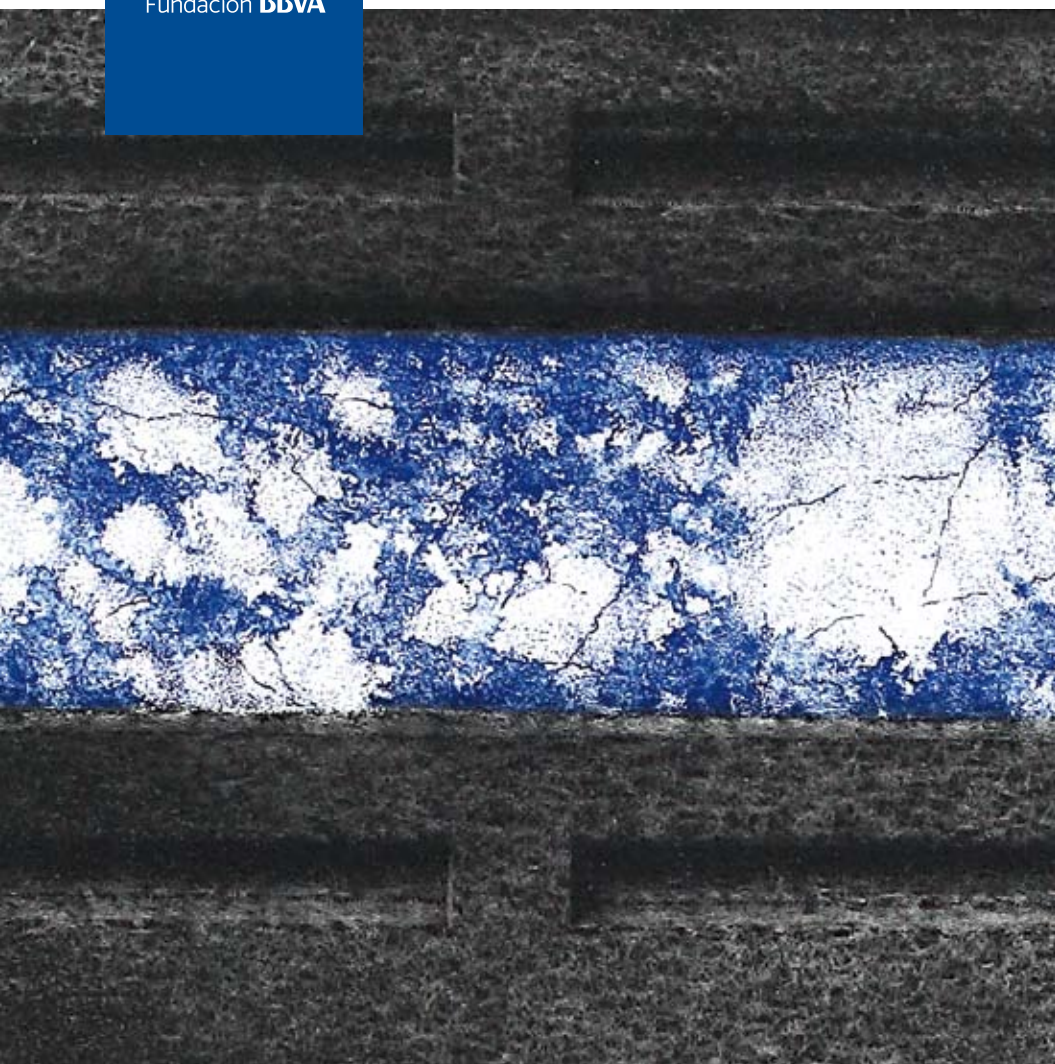


# **TOWARDS A NEW THEORY OF THE FIRM**

## **Humanizing the Firm and the Management Profession**

Fundación **BBVA**

Joan Enric Ricart Costa  
Josep Maria Rosanas Martí (Eds.)







## **TOWARDS A NEW THEORY OF THE FIRM**



# Towards a New Theory of the Firm Humanizing the Firm and the Management Profession

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# Preface

*Jordi Canals*

Dean of IESE Business School

A paradox shapes the current debate on leadership in the business world. With the falling reputation of some business leaders and companies after the financial crisis, there is no credible alternative to a market-based economy based on free markets and the entrepreneurial initiative of its citizens. But this paradox is dangerous: it looks like there is no alternative, either, to living in a society where markets seemed to dominate the way companies are organized and operate, and shape the rest of social life as well, without room for non-market criteria.

This book that IESE professors Joan E. Ricart and Josep M.<sup>a</sup> Rosanas have coordinated and edited, offers a very clear pathway: companies are vital institutions in society, but can only fulfill their mission if we look at them not only with financial dimensions, but also with other criteria. Moreover, they claim that companies need a more humanistic foundation, one that takes into account that they are essentially groups of people; firms' management coordinates their professional efforts to effectively achieve some common goals.

It is also a striking paradox that in this age where scholars, CEOs and public opinion extol the virtues of talent and the need to develop it as a way to compete in a more global world, so little effort is devoted to better understanding and, more important, making decisions in the business world taking into account that companies are based on people.

In the aftermath of the financial crisis, new proposals are being made to avoid another economic disaster as the one that the Western world has seen over the past few years. The range of options



is quite diverse: banking reform, higher capital requirement for banking, better supervision, improved corporate governance or additional corporate transparency.

Each one of these initiatives has its own virtues and advantages, and should be welcomed. Nevertheless, they only change some external symptoms of the disease and do not tackle its core, which has three basic factors. The first factor is that we have created a big disconnect between good ethical, personal values –including integrity, honesty, respect, truthfulness, among many others– and the values that business leaders live in their professional activities, where some of those personal values are left aside. This evidence is also reinforced by a second factor: scholars, business leaders tend to see companies as pure mechanical institutions whose purpose is to make money; top managers organize them, lead them and design compensation systems according to basic financial performance.

The final factor is a historical one: since the 1980s, with the deregulation of the financial system in the U.S. and later on in Europe, we have moved from a market-based economy where services –including financial services– were supportive of the manufacturing of goods and real services, to a financial markets-based economy, where capital markets dominate the rest of the economy.

In this new variety of capitalism, financial markets' key actors create major trends, decide new corporate fashions and make companies more or less attractive for investors. This is always dangerous, because the criteria of financial analysts or short-term investors is essentially different from the mindset of long-term owners. And when leaders in financial services firms adopt this short-term perspective, and behave more like short-term investors rather than stewards, professional competence decreases, integrity evaporates, the impact is felt across the economy and the whole society, as we observe today in the Western world.

The design of a more humanistic view of management and the corporate world is not just an lofty aspiration worthy to try. It is not just an answer to the recent financial crisis or the fall in corporate reputation. It is an effort to rethink the theory of the firm and the notions of management, and base it on the reality of human beings. It is the determination to end the divide between the values

that we think are right and useful in our private lives as citizens and the values that we may bring to the business world. Lack of coherence in organizations leads, sooner or later, to corporate crisis. Lack of coherence in the personal and corporate values lead a deep crisis of capitalism, which is where we are today.

Professors Ricart and Rosanas, and their co-authors have done an outstanding job in laying some foundations to restore a positive view of the firm and management and should be congratulated on their important contribution. They go beyond the mere restoration of confidence or reputation. They try to set the groundwork to develop companies that most of us, as individuals and citizens, feel proud about them, And they try to highlight some basic notions of management and leadership that have got lost for too long.

