequate monitoring and transparency.

Jensen's own analysis of the causes of this misinterpretation, however, was more benign: it had little to do with the theory, and much to do with bad ethics. He had retired to Florida from Harvard Business School, but his conviction and energy for persuasion were intact. The crisis, in fact, seemed to open up opportunities for a new moral enterprise. The disaster of 2008 taught us that "without [integrity], nothing works," Jensen (2009) argued. In November 2015, he released a working paper on SSRN, the open-access publishing website he founded some twenty years earlier.²⁰ Abounding in citations of Thomas Kuhn, the piece²¹ suggests that another paradigm shift in economics is around the corner, which will model integrity as a production factor. Using a rhetoric that has become familiar by now, it outlines "a new theory [of] integrity as a purely positive phenomenon with no normative aspects whatsoever."

20. SSRN was sold to Elsevier in 2016, along with the intellectual output and personal data of the more than 300,000 authors who entrusted their work to the repository.

21. See Erhard and Jensen 2015.

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