THE STRATEGIC TIMES · EDITORS CHOICE

Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure

Michael Jensen and William Meckling, Journal of Financial Economics, 1976

What happens when the people running an organisation aren't the people who own it.

The big idea

Jensen and Meckling looked at the relationship between owners (principals) and the managers they hire to run things (agents). Because managers don't own the business, their interests won't always line up with the owners'. Keeping them aligned costs money, and those costs they called agency costs.

The famous example

Jensen and Meckling split agency costs into three parts.

MONITORING
Watching
Owners checking on managers

BONDING
Promising
Managers proving they're aligned

RESIDUAL LOSS
Leakage
The gap that's left

Their classic case: as an owner-manager sells off more of the business, they have less reason to avoid spending on perks, because others now pay most of the bill.

Why it matters

It's a question every club, company and union faces: who are the people running it really working for? Community ownership models like the Green Bay Packers are one answer to that question.

Featured in
The Green Bay Packers: Ownership, Belonging and the Question of Agency

Read the original
Jensen, M. C. & Meckling, W. H. (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics*, 3(4), 305–360.

The Strategic Times
Summary by The Strategic Times
thestrategictimes.com