Educators and business leaders need to adjust quick to this new realities. Societies and individuals depend on companies and their leaders, and we need them to do the best possible job. This book is a great step in this direction.

August 4, 2012



# Introduction

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MIDWAY into the xxist century, management as a discipline is facing important challenges. The crisis we are still struggling with has received many names and adjectives: financial, economical, crisis of values... Many different issues get mixed up in the rising debate about management and the crisis. Are managers too greedy? Are our governance and incentive systems making them too greedy? Or it is our management education that develops the greedy tendencies or even selects greedy individuals for management positions? Are our theories about management and managers and the reason for our errors in teaching and our prescriptions in research faulty? as a consequence of all this? Is the management profession at risk. Is it losing respect and is it under criticism not just by radical positions but by our society at large?

All the above questions are big issues we need to deal with. They are also debates that were already opened before the crisis started. Scholars as S. Ghoshal, J. Pfeffer or H. Mitzberg, just to mention a few, were already raising these issues. The crisis, of course, moved the debate from the scholars and Academia to the general press and the public. Most importantly, whether the debates are old or new, they are relevant questions to deal with.

Firms have historically proved to be a very important organizational form to transform society. Firms help solve real problems: they create economic value, they also create social value; they introduce change in our Society. firms, of course, do not work in isolation and society at large has created and keeps creating many other institutions that help in this process ensuring that such

transformations do more good than bad for the benefit of the society.

Management has a crucial impact on firms, markets and, in fact, in any organizational form. Management and managers are then important as they have a tremendous influence in the well being of a lot of people. Therefore, our questions in the first paragraph are extremely important for our society. In fact, it might even be surprising that such an important profession with such an impact has not developed as much as other influential professions like engineers, doctors or lawyers, for instance.

Important questions require good answers. Fundamental questions require deep and profound answers. Einstein used to say that we cannot solve the problems with the same theories that created them. Therefore, if we want to provide positive answers helpful for management and managers looking into the future, we need to develop new lenses, new approaches and new theories.

Management being so important, it is surprising that both in practice and in theory we seem to be using very old foundations. We still think about our organizations with fundamental principles that are more than 100 years old. We still theorize about firms and management with economic principles developed when most firms were just small shops. Of course, we have learnt a lot in the meantime... but we have not debated enough on the fundamentals.

Facing this challenge was important for our institution. For many years we have been working with doctoral students to help them understand the relevance of the underlying theory of the firm in management research and the need for foundations built on more robust anthropological basis. IESE Business School is committed to the “development of leaders who aspire to have a positive, deep and lasting impact on people, firms and society through their professionalism, integrity and spirit of service”. With this explicit mission, it should not be any surprise the interest of IESE in launching an international conference on “Humanizing the Firm and the Management Profession”.

The dimensions of the current crisis that affects mainly the developed World, have shown some weaknesses in our models of behavior, which are to some extent based in conventional ap-

proaches to the theory of the firm. To be sure, one may wonder whether there is something that can be properly called a *theory of the firm*. Probably, it would be more reasonable to assume that what we have are some elements of such a theory, possibly not very well connected with each other, that together form the conventional approaches mentioned. Among them, the classical economics-based *theory of the firm* that was already under severe criticism more than half a century ago, when some of the different theories generated by business schools were beginning to be developed. Most of them (if not all) have to do with *partial* aspects of the tasks of managing an organization, e. g., marketing techniques, costing systems, strategic analysis, or the sociological approaches to the development of firms and so on. None of them is inclusive of all the factors that have to be taken into account when managing an organization.

The current crisis, as we just suggested, has made things only worse and has shown how a different way of looking at firms might be needed. We would need a new theory that is able to unify the different partial theories that already exist on the one hand, and, on the other, to include variables that may be absent of such models, that can explain the current crisis and help avoid future crises. In the second edition of the Conference, on June, 27th and 28th, 2011, we decided to focus on new lenses and new theories of the firm. This was the challenge we proposed to a selected set of scholars. We think that there is a long way ahead and we did not, of course, expect that in one Conference everything would be solved. Each of those scholars developed his or her own thoughts on it and we all shared them in that Conference in Barcelona. The result of this debate is the content of this book.

Facing this challenge was also important for BBVA Foundation, which immediately accepted our proposal and committed their resources and their enthusiasm to this important task of developing better theoretical foundations for a humanized firm and management profession. The coalition was formed and the final output is presented below.

The book is organized in three parts with a total of 12 papers. The first part, “On Leaders and Society: What Future are We Building Today?” sets the stage for the debate by providing

a diagnosis of the situation. It presents some positive views but also some negative ones; some empiric reflections but also some normative thoughts. Overall, we can say that the diagnosis detects some levels of weaknesses, but also identifies some positive trends and directions.

The first paper by Hambrick and Wowak, “Whom Do We Want as Our Business Leaders? How Changes in the Corporate Milieu Have Brought About a New Breed of CEO”, develops the evolution of U.S. CEOs from the so called *managerial capitalism* prevalent in the 1950’s to 70’s to the so called *investor capitalism* prevalent in our days and mostly developed under the influence of agency theory. The authors claim that this change has affected the demographics of CEOs. In particular today, where they are more individualistic, more materialistic, more narcissistic and more detached from their firms. Looking into the future the authors ask if we want to accept these changes, control them, try to improve on them... or we can simply allow diverse competition.

Miles’ paper, “Some Thoughts on Theory X and Theory Y Economics”, goes back to McGregor’s management theories X and Y but tries to develop some of its systemic implications. Each management theory is consistent with a different economic context, be it Theory X or Y “Economics”. Therefore, the full development of Theory Y “management” requires overcoming some barriers in Theory Y “Economics”. We cannot deal with management theories without changes in the broader economy and Society.

Kanter’s paper, “The Institutional Logic of Great Global Firms”, focuses in the direction that leading companies are showing us and puts forward six proposals on institutional logic that can be used as building blocks for a new theory of the firm. The inductive work concludes that “conceiving a firm as a social institution” is a buffer against uncertainty and change, generates long term perspectives, evokes intrinsic motivation, requires concern with public interest, takes action towards Societal values, and allows people to be treated as self-determining professionals. At the end, these proposals close the loop of creating meaning that develops professionals and vice versa. In doing so, the firm as a social institution emerges.

The final paper, by Rosanas and Andreu, “Manifesto for a Better Management. A Rational and Humanistic View”, is a more

normative manifesto as the title indicates. The authors claim that management is very important in its multiple dimensions, but that currently it is going through both lights and shadows, and they identify the main causes of the problems. From this diagnosis they develop both recommendations for practice and for theory. With respect to theory, they claim that a new theoretical perspective should consider purpose, satisfy all types of motives of individuals (not just extrinsic ones), take bounded rationality seriously, be built from a logical (rational) perspective, and forget about stability (equilibrium).

With all those principles, we are able to move into the second part of the book, “Building Blocks for a New Theory of the Firm”, with four papers that develop some core elements of a new theory of the firm.

Mahoney’s paper, “Towards a Stakeholder Theory of Strategic Management”, develops a solid foundation of a stakeholders theory of Strategic Management based on incomplete contracting and residual control rights. The strategic logic, vs. the finance logic, arises from market frictions that make the value of the firm dependent on the value of other stakeholders (different from just shareholders.) Governance plays an important mediating role and therefore stakeholders representation is very important.

Spender’s paper, “A New Theory of What? Humanizing the Firm in the Time of the Precariat”, develops a more philosophical perspective to think about a new theory for humanizing management and democratizing capitalism. That brings the debate to the interplay among socio-economic institutions and private firms where individuals are first of all human beings, and firms exists as an apparatus to foster other agencies towards the agent’s human projects.

