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# SELF-INTEREST, ALTRUISM, INCENTIVES, AND AGENCY THEORY

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**I**n his article in this issue entitled “Incentives, Rationality, and Society,” Michael Brennan attacks the use of incentives for corporate executive compensation and, by implication, for society at large. Professor Brennan argues that the tendency of economists to equate rationality with the pursuit of self-interest is wrong both in a positive sense (that is, people don’t behave that way) and in a normative sense (because if they did behave that way, the world would be a much less desirable place). Brennan is correct that people do not always behave rationally, but this provides no support for his opposition to incentives, or for his opposition to self-interest.

Professor Brennan’s arguments, although popular in many quarters, are both logically flawed and empirically incorrect. Underlying his argument is a strong aversion to incentives, an opposition that reveals itself in several places to be primarily, if not wholly, an antagonism to the use of monetary incentives. (He cites approvingly the incentives provided by awards banquets and small prizes.) He also is not fond of the agency model; indeed, he concludes (p.39) that “if we go on hammering into our students the mistaken notion that rationality is identical with self-interest we shall make our agency models come true, but at the cost of producing a society that will not function.”

These views are based on misconceptions held by many people and, for this reason alone, are worthy of discussion. I set out by explaining what Bill Meckling and I intended to accomplish with our original paper on agency theory, and then go on to discuss the roles of self-interest, incentives, and altruism in our model. The paper ends with an introduction to what I view as a new line of approach for agency theory—systematically non-rational behavior.

## AGENCY THEORY

In the early 1970s, William Meckling and I wrote an article entitled “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” The purpose of that article, published in the *Journal of Financial Economics* in 1976, was to pry open the “black box” in economics and finance called the firm. In so doing, we reexamined the standard economists’ assumption that public companies systematically attempt to maximize firm value.

A large part of our article was devoted to demonstrating the potential for costly conflicts of interest between corporate managers and shareholders—particularly over the optimal size of the firm—and the means by which such conflicts are (or could be) managed so as to preserve value. In the absence of significant stock holdings by managers, we argued that one potentially effective method for controlling such conflicts was incentive compensation contracts tied to performance.

Professor Brennan, in criticizing the widespread corporate use of incentives and the “cynicism” of agency theory, appeals repeatedly to the kinder, gentler side of Adam Smith as authority for moderating what he (Brennan, not Smith) sees as the “harshness” and inhumanity of free-market economics. I find this repeated appeal to Smith ironic, not because I disagree with any of Smith’s sentiments, but because Smith himself properly deserves to be regarded as the father of agency theory. Although he didn’t use the language of agency costs, he clearly understood the problems arising from inevitable conflicts of interest between the professional managers and owners of a business. Indeed, our agency paper begins with the following words from *Wealth of Nations*:

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Gabarro, Richard Hackman, Steven Hyman, William Meckling, Steve-Anna Stephens, Richard Thaler, Karen Wruck, Abraham Zaleznik, the participants in the Mind, Brain, Behavior initiative at Harvard University, and my former colleagues at the University of Rochester.

*The directors of such [joint stock] companies... being the managers rather of other people's money than their own...cannot be expected...[to] watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. (The Wealth of Nations, 1776 (Modern Library, p.700))*

In fact, Smith believed so strongly in the power of self-interest and the conflicts it generates that he was pessimistic about the ability of the joint stock company to survive in any but the simplest of activities. As he goes on to say:

*Without a monopoly... a joint stock company, it would appear from experience, cannot long carry on any branch of foreign trade. To buy in one market, in order to sell, with profit, in another, when there are many competitors in both; to watch over, not only the occasional variations in the demand, but the much greater and more frequent variations in the competition...is a species of warfare...which can scarce ever be conducted successfully, without such an unremitting exertion of vigilance and attention, as cannot long be expected from the directors of a joint stock company. (Smith, 1776, pp. 712-713)*

Observing the failure of dozens of stock companies in his day, Smith concluded that the only activities a joint stock company (the forerunner of the modern public corporation) could carry on successfully without a state-granted monopoly were those that were easily monitored—in his words, those in “which all the operations are capable of being reduced to what is called a routine, or to such a uniformity of method as admits of little or no variation” (p. 713). In Smith’s view, this limited the probable future success of joint stock companies to banking, fire and marine insurance, canals, and municipal water supply. Thus, Smith’s principal error as the first agency theorist was his failure to anticipate the evolution of the corporate governance mechanisms—including incentive compensation contracts—that have helped enable the corporation to survive and indeed dominate most economic activities throughout the world.