Argandoña’s paper, “The ‘Management Case’ For Corporate Social Responsibility: A Way To Enrich The Practice of Management”, focuses on the question of why firms must be socially responsible. The author develops as answers the legal case, the social case, the moral case and the business case, to show that each one of them is incomplete. Then the core of the paper develops the management case that essentially encompasses all of the previous cases in an integrative way, through the enrichment of manager’s criteria for decision making (or motivation).



Cennamo, Gómez-Mejía and Berrone's paper, "Caring about Firm Stakeholders: Towards a Theory of Proactive Stakeholder Engagement", deals with a similar question, why some firms engage more proactively with their stakeholders than others. In their theoretical search they develop three antecedents for proactive stakeholder engagement: Explorative capacity, managerial empowerment, and incentive systems alignment. They also highlight three moderating factors: Resource slack, environmental dynamism and individual values.

Finally, the last 4 papers on the third part of the book, developed "On Micro Foundations", elaborates on some of the key elements that can provide support to a new theory of the firm.

Osterloh and Zeitou's paper, "Corporate Governance Modes and Their Motivational Foundations", starts with the premises of bounded rationality and tries to understand the impact of motivation on governance choices. The authors develop a framework with two dimensions, shared decision making and arbitration. When both dimensions are low, shareholders pricing is a good governance mechanism and extrinsic motivation is enough. However, in all other cases, with different stakeholders involvement, other types of motivations are important and the issue of matching motivation and governance gets to be especially important for value creation.

Frey and Cueni's paper, "Repressed Voice and Costs of Non-Herding", is a qualitative study on herding behavior. By studying the different elements of the cost of non-herding behavior as well as the institutional factors affecting such behavior, they conclude that herding is very real and affects decision making in organizations. Such behavior is induced by the different elements of the cost of non-herding, is affected by institutional factors, but tends to be self-reinforcing.

Andreu, Riverola, Rosanas and de Santiago's paper, "Firm Evolution and Learning in a Market Economy with Bounded Rationality", is an explorative experimental work based on simulation. Firms choose projects with different levels on three main characteristics of efficiency, attractiveness, and unity. The choices depend on the firm's capabilities but they also allow learning on such capabilities but under bounded rationality. Bounded ration-

ality decreases the stability and managers are advised to know well their firm and to avoid states where they stop learning.

Ben-Ner and Ellman's paper, "The Effects of Organization Design on Employee Preferences", follows Ben-Ner's previous work on how employees preferences affect organizational design but they revert the causality trying to understand how organizational design affects employees preferences as a way to capture the underlying dynamics in organizations. Mechanisms for change may include dissent groups in organizations. Important moderators are the strength of employees' preferences and their origin.

Have we solved our problems and questions as stated at the beginning of this short introduction? We do not think so, and I do not imagine the reader expecting such stellar resolution either. But I do think we have moved with this set of papers in the right direction and we already made an important step.

We have seen something about how our world is, why it is this way, and what we can do to make it different. We can better understand our reality and the forces that explain some of the negative trends we can observe. We also better understand the positive forces that can help or may even be helping in a positive transformation.

In the theoretical front we see how bounded rationality takes a central stage in the exploration of new lenses. Once we talk about bounded rationality, we automatically find that learning and dynamics are extremely important and so are the governance mechanisms. Furthermore, such governance mechanisms, far from being only Williamson's safeguards, are extremely richer and are based on more sophisticated motivational assumptions about individuals in any form of interaction. In this richness we have seen elements so different as property rights, humanizing philosophy, purposive adaptation, the management case for social responsibility or the antecedents for proactive stakeholder engagement.

Different theoretical lenses complemented by important micro foundations where we can highlight governance, not as a controlling function but as a fundamental managerial mechanism, voice for different stakeholders, criteria for choice and its relation to basic motivations and of course employees' preferences.

Once one is able to assimilate and understand most of the great ideas contained in the papers in this book, one realizes how important but also how difficult it is to develop a theory of management. Then one can only thank the authors for their willingness to deal with a challenge of such proportions and congratulate them for being able to do such a relevant first step.

PART ONE

ON LEADERS AND SOCIETY:  
WHAT FUTURE ARE WE BUILDING TODAY?



# 1. Whom Do We Want as Our Business Leaders? How Changes in the Corporate Milieu Have Brought About a New Breed of CEOs

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AS mentioned in the introduction, events of the past decade have prompted great unease, if not outright disdain, towards corporate leaders. First came the misdeeds of such companies as Enron, WorldCom, Adelphia, and Arthur Anderson. Next were the cover-ups of life-threatening product defects by Merck, Guidant, and other health products corporations. Then came the colossal recklessness of major financial institutions, including Citigroup, Bank of America, Lehman Brothers and AIG. Of course, companies headquartered outside the United States have experienced their own share of recent debacles. Think, for instance, about Bridgestone Tire, Toyota, BP and Landsbanki.

It is only fitting then, that prominent scholars (e. g., Davis 2009; Ferraro, Pfeffer and Sutton 2005; Ferraro, Pfeffer and Sutton 2009; Frey and Osterloh 2005; Ghoshal 2005; Khurana 2007) have begun to ask questions such as these: Is our business system broken? If so, how did this happen? Is there a solution? Are we confident that the “solution” won’t just make things worse? These questions constitute the scope of this conference and we are honored to be included in such an important discussion.

Our own contribution will be circumscribed. Since we are not trained as political economists, we are not equipped to critique the overall economic system. In the next chapter, Prof. Miles will deal with these issues. Moreover, as far as we can tell, the basic framework of democratic capitalism is here to stay. Pondering wholesale change would amount to a strictly academic exercise, ultimately not going very far. We accept the broad contours of capitalism, while recognizing that differences in national institutions can give rise to different “varieties of capitalism” (for an overview, see Hall and Soskice 2001). More importantly, we accept—and build upon—the premise that a given country or region can modify its institutions somehow and thus alter its own style of capitalism.

We will draw upon our understanding of corporate management, particularly our knowledge of executive psychology and behavior, to explore these questions: *How do societal institutions influence the type of person who strives to be and is selected to be, the chief executive officer (CEO) of a publicly-traded corporation? Can changes in institutions bring about changes in the fundamental attributes of the people who head business enterprises?*

In our conceptualization, corporate executives are the linking mechanism or mediating element between a society’s institutional arrangements and the ultimate behaviors of companies. On the one hand, institutional arrangements (e. g., DiMaggio and Powell 1983; North 1990) influence who will become a CEO; on the other hand, the CEO’s individual attributes—motives, personality, experiences—greatly shape how a company will behave (Hambrick and Mason 1984). Therefore, if we want to advance our understanding of how institutions affect the actions of companies, we must improve our understanding of how institutions affect the motives and priorities of corporate leaders.

We illustrate our argument by tracing how an institutional shift—the widespread implementation of the precepts of agency theory—has brought about changes in the basic attributes of corporate CEOs in America. Several scholars have discussed how the ascendance of agency theory over the last 30 years has changed the outlook and behavior of executives (e. g., Englander and Kaufman 2004; Ferraro et al. 2005; Ghoshal 2005; Khurana 2007). We go one step further, arguing that the shifting rules and social

milieu of business have brought about a *fundamental change in the CEO population*. That is, agency theory has not only shifted the priorities of a given group of executives but has also ushered in a new breed of CEO.