Agency theory says that because people pursue their own best interests, conflicts of interests inevitably arise over at least some issues when they en-

gage in cooperative endeavors. Such activities include not only the commerce conducted by partnerships and corporations, but also the interaction among members of families and other social organizations.

Bill Meckling and I argued that because conflicts of interest cause problems and therefore losses to the parties involved, the parties themselves have strong incentives to find ways to reduce the “agency costs” (as we called them) of such cooperation. This *conservation of value principle* is the basic force that motivates both principals and their agents (and partners) to work together to minimize the sum of the costs of writing and enforcing contracts (implicit as well as explicit), the costs of monitoring and bonding activities, and the residual losses incurred because it will not pay to enforce all contracts perfectly. The theory provides a structure within which to understand and model a broad array of human organizational arrangements, including incentive compensation, auditing, and bonding arrangements of all kinds.

To the extent we can judge from the subsequent theoretical and empirical work stemming from our agency concepts, the academic finance and economics profession has found the approach a productive one. The agency cost literature is large and continues to grow. (And, toward the end of this paper I describe what I believe will come to be recognized as a second important source of agency costs—namely, *internal* conflicts of interest, or self-control problems, that manifest themselves in the universal human tendency to take actions that are not consistent with one’s self-interest.)

## THE MEANING AND ROLE OF INCENTIVES IN THE LOGIC OF CHOICE

Professor Brennan’s objection to the use of incentives appears to be premised on the assumption that there are no major conflicts between the interests of corporate managers and the corporate goal of maximizing firm value. But, when he complains that economic man “will never perform without incentives” (p. 34), he appears to be envisioning a world in which people have no incentives of any kind; at times he seems to suggest that action in the absence of incentives is the natural and, therefore, desirable state of affairs. Many managers, policy makers, and religious leaders share this view.

It is inconceivable that purposeful action on the part of human beings can be viewed as anything

other than a response to incentives. The issue of incentives goes to the heart of what it means to optimize, or achieve the greatest possible good—indeed, it goes to the very core of what it means to choose. Rational individuals always choose the option that makes them best off as they see it. It is the difference in well-being expected from taking one action instead of another that provides incentives and results in choice.

Much of the resistance to the use of incentives appears to be based, then, on the notion of a natural state of affairs in which there are no incentives and thus no conflicts of interest. In a world without incentives, all alternative courses of action or choices must promise the same degree of utility as viewed by the individual. Such a world is virtually inconceivable. It does not exist in the state of nature: not all land is equally fertile, nor are all paths equally level or unobstructed. Incentives exist (like it or not) in all cases in which people have real choice.

Managers in every organization, even one with no pay-for-performance, face complicated incentives, including incentives to weaken the organization (by making it too large or too diversified) as well as to strengthen it. Thus, the issue for any organization is not whether to introduce incentives to motivate its employees. There are always incentives; the issue is simply which incentives do we want to encourage and which do we want to suppress.

Managerial decisions designed to strengthen organizations often meet with opposition (and even retribution) from colleagues, employees, communities, policy makers, regulators, and others with conflicting interests—thereby providing managers with incentives to compromise their decisions. To increase the chances that managers will take the best actions possible, we must ensure that the incentives (that is, the trade-offs) they face encourage them to move in the correct direction.

The main advantage of money in this mosaic of organizational incentives is that general purchasing power is valued by almost everyone (because it is a claim on all resources), and it can be varied easily with performance. In contrast, it often is difficult to vary nonmonetary forms of reward—praise, prizes, sometimes even promotions—in ways that relate to organizational, group, or individual performance.

I hasten to add that, for a variety of reasons, monetary incentives are not the best way to motivate every action. Because monetary incentives are so potent, and because it is sometimes difficult to

specify the proper performance measure, monetary incentives are often dominated by other approaches. But, in the end, where money incentives are required, they are required precisely because people are motivated by things other than money.

## **SELF-INTEREST, ALTRUISM, AND PERFECT AGENTS**

Professor Brennan, like many social scientists outside the field of economics, also criticizes the economist's model of human behavior. By identifying rationality with self-interest, he suggests, such a model not only fails to capture the full range of human feeling and action, it also works to the detriment of society by encouraging narcissism and discouraging concern for others.

But the model of self-interested behavior that Brennan has in mind here is not ours. (Nor is it the one used by most economists in practice—that is, apart from their most perfunctory kinds of model-building.) People do care about failure and success; they do have emotions and care about honor and self-esteem; and they feel shame and pride.