We focus on the American scene because it is the locale with which we are most familiar and its trends have been well documented. Research suggests however, that other countries have been adopting the precepts of agency theory in varying degrees (e. g., Chung and Luo 2008; Sanders and Tuschke 2007), and therefore our line of argument may be widely applicable. Although our analysis of the U.S. is retrospective in describing recent history, our ideas might be considered as somewhat of a forecast for other countries.

We commence with a historical overview of the transformation of the CEO position over the last sixty years with a particular emphasis on the changes that have occurred since 1980. Then, we develop our argument that the CEO population has fundamentally changed over this period identifying several specific traits that are more prevalent in today's CEOs compared to their counterparts of yesteryear. Next, we review a commonly espoused alternative to agency theory, stewardship theory, arguing that it has its own significant limitations. We especially caution against a return to the "good old days" preceding agency theory, highlighting the legitimate reasons for the ascendance of the shareholder-focused governance model. Finally, we offer a rapprochement between the agency and stewardship views, setting forth proposals that could better complement the new breed of CEO and ultimately engender greater variety in the CEO population.

### **1.1. How the life of the CEO has changed**

The rise of the large public corporation in the early part of the twentieth century introduced an unprecedented challenge: How can widely dispersed owners (principals) ensure that the individuals charged with running their firms (agents) act in the owners' best interests? Berle and Means (1932), among the first to address this issue in detail, characterized the modern corporation as "ownership of wealth without appreciable control and control of wealth without appreciable ownership" (69).



Eventually, this dilemma was accommodated if not resolved, by a form of governance widely described as “managerial capitalism”, (e. g., Marris 1964; McEachern 1975; Williamson 1964) in which professional managers, who generally had abundant firm-specific expertise but little ownership stake, led America’s large enterprises (Useem 1996). These professional managers took satisfaction in balancing the needs of various stakeholders. In his landmark description of the post-World War II modern corporation, economist Carl Kaysen (1957, 314) wrote:

[T]here is no display of greed or graspingness; there is no attempt to push off onto the workers or the community at large part of the social costs of the enterprise. The modern corporation is a soulful corporation.

This model prevailed for roughly the period 1950 to 1980, accompanied by increased size and influence of major corporations. as Khurana (2002, 53) noted:

The steady, visible hand of the professionally trained manager guiding the corporation toward stability and long-term growth was seen as superior to that of the jumpy manager continually reacting to the unpredictable and fickle “invisible” hand of the market.

By the late 1970s however, skepticism about managerial capitalism mounted. America’s manufacturing sector was in steep decline, lagging international competitors in both efficiency and quality. (This section draws heavily from Ghoshal 2005; Hambrick 2005; Hambrick et al. 2005; Khurana 2002; Useem 1996 and Ward 1997). Many companies had diversified into far-flung activities, yielding benefits for no one except their top executives. Indeed, during the latter period of managerial capitalism, roughly 1970 through 1980, corporate profitability (measured as return on assets) dropped steadily. There was an increasing belief that America’s CEOs—and their boards—were not serving owners or the overall economy very well.

It was around 1980 that the corporate milieu at least in the United States, began a tectonic shift. Corporate executives were allowed, indeed encouraged, to become much more aggressive in

their marketplace dealings. They were simultaneously subjected to much harsher penalties for their shortfalls and more abundant payoffs for their successes. What had been polite jousting became gladiatorial combat.

The election of Ronald Reagan as U.S. President in 1980 ushered in a new era of unfettered markets and shareholder primacy. Known for his fervent free-market views, Reagan followed the experiments of President Jimmy Carter in eagerly deregulating numerous industries. Moreover, the competitive successes of Japanese companies in several important sectors (including automobiles, computers and steel) prompted Reagan to sharply curtail antitrust enforcement. Big mergers were permitted; market shares were allowed to advance; cozy oligopolies gave way to vigorous competition.

Not only was Reagan pro-competition but he was also pro-shareholder. An unabashed booster of supply-side economics, Reagan quickly lowered tax rates for businesses (as well as individuals), under the logic that the existing rates were excessive to the point of decreasing government revenue—an idea illustrated in the well-known Laffer curve. Reagan's overall economic platform, famously dubbed "Reaganomics," was framed as a return to free-enterprise principles and empowerment of the private sector.

One cannot begin to consider Reagan's policies without also acknowledging the influence of the prominent economist Milton Friedman on the president's beliefs. A staunch advocate for shareholder wealth maximization, Friedman decided to take aim at the post-war "soulful corporation" and its accompanying emphasis on balancing various stakeholders' interests (Friedman 1970):

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...

During his eight years as president, Reagan closely adhered to Friedman's economic principles, even using variations of Fried-

man's own language in spelling out his policies.<sup>1</sup> Documenting the similarities between Reagan's annual Economic Reports and Friedman's earlier writings, Elton Rayack (1986) wrote: "So closely do the *Reports* adhere to Friedman's free-market ideological framework, even with respect to rethoric, it is almost as if they were ghostwritten by Friedman himself." (198)

At the same time that corporate executives were being encouraged to increase their companies' profits, they were also being subjected to new forms of heightened scrutiny and discipline. The shares of major American corporations were increasingly held by large institutional shareholders (notably pension funds, mutual funds and insurance companies), which had much more power to sanction corporate executives than did the small individual investors who had previously been prevalent (Gompers and Metrick 2001). The invention of junk bonds allowed hostile takeovers of corporations of almost any size. If a raider thought he could improve the performance of a company or saw an opportunity to break it up and sell the pieces for more than he paid, there was now little to stop him—no matter how big the target (Davis, Diekmann and Tinsley 1994; Holmstrom and Kaplan 2003).

And then of course, there was the rise of agency theory. This theoretical perspective, developed and promulgated by several influential economists from the University of Chicago (Fama and Jensen 1983; Jensen and Meckling 1976), quickly gained visibility and adherents both in academia and on Wall Street. According to agency theory, corporate executives who are not the company's owners have ample opportunity and motive to serve their own interests rather than the owners' interests (for a recent review of agency theory, see Gómez-Mejía, Berrone and Franco-Santos 2010). They can shirk, steal or take actions that promote their prestige, security and other pet agendas instead of shareholders' wealth. In turn, there are two major ways that owners can resolve the "agency problem." They can appoint a

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<sup>1</sup> The two were also friends going back to 1970, when Friedman met then-Governor Reagan while serving a visiting professorship at the University of California (Los Angeles). Reagan went on to write a "highly laudatory blurb for the dust jacket of Friedman's (1980) best seller, *Free to Choose*". (Rayack 1986, 2).

vigilant board to closely monitor the CEO, carefully watching for missteps or misdeeds, and they can install financial incentives that align the executive's interests with those of the owners (Zajac and Westphal 1994).

All told, these various forces had massive effects on corporate America and its CEOs—again, beginning in the 1980s and continuing through today. Starting in the mid-1980s, a number of iconic corporations, including Disney and Gillette, were targeted by takeover raiders. Even though these companies were profitable, the raiders thought that they could make them *even more profitable*. The message to CEOs was abundantly clear: “Satisfying is no longer sufficient. If you are not maximizing the economic returns from your company’s assets, we will take your company over and throw you out”.<sup>2</sup>

At the same time, newly-dominant institutional investors exerted more pressure for financial performance. They cajoled managers, put underperforming companies on public “watch lists” and engineered CEO ousters. Indeed, CEOs became much more vulnerable to dismissal, a trend that became exceedingly evident when 13 CEOs of *Fortune* 500 firms were fired in the short span of April 1992 through August 1993 (Ward 1997). Between 1980 and 1999, CEO dismissal rates tripled (Charan and Colvin 1999). And recent data suggests that, over the period 1998 to 2005, CEO turnover increased yet more and became more tightly linked with (poor) firm performance than in earlier periods (Kaplan and Minton 2008). In short, CEOs were held to higher standards of performance and they were much less secure in their jobs.