In our paper "The Nature of Man" in this issue, Bill Meckling and I discuss at length the minimal characterization capable of capturing the complexity of human beings. We describe people as Resourceful, Evaluative Maximizers—REMMs, for short—and argue that these three characteristics are effective in explaining much (though not all) human behavior. As we show in the paper, the model is especially powerful in predicting the aggregate behavior underlying general economic and social change.

Moreover, although Professor Brennan's definition of self-interest excludes the possibility of altruism, our REMM model explicitly acknowledges the willingness of people to sacrifice their own time or resources for the betterment of others. The satisfaction people get from helping others is another "good" to be sought in their efforts to maximize their own utility. In seeking to achieve the greatest possible good for themselves, people choose from an "opportunity set" that includes love, honor, and the welfare of others as well as money and material objects. In short, there is nothing in REMM or agency theory that excludes or in any way devalues altruistic behavior.

We agree with Brennan, then, that people are much more than money maximizers. But he takes this argument one step farther than we are willing

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to go when he suggests that people “are more likely to rise above [their] own narrow self-interest...the greater is [their] responsibility for the welfare of others” (p. 37). If by this he means that people in positions of authority are more likely to have genuinely altruistic motives, then I might at least entertain the premise (although the behavior of politicians generally, and of national leaders of countries like Romania, Yugoslavia, and the old USSR, should give us pause). But Brennan’s statement comes very close to the assertion that, because some people devote more of their time and energies to others, they are also “perfect agents.” By perfect agents, I mean people who make decisions with no concern for their own preferences, but only for those of their principals.

As we point out in “The Nature of Man,” there is compelling evidence—in family life and social organizations as well as the worlds of business and politics—that people are not perfect agents. How else can we explain the widespread failure of internal control systems at large corporations like IBM, Gulf Oil, and GM, which systematically wasted billions of dollars of resources until curbed by the market for corporate control and shareholder activism?<sup>1</sup> And if government officials are perfect agents, how can we explain the massive deficits combined with ineffective social programs that characterize most governments around the world? Or consider the recent scandals—and evidence of chronic mismanagement—that seem to be proliferating at non-profit organizations like Blue Cross and United Way.

The fact that further evidence of scandal, waste, and inefficiency in the U.S. public and non-profit sectors now seems to furnish daily headlines for our newspapers lends force to Adam Smith’s endorsement of the social value of profit-making activities. As Smith showed us over 200 years ago, the pursuit of one’s enlightened self-interest, far from reducing the public welfare, leads to general prosperity provided governments set the proper rules of the game. And, as I suggest in the next section of this paper, greater attention to self-interest or rational behavior would make the world a better, not worse, place to live.

## NON-RATIONAL BEHAVIOR

Brennan cites several examples from an article by Steven Postrel and Richard Rumelt<sup>2</sup> in which soldiers and managers behave in ways that are clearly inconsistent with their own near-term self-interest. The soldiers fail to take obvious steps (such as keeping their helmets and arms, changing wet clothing, and digging fox holes) to maintain their own protection and fighting capability, while the managers routinely mistreat customers. Such self-damaging behavior is not unusual, and economists viewing the world through their lens of rationality generally fail to see that such behavior is common to virtually everyone.

Moreover, the fact people do not always act in their own self-interest provides no support for Brennan’s call for less use of incentives. In fact, Postrel and Rumelt correctly see the import of their stories as calling for even more precise use of incentives to address self-control problems—for example, by paying attention to the timing and context of rewards and punishments to help individuals resist self-destructive impulses.

REMM provides great predictive power and a solid basis for policy decisions in business as well as personal and public life; but it is not complete. It fails to acknowledge the essentially dualistic nature of human behavior—the fact that the same people exhibit non-rational as well as rational behavior. While this may appear to be a contradiction, such internal division or inconsistency is not an aberration but an integral part of normality itself. The soldier example illustrates behavior that contradicts REMM, but the contradiction goes far beyond the extreme conditions of war. Clinical psychological records as well as daily observations of family, organizational, and social action abound with examples of non-rational behavior.

By non-rational I do not mean “random” or “unexplainable”; I mean behavior that systematically harms the individual. Although inconsistent with REMM, I believe that such non-rational behavior can be modeled and then integrated with REMM. By so doing, we can significantly increase the predictive power of our analytical apparatus.

1. For an account of the role of corporate restructuring in addressing both the U.S. and a worldwide problem of chronic overcapacity, see Michael C. Jensen, “The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems,” *Journal of Finance* (1993); for a shorter, less technical version, see the article by

the same title in the *Journal of Applied Corporate Finance*, Volume 6 Number 4 (Winter 1994).

2. S. Postrel and R. Rumelt, “Incentives, Routines, and Self Command,” *Industrial and Corporate Change*, V. 1, 1992, pp. 397-425.