In line with the prescriptions of agency theorists, the use of the stick as a motivational device was supplemented by the use of the carrot. CEOs were increasingly given large baskets of stock and stock options (mostly the latter) to align their interests with those of shareholders (Murphy 1999). In 1980, equity-based incentives (stock and option grants) made up around 13 percent of

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<sup>2</sup> Eventually, some companies adopted a variety of anti-takeover protections, abetted by varying state-level anti-takeover laws, but the new emphasis on maximizing shareholder returns was here to stay.

total CEO pay (Mehran 1995); in 2006, it was 58 percent (Mercer Human Resource Consulting 2007), a proportion that remains roughly the same today.

In a well-documented trend, the aggregate size of CEO pay packages increased markedly (Bebchuk and Grinstein 2005; Frydman and Saks 2010; Gabaix and Landier 2008). For instance, the ratio of CEO pay to average worker pay increased from around 25:1 in 1970 to almost 500:1 in 2000 (Murphy and Zabojnik 2004). This meteoric rise has directly contributed to the public attention (often scorn) heaped upon today's CEOs, as well as upon the boards whose job it is to select, reward and discipline these CEOs.

Indeed, with institutional investors nearly doubling their share of the stock market from 1980 to 1996 (Gompers and Metrick 2001), boards themselves were subjected to considerably increased scrutiny and reform. The composition of boards shifted from a relatively even mix of company executives and outsiders to a much higher proportion of the latter, who were increasingly expected to be totally "independent" (i. e., with no business ties to the firm or its managers). Instead of being hand-picked by the CEO, new directors were to be selected by a nominating committee consisting only of independent directors. Directors were increasingly compensated with company stock and stock options instead of cash alone, further strengthening their focus on maximizing shareholder value (Holmstrom and Kaplan 2003). More recently, following the fall of Enron and the passage of the Sarbanes-Oxley Act in 2002, every board was admonished to have either a separate chair (other than the CEO) or a "lead director", a prominent outside director who can marshal the board in the event of any concerns about the CEO's actions or performance. In short, if America's CEOs once had cozy relationships with their boards, that is less the case today.

The involvement of boards in CEO appointments also changed. Before 1980, boards played relatively passive roles in the CEO selection process, typically ratifying the anointment of internal candidates who were hand-picked by incumbent CEOs. Khurana (2002) highlighted the example of Jack Welch, who famously emerged victorious in the "horse race" to replace Reginald Jones

(“Reg”) as CEO of General Electric in 1980. Welch recounted this experience in his autobiography, making clear who held the power in the succession process:

On that wintry Monday, Reg told me that he had recommended me for the job and the board unanimously supported it... Reg had given the board a month’s time to... raise any issues they wanted after the vote. There were none. (Welch and Byrne 2001, 87).

As part of the shift in governance norms (especially after the late 1980s), boards were expected to be much more systematic and comprehensive in selecting new CEOs. Instead of bowing to incumbents’ suggestions of insider successors, boards were now expected to look far and wide for ideal candidates; additionally, boards were now expected to engage executive search firms to help with this process. As Khurana (2002) documented, boards were expected to place extra-heavy emphasis on charismatic qualities—energy, eloquence, irreverence for the status quo, and splash—in their selection process. In seeking candidates with these attributes, boards were increasingly inclined to look outside their firms; indeed, the proportion of external CEO appointments rose from 15 percent in the 1970s to more than 26 percent during the 1990s (Murphy and Zabochnik 2004).

In short, the milieu surrounding CEOs and boards has undergone a quantum change since the 1980s. The process by which CEOs are selected, the manner in which they are paid and the heightened rate of CEO turnover have all contributed to more of a high-stakes game, where the potential rewards—and career risks—are much greater than in the era before agency theory. Moreover, these trends have spread beyond the United States, with recent research suggesting a move toward more shareholder-oriented policies in other countries, including Germany (e. g., Fiss and Zajac 2004; Sanders and Tuschke 2007), Japan (e. g., Jackson 2009) and China (e. g., Xu and Wang 1999). By any measure, agency theory has been a wild success in the marketplace for ideas, both within the scholarly and business communities. Indeed, it is perhaps the most influential theory developed within the business disciplines in the last 30 years.

## 1.2. What has agency theory wrought?

When the rules or contextual conditions of a game change, the players will tend to modify their behaviors; those who best adapt will survive and prosper. Less obvious however, is that a new context will attract qualitatively different types of players whose skills and dispositions are suited to the new regime. Over time, new rules will bring about a new breed of players.

Consider for instance, how changes in tennis racket technology altered professional tennis as well as the types of players who excel at the sport. In the days of wooden rackets, a variety of playing styles proved effective—serve and volley, baseline stamina, finesse (including lobs and drop shots), and artful combinations of all these. Accordingly, professional tennis players came in all shapes and sizes. With the advent of rackets made of advanced materials (mostly graphite composites), tournament tennis became almost wholly a power game, dominated by big serves and blistering ground strokes. In turn, there was a new premium on the physical stature of players. As telling evidence of this change, among the top ten men players in the world in 1975, only one was more than six feet tall (183 cm); at the close of 2010, nine of the top ten players were over six feet tall.<sup>3</sup>

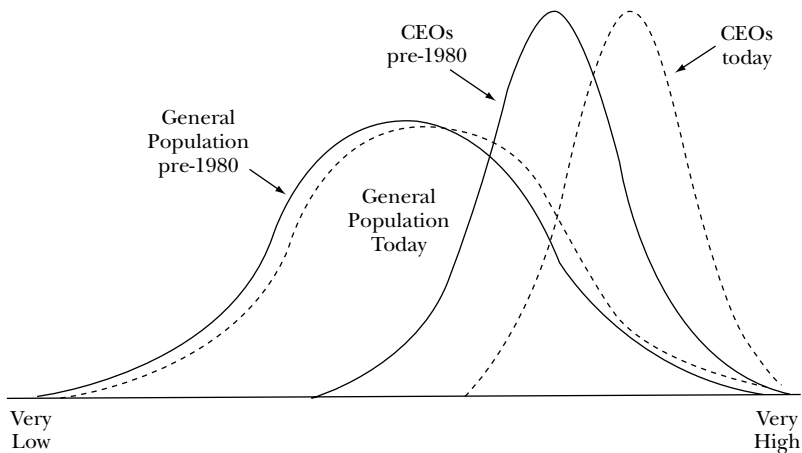
Consider how changes in health care in the U.S. over the past several decades have dramatically altered the lives of primary care physicians—and the kind of person who is drawn to and flourishes in this role. The combination of changes in the social milieu (e. g., greater educational opportunities for women and minorities, more women entering the workforce, etc.), along with the trend in the medical profession from primarily self-employment to salaried employment has resulted in a wholesale shift in the demographic makeup of physicians (Hoff 1998). In the 1970s, over 90% of physicians were white males (Starr 1982); today, nearly half of all graduating medical doctors are female (Boulis and Jacobs 2008), and more than a third belong to minority groups (Butler, Longaker and Britt 2010).

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<sup>3</sup> Historical tennis rankings and player data are available on the Association of Tennis Professionals website (<http://www.atpworldtour.com>).

Closer to our domain, scholars have discussed how the altered rules of American business have prompted CEOs to change their behaviors (e. g., Boatright 2009; Englander and Kaufman 2004; Ferraro et al. 2005; Frey and Osterloh 2005; Ghoshal 2005). There has been the little attention to the possibility—indeed likelihood—that the rise of agency theory has squeezed out certain types of CEOs and has attracted others. The ascendance of what Ghoshal (2005, 77) referred to as a “gloomy vision of managerial motives” (adopted from Hirschman 1970) has ushered in a population of CEOs who have very different fundamental outlooks and dispositions than their pre-1980 predecessors. Although we do not assert that today’s CEOs are homogeneous, we will argue that they differ on average from their predecessors in the following ways: they have more individualistic values, more materialistic values, more narcissistic personalities and less psychological identification with their companies.

**FIGURE 1.1: Envisioned changes in the CEO population from 1980 to present, with narcissism as illustration degree of narcissism**



Our line of thought is illustrated in Figure 1.1, showing how we envision the profiles of CEOs as having changed over recent decades. To ease exposition, the figure refers specifically to nar-



cissism but similar figures could be drawn for any other dispositional qualities of interest. The figure conveys several key points. First, CEOs (in any era) are almost certainly more narcissistic than the general population (Chatterjee and Hambrick 2007; Hiller and Hambrick 2005). Second, as noted above, CEOs are not uniformly narcissistic; they vary somehow. Third, even allowing for the possibility that the overall population might have become slightly more narcissistic in recent decades (Twenge et al. 2008), the CEO population has shifted even more. Because of changes in the fundamental business milieu, today's CEOs are appreciably more narcissistic than their predecessors and far more so than can be explained by personality shifts in the general population. The same can be said for the values of individualism and materialism among CEOs; in the other direction, today's CEOs have far less psychological identification with their companies than did their predecessors. We now discuss how these shifts in the CEO population occurred.

### **1.3. The causal logic**

Scholars have used a variety of lenses to consider the tendency for individuals to be drawn to and prosper in jobs that suit their personal attributes. Perhaps the most well-known view of person-job matching is Benjamin Schneider's (1987) "attraction–selection–attrition" (ASA) model, which argues that an organization attracts and selects employees who suit or match the prevalent conditions of the organization—its culture, strategy, and so on—and weeds out those who do not fit. As long as organizational conditions remain the same, the employee population becomes increasingly homogeneous. However, when organizational conditions change, say because of environmental or strategic shifts, the equilibrium is correspondingly disrupted; people who had previously been ideal are now ill-suited and will leave or be dismissed; entirely new types of people will be drawn to and welcomed by the new regime's authorities. Over time, a new employee profile will prevail.

A second perspective is that of occupational psychologists who are interested in how differences in individual preferences and personalities influence job and career choices (e. g., Holland

1985; Tom 1971). This literature however, has been relatively silent as to the dynamic processes that arise when there are changes in the conditions associated with an occupation or job category—a research void noted by John Holland (1996), one of the leading figures in this intellectual tradition.

A third orientation is taken by sociologists who study careers and specifically how institutional changes influence the characteristics of those who choose to enter certain professions (e. g., Boulis and Jacobs 2008; Hoff 1998). Some researchers have begun to investigate how worker (including executive) characteristics have changed over time in responses to changes in institutional norms (e. g., Keiser 2004; Temin 1999). Although this research does adopt a dynamic perspective in studying changes in the workforce makeup, the focus tends to be primarily on demographic, socioeconomic, and educational characteristics—rather than psychological characteristics—of workers.

In sum, even though researchers have set forth various frameworks for considering job-person fit, there is no theory that exactly suits our phenomenon. As such, we must be somewhat speculative and tentative in portraying the dynamic process by which changes in the CEO position over the past 30 years or so, have brought about changes in the type of person found in that office.

Of course, the profile of a CEO depends on two intersecting sets of decisions: Who most wants the job? And whom does the board pick? So, in asserting that the profile of the CEO population has changed, we must ponder these questions: Have there been changes in who aspires to be a CEO? And have there been changes in boards' selection criteria?

It is exceedingly difficult to model “the aspiring CEO”, because relatively few people—including those who ultimately reach corporate pinnacles—start their careers intent on being CEOs. Instead, we assume that people start their business careers with more proximate dilemmas, including these questions: Do I want to stay in the corporate sector? If so, do I want a managerial role or will I be happier as a technical specialist or individual contributor? If I want a managerial role, just how high do I hope to rise? In pondering these questions, an individual continuously engages in an assessment of his or her life goals, values, and preferences;

assessment of his or her abilities and how well they suit various contexts and assessment of the pros and cons of alternative job tracks—in terms of meaningfulness, money, security, challenge, flexibility, and so on (e. g., Holland 1985; Levinson 1978; Super 1957). Thus, the people who remain and rise within companies represent the subset who possess the ideal skills for their contexts, who impress higher-ups enough to get promoted and who are motivated by the (financial and nonfinancial) rewards that come with climbing the corporate ladder.

Even for those who are within striking distance of the CEO position, say roughly all corporate vice presidents, the top job will still be viewed in terms of its plusses and minuses—a set of potential rewards along with a set of challenges and risks, all of which must be weighed against the rewards and risks of other alternatives. We are personally aware, for instance, of executives of major public corporations who have been viewed as “CEO material”—including COOs, CFOs, division presidents and others—but who opted for different paths: remaining where they are, becoming a professional corporate director, partner in a private equity firm, CEO of a not-for-profit, executive-in-residence at a business school, dean of a business school and—our favorite—student in a divinity school. In short, not everyone wants to be a CEO. Even among talented executives who appear to have ambition in their bones, there are alternatives to the top corporate job.

Before continuing, let us briefly recap on how the CEO job has changed. Clearly, over the past 30 years, the financial rewards of being a CEO have increased considerably as has the potential for visibility (if not outright celebrity) (e. g., Hayward, Rindova, and Pollock 2004; Malmendier and Tate 2009). At the same time, new risks and challenges have appeared. The likelihood of being fired is greater than ever. Demands from stakeholders are heavier than in prior decades (Hambrick, Finkelstein and Mooney 2005). These constituencies not only push today’s CEOs for maximum performance but also place considerable demands on their time, attention, and emotional energy—in ways that earlier CEOs did not face. Moreover, boards are not as co-opted or as congenial as they used to be. Who would be most drawn to or conversely most repelled by these new conditions?

Boards in search of CEOs face their own changed conditions. They are expected to be very exhaustive in their search process, looking well beyond their own firms for talent and certainly not allowing incumbent CEOs to dictate the outcome. As noted earlier, external hires are now much more prevalent. Not only have boards come under greater pressure to be comprehensive in their search, they also have come under pressure to hire a certain type of person: the charismatic CEO. As Khurana (2002) has documented, boards are no longer content to look for reliable, knowledgeable, capable managers; instead, they are in search of “transformational leaders” (Bass 1985; Burns 1978)—individuals who stand out, are colorful, energetic, eloquent or as Khurana described them: “corporate saviors”. What have these changed selection criteria yielded?

#### **1.4. Changes in the CEO population**

One of the primary ways to characterize the dispositions of executives is according to their values or deeply-held preferences for some states of affairs over others (Hambrick and Brandon 1988; Hofstede 1980; Rokeach 1973). Scholars have long theorized that executives’ values are not uniform but instead vary in ways that influence managerial perceptions and behaviors (England 1967; Hambrick and Mason 1984); empirical studies have supported this premise (e. g., Agle, Mitchell and Sonnenfeld 1999; Simsek et al. 2005).