In a paper entitled "Economics, Organizations, and Non-Rational Behavior" that will be published in *Economic Inquiry* next year, I formulate a Pain Avoidance Model (PAM) that is intended to complement REMM.<sup>3</sup> PAM describes non-rational human behavior that arises under conditions of fear. While attempting (generally subconsciously) to avoid the pain associated with acknowledging their mistakes, people often end up incurring far more pain, and making themselves worse off, than if they had simply recognized and responded to their errors.

Unfortunately, this non-rational behavior is not random, but systematic and indeed virtually universal. Recent brain research suggests that such counterproductive defensive responses derive from the biological and chemical structure of the brain, and are connected to the brain's "fight or flight" response.<sup>4</sup>

What is surprising about this defensive behavior is the seeming triviality of the events or challenges that arouse fear, and the extent to which this fear is registered, and the defensive response takes place, below the level of conscious awareness. That is, the mechanisms of the brain commonly blind people so that they are unaware of their own fear and defensiveness. Such defensive behavior often occurs, for example, when we are faced with evidence or theories that threaten to change the lens through which we view reality, including not only the world around us, but our view of ourselves.

The primary consequence of such defensiveness is the reluctance of people to learn and their resulting inability to respond properly to feedback and change—even when the personal consequences of not responding are great. These non-rational responses are evident throughout organizations and society. Examples include the tendency of people to overrate themselves systematically in rankings of their peers, the infrequent use of pay-for-performance compensation systems, the common refusal of people to welcome feedback on their errors, and the systematic tendency for corporate managers to

overpay for acquisitions and to fail to adapt to changes in the competitive environment in the absence of an organizational crisis.<sup>5</sup> These non-rational responses lie, for example, at the heart of the failure of corporate internal control systems that led to the waste of hundreds of billions of dollars and the failure of a number of crown jewels of corporate America over the last two decades.<sup>6</sup>

While grounded in the flight-or-fight response—a mechanism that has contributed to survival for millions of years—the human responses to emotional or psychic pain appear to be highly counterproductive in our densely populated and complex modern industrial world. Such defensiveness reduces people's capacity to assimilate new information and adapt to an environment in which continuous change is increasingly becoming the rule. People become wedded to their own theories in ways that make them systematically worse off.

An interesting aspect of this non-rational behavior is the tendency for humans to hold views of themselves and their behavior—"espoused theories," in the language of Chris Argyris—that are false. They are false because they are inconsistent with the theories on which the individuals act—what Argyris calls their "theories in use."<sup>7</sup> Discovering these violations of our own principles and beliefs amounts to discovering our "irrationality," and this is highly threatening to an individual's self esteem. The brain's fear response and the associated anxiety then severely limits our ability to perceive when our espoused theories are false. It is obviously difficult to change incorrect behavior under such circumstances.

Moreover, this common discrepancy between espoused theories and theories in use undermines the premise of Brennan's argument for limiting students' opportunities to learn that people are generally self interested. In his opening words, he suggests that people's espoused theories largely determine their behavior. "Self-image is a major determinant of behaviour. If I think of myself as an

3. To some extent, this non-optimal behavior can be incorporated into REMM by recognizing that individuals' visions of the world and their ability to act or react depend on various factors (such as the intensity of emotions) that have the power to change, if only temporarily, their perception of "goods." Such an expanded model could explain deviant behavior as the result of maximizing actions in situations where an individual's perceptions of the world are systematically different, or more constrained, than normal. For a survey of the effects of stress on the behavior of humans that is consistent with such a view, see Karl E. Weick, "Stress in Accounting Systems," *Accounting Review*, Vol. LVIII, No. 2 (April, 1983).

4. See LeDoux, Joseph, "Emotion, Memory and the Brain," *Scientific American*, V. 270, (June 1994), pp. 50-57, and the references therein, as well as the September 1992 *Scientific American* special issue on the brain.

5. For example, in large sample surveys, almost no one ranks themselves below the 50th percentile of their peers. For discussion of these phenomena see George Baker, Michael Jensen, and Kevin Murphy, "Compensation and Incentives: Practice vs. Theory," *J. Finance*, 43 (1988); Michael Jensen and Kevin Murphy, "Performance, Pay and Top Management Incentives," *J. Political Economy* (April, 1990); G. W. Schwert "Mark-up Pricing in Mergers and Acquisitions," Unpublished manuscript, University of Rochester (1993), and the references therein.