Among the prominent values typologies, all have identified the *individualism vs. collectivism* dimension as centrally important (e. g., Hofstede 1980; House et al. 2004; Rokeach 1973). A person has individualistic values to the extent that he or she believes in the importance of individual autonomy and accountability; in contrast, one has collectivistic values to the extent that he or she believes in the importance of group or societal consensus, harmony and shared fates (Hofstede 2001; Smith, Dugan and Trompenaars 1996). Cross-cultural researchers have shown that the prevalence of individualism vs. collectivism varies substantially between different countries or regions (Hofstede 1980; House et al. 2004). For instance, people in the United States are, on average, more

individualistic than those in Western Europe, who in turn are more individualistic (or less collectivistic) than, say, those in Japan (Hofstede 1980). Substantial variance exists within cultures as well, including among top executives. For instance, Simsek, Veiga, Lubatkin and Dino (2005) showed that a sample of CEOs in the U.S. varied in their degree of collectivistic values and that these differences were manifested in the dynamics of the CEOs' management teams—specifically their propensity for collaboration, information-sharing, and joint decision-making.

One can readily envision how institutional shifts in Corporate America over the past few decades have given rise to a population of CEOs who are, on average, much more individualistic than those before them. If CEOs now think of themselves as participants in an atomistic executive labor market instead of as members of their organizations, if their pay is relatively unconnected to the pay of others in their firms, if they are brought in from the outside and if they are promptly dismissed when they falter, then it is straightforward to argue that America's CEOs increasingly subscribe to the old sailor's adage "Every man for himself." This has of course been the agency theorist's conception of managers all along, but their view now has more validity than ever.

*Proposition 1: Today's CEOs of public companies in the U.S. have more individualistic values than did their pre-1980 predecessors.*

As a result of changes in the business milieu, today's CEOs differ from their predecessors on yet another values dimension: they are more materialistic. Here too, most typologies have identified materialism (or one of its variants) as a dimension on which people vary (e. g., England 1967; Hofstede 1980). A person places a high value on materialism to the extent that he or she has a strong personal desire for wealth and tangible possessions (Richins and Dawson 1992). One who is materialistic may value wealth for what it can literally buy or for its scorecard symbolism. Importantly, one's degree of materialism (or any other value) can only be assessed relative to one's other values. Highlighting this relational nature of materialism (Rokeach 1973), Richins and Dawson (1992, 304) said "it is the pursuit of happiness through acquisition rather than through other means

(such as personal relationships, experiences, or achievements) that distinguishes materialism.”

Although business executives—in all eras and all locales—are probably more materialistic than their societal averages, contextual conditions can influence just how money-minded a CEO population is. We believe that recent trends in the U.S. have propelled an increased money-mindedness among top executives. Not only has CEO pay increased dramatically relative to almost any societal benchmark, the increased incentive element of CEO pay can now bring about very, very big paydays for CEOs. This incentive feature attracts a certain kind of person and propels a certain kind of outlook. Because of vastly increased pay levels of CEOs as well as increased variability of pay, there is far more commentary and attention to CEO compensation than there used to be. Media outlets now frequently provide lists of the highest—and lowest-paid CEOs, the most over—and underpaid, etc. Indeed, the “scorecard symbolism” of seeing their names atop the annual pay rankings may itself be a coveted outcome for CEOs apart from the obvious purchasing power of high pay (e. g., Finkelstein and Hambrick 1988). This spotlight on CEO pay, combined with the genuine potential for staggering levels of income is clearly an attraction for individuals who strongly value these types of rewards.

*Proposition 2: Today's CEOs of public companies in the U.S. have more materialistic values than did their pre-1980 predecessors.*

Beyond considering executives' values, leadership researchers have also examined CEO's personalities (e. g., Chatterjee and Hambrick 2007; Hayward and Hambrick 1997; Peterson et al. 2003; Resick et al. 2009), including a personality dimension of great relevance for our portrayal of today's top executives: narcissism. Narcissism originally entered the psychology literature as a label for an emotional disorder—the pathology of excessive self-admiration—and still retains that meaning among clinicians. More recently however, psychologists have shown that narcissism can be thought of as a personality dimension along which all individuals can be arrayed (Emmons 1987; Raskin and Terry 1988). Under this view, narcissism is defined as the degree to which an individual has an inflated self-view and is preoccupied with having

that self-view continuously reinforced (Campbell, Goodie and Foster 2004). The chief manifestations of narcissism include feelings of superiority, entitlement, arrogance and a constant need for attention and admiration (Bogart, Benotsch and Pavlovic 2004).

Recently, Chatterjee and Hambrick (2007) developed and validated an index of unobtrusive indicators of narcissistic tendencies in CEOs; in a longitudinal sample of 111 CEOs, the researchers found that CEOs' narcissistic tendencies were associated with their companies' strategic dynamism and grandiosity during their tenures as well as performance extremeness and volatility. In short, CEO narcissism affects firm outcomes; highly narcissistic CEOs are especially prone to outsized actions that will place them—and their firms—in the public eye (for good or otherwise).

There is abundant reason to believe that changes in the corporate milieu over the past 30 years have brought about an increased proportion of highly narcissistic CEOs. Consider for instance, the increased media attention to CEOs or the dramatic increase in CEO pay (including in the ratios of CEO pay to second-level executive pay). CEOs are now often portrayed by the media as larger than life figures who dramatically influence the fates of their firms. The idea of the “celebrity CEO” has become a central focus of scholars (e. g., Wade et al. 2006) who argue that increased media attention causes CEOs to believe their own press and to attribute firm outcomes to their own actions (Hayward et al. 2004). Moreover, the “scorecard symbolism” of being atop the widely publicized annual CEO pay rankings may itself be a motivation for CEOs desiring public attention (Finkelstein and Hambrick 1988). It is thus reasonable to imagine that contextual conditions have led to a more narcissistic population of CEOs than in the past.

*Proposition 3: Today's CEOs of public companies in the U.S. have more narcissistic personalities than did their pre-1980 predecessors.*

Finally, and perhaps superseding all the other changes we have noted, today's CEOs do not have as much psychological identification with their companies as did CEOs a few decades ago. Identification with an organization is the degree to which one's sense

of self is intertwined with the organization (Dutton, Dukerich and Harquail 1994; Mael and Ashforth 1992). A central finding in the large literature on organizational identification is that employees who strongly identify with their organizations are most willing to engage in an array of positive citizenship behaviors, particularly exerting extra effort for the organization and for fellow members (e. g., Dukerich, Golden and Shortell 2002; O'Reilly and Chatman 1986). A person who strongly identifies with an organization will act in ways that constructively serve the organization as doing so enhances the individual's own self-concept.

Researchers have recently extended the concept of organizational identification to the study of CEOs. Arguing that a CEO's psychological identification with his or her company will motivate the executive to do what's right for the company, Boivie, Lange, McDonald and Westphal (2011) gathered impressive survey data from 793 CEOs and found that a CEO's identification with the company was inversely related with—or tended to lessen—several behaviors that are generally seen as strictly self-serving: personal use of the company's jet, decoupling of pay from performance, and unrelated diversification. The authors more broadly reasoned that a CEO's sense of identification with the company can be highly efficacious in protecting shareholders' interests, but not nearly as expensive as aggressive incentive compensation schemes or board monitoring.