6. See Jensen (1993), cited above.

7. See Chris Argyris, *Knowledge for Action, A Guide to Overcoming Barriers to Organizational Change* (San Francisco, California, Jossey-Bass Inc., 1993); and "Teaching Smart People How To Learn," *Harvard Business Review* (May-June 1991), pp. 99-109.

**The central proposition of agency theory is that rational self-interested people involved in cooperative endeavors *always* have incentives to reduce or control conflicts of interest so as to reduce the losses resulting from them.**

honest person, I shall behave in an honest way.” Evidence to the contrary is all around us.

### **PAM and the Normative Import of REMM**

As stated above, the combination of REMM and PAM leads to a richer positive description of behavior. Even more important, this dualistic model will lead to more effective normative propositions, including programs and methods for helping people reduce the counterproductive, self-debilitating aspects of their own behavior.

Note that these tendencies for individuals to act in ways that are inconsistent with their self-interest are another source of conflicts with employees, employers, partners, mates, colleagues, and so on. In this sense, they are another source of agency costs. Along with the conflicts of interest *among* people discussed by traditional agency theory, such *internal* conflicts<sup>8</sup> must also be addressed in any cooperative effort. And this, in turn, leads us to a structure for thinking about how to use group processes and organizational procedures to limit the unwanted effects of non-rational behavior.

In this expanded view of human behavior, REMM becomes more than a positive description of human behavior—it also becomes a prescriptive model that says this is how humans should behave. Consistent with this view, the solutions suggested by the psychological and psychiatric professions are best interpreted as helping people learn to correct their “mistakes” in order to behave in more REMM-like ways.<sup>9</sup> In short, the problem is not to persuade people to stop acting in their own self-interest, but to help them learn to avoid the systematic mistakes that make themselves, and those around them, worse off.

### **SOME CLOSING THOUGHTS**

Professor Brennan laments that the teaching of agency theory and the use of incentives will somehow “coarsen” humanity and make the world we live in a less hospitable place. Although this issue is

worthy of careful research, it does not follow logically from the content of the theory, nor does his conjecture fit with my observations from 20 years of teaching this material.

When I teach agency theory, I do not find my students surprised by the existence of conflicts. They live in the midst of them—and those conflicts which are not experienced personally can be shared in the daily torrent of offerings from the world’s media. Because of the universality of conflict, the danger is that we may take it for granted and thus fail to see it at all.

I find that students and business people are excited by the central proposition of agency theory. And the proposition that excites them is *not* that people are self-interested, or that conflicts abound. The central proposition of agency theory is that rational self-interested people involved in cooperative endeavors *always* have incentives to reduce or control conflicts of interest so as to reduce the losses resulting from them. The gains can then be shared by some or all of the parties.

Perhaps Professor Brennan and others object to the fact that agency theory holds out no encouragement that human nature can be improved, and that society, organizations, and even individuals themselves can rid themselves of these costly conflicts of interest. The reality, however, is that even if we could instill more of a spirit of altruism in everyone, agency problems would not be solved. Put simply, altruism, the concern for the well-being of others, does not turn people into perfect agents who do the bidding of others.

I am skeptical of our ability to change human nature. Thousands of years of effort by all great religions of the world have failed to eradicate the reality of self-interest. Instead, I place my bets on the institutional structures, contracts, and informal arrangements that we create to reduce conflict, to govern our relations, and to increase the extent of cooperation and the benefits we reap from it. Such efforts, which arise from self-interest, are privately rewarding and improve the quality of life in our society.

8. As Richard Thaler has put it, people face agency problems in the form of conflicts with themselves. See Richard T. Thaler and H. M. Shefrin, “An Economic Theory of Self Control,” *Journal of Political Economy*, Volume 89, Number 2 (April, 1981): 392-406. I am embarrassed to admit that Richard was a colleague at Rochester at the time he did this original work, and although I always found it interesting, I failed for more than a decade to see the generality and the importance of this self-control issue.

**Source:** Jensen, Michael C. “Self-Interest, Altruism, Incentives and Agency Theory.” *Journal of Applied Corporate Finance* 7.2 (Summer 1994): 40-45. © 1994 Morgan Stanley. Reproduced with permission of Blackwell Publishing Ltd.

9. See Argyris (1991, 1993) and M. Scott Peck, *The Road Less Traveled* (Simon & Schuster, 1978), pp. 11-77. Consistent with this, there is some evidence that those behaving according to the REMM model live more successful lives. See, for example, R. P. Larrick, R. E. Nisbett and J. N. Morgan, “Who Uses the Cost-benefit Rules of Choice? Implications for the Normative Status of Microeconomic Theory,” *Organizational Behavior and Human Decision Processes* (December, 1993, pp. 331-347.)