Shifts on the corporate landscape over the last 30 years almost certainly have brought about a diminished sense of organizational identification among CEOs. Many more of them are recent arrivals to their companies rather than career-long employees. Their continued service is precarious. They are continually reminded to primarily attend to the interests of shareholders—who are not themselves organizational members and who may care little about its texture or continued existence. In addition, of course, CEO pay bears little correspondence to the pay of other organizational members, adding to the psychological sense of separation and distinctness.

*Proposition 4: Today's CEOs of public companies in the U.S. have less psychological identification with their companies than did their pre-1980 predecessors.*



### 1.5. Stewardship theory and “the good old days”

If the rise of agency theory and widespread implementation of its precepts has engendered a new type of CEO—a more individualistic, more materialistic and more narcissistic *über-agent* who is less psychologically connected to his or her company—one must ask: What were the alternatives? What might have been?

Stewardship theory, the framework most often espoused as an alternative to agency theory, holds that many executives are quite able to subordinate their own selfish motives and to act in the best interests of their companies (Davis, Schoorman and Donaldson 1997; Donaldson 1990; Donaldson and Davis 1991). The prototypical CEO of stewardship theory is described as follows (Davis et al. 1997, 24):

In stewardship theory, the model of man is based on a steward whose behavior is ordered such that pro-organizational, collectivistic behaviors have higher utility than individualistic, self-serving behaviors. Given a choice between self-serving behavior and pro-organizational behavior, a steward’s behavior will not depart from the interests of his or her organization.

This approach adopts a “Theory Y” model of human motives (McGregor 1960), in which tight control and close supervision are unnecessary and counterproductive because individuals—including CEOs—are inherently predisposed to do what’s right. Stewardship theorists contend that companies will benefit by allowing executives greater latitude to determine company actions (for example, by making the CEO the chair of the board), as this increased autonomy will maximize the executive’s fulfillment and hence, performance. Obviously, this idea runs directly contrary to the assumptions of agency theory, which is geared specifically toward reigning in executive self-dealing.

The key idea here is trust. That is, the stewardship perspective argues that trust sets the stage for a productive relationship between principals and agents. This of course, this implies a sanguined view of the agent’s (CEO’s) motives; empowering a self-

interested CEO would simply allow him or her to take advantage of the company.<sup>4</sup>

But stewardship theory warrants its own critique—on multiple grounds. First, it would seem that “steward CEOs” might themselves be prone to certain dispositions that are not completely laudable for business leaders. If agency theory has brought us aggressive, ambitious, self-centered, swashbuckling CEOs, we can readily envision that the adoption of the stewardship framework would yield its own skewed population of top executives: risk-averse, conformist, rule-following and incrementalists.<sup>5</sup> As we think about the many executives we have studied or observed and the array of personality profiles we have seen, we question whether the archetype espoused by stewardship theory would yield a cadre of CEOs capable of bold or innovative leadership in dynamic environments.

Second, it could be fairly argued that stewardship theory already had its test and was found to be lacking or at least less salutary than its advocates portray. After all, in the period between 1950 and 1980, CEOs in the U.S. were subjected to almost none of the strictures of agency theory. Their pay was primarily in salary and modest cash bonuses (Frydman and Saks 2010). They hand-picked their own company directors, especially favoring friends and acquaintances (Lorsch and MacIver 1989; Mace 1971). They overwhelmingly served as their companies’ board chairs, essentially reporting to themselves (Kesner and Dalton 1986). By design or by accident, the system conferred to CEOs a great deal of “trust” or, at least, little supervision.

And what was the result? In some ways, things worked out well. Big companies got bigger and the economy steadily advanced. At

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<sup>4</sup> Stewardship theorists acknowledge this possibility as evidenced by statements such as “Implementing stewardship governance mechanisms for an agent would be analogous to turning the hen house over to the fox. Agency prescriptions can be viewed as the necessary costs of insuring principal utility against the risks of executive opportunism.” (Davis et al. 1997, 26) since knowledge of the agent’s motives is generally unknowable *ex ante*, one can argue that the potential costs of a mismatch are almost always too steep to justify.

<sup>5</sup> As an aside, the progenitors of stewardship theory may have impeded their cause by adopting an unfortunate label, as the term “steward” distinctly connotes “caretaker” or “one who maintains.” At a recent meeting with business executives we mentioned that we were studying steward CEOs and one of the participants tellingly sought a clarification: “Do you mean ‘interim’ CEOs?”.

the same time however, these “trusted CEOs” were engaged in an array of behaviors that were less than noble. They undertook unrelated diversification, which served no one except themselves (Amihud and Lev 1981; Rumelt 1974, 1982). They feathered their own nests, lavishing themselves with executive dining rooms, fleets of chauffeured cars, country club memberships and various other emoluments (e. g., Williamson 1963; Williamson 1964). Moreover, they were eminently susceptible to missteps and misdeeds. For instance, in the early 1960s, amidst the era of the “soulful corporation,” corporate giants GE and Westinghouse were implicated in a price fixing scandal that was unprecedented in scale and scope—so serious, in fact, that several key executives from each company went to prison. There was the famous “Salad Oil Scandal” of 1963, in which Allied Crude Vegetable Oil Company fraudulently obtained over \$150 million (over a billion dollars in today’s terms) in loans by filling the storage tanks of its ships mostly with water and just slight amounts of salad oil—which, of course, floated on top of the water and fooled inspectors who authorized loans secured on this phony inventory. We could go on as these were not isolated incidents.

Whether CEOs of the 1950–1980 era were less saintly or more saintly than the CEOs of today cannot be reliably said. What can be said however, is that unsupervised—or “trusted”—CEOs appear to be susceptible to abusing such trust.

Perhaps proponents of stewardship theory would argue that their framework has not yet been tested and that the 1950–1980 era was not at all the heyday of steward CEOs but, instead, was a period of watered-down agency theoretic arrangements—or something else altogether. Namely, advocates might claim, the stewardship model has yet to be really tried. Which takes us to a third potential doubt about stewardship theory: *Is it at all realistic?*

Is it plausible to expect business executives to be utterly selfless, collectivistic and freely willing to subordinate their own selfish ends? Is it sensible to think of any occupational group—say, accountants, artists, clergy, doctors or professors—as uniformly selfless? Probably not and we should least expect these qualities from people engaged in substantively uninspiring work—overseeing the production and marketing of widgets, pet food and

pots and pans as it were. It may be very stirring to think of corporate management as a lofty calling, a vocation that talented individuals will embrace for its own sake. But the cold reality is that being a CEO is a difficult and generally mundane undertaking—replete with budget reviews, capital investment reviews, financial statement reviews, long flights to visit grumpy customers, quarterly conference calls with investment analysts, and various other unpleasantries (see Mintzberg 1973, for a classic description of day-to-day managerial work). We want and need talented, hard-working people to do these jobs and do them well, but it is not at all clear why such people would be drawn to these positions for their intrinsic appeal. Rather, they must be paid handsomely to do so, which of course then, makes them merely mortals.

Here's a different way to think about it: Let us generously assume that, by adopting the trusting stance of stewardship theory, we could ultimately gravitate to a new regime, a near-utopia, in which 95 percent of all CEOs are highly talented, well-meaning, and concerned about their companies and stakeholders at least as much as they are concerned about themselves. The other five percent are bad apples, with dubious talents and/or selfish motives. Of course, under this regime, these bad apples have no reasons *not* to act on their self-serving drives and because they are unsupervised, we cannot identify them as bad apples until *after* they have damaged their firms. Would we be willing to accept this bargain or would we prefer to live with the consequences of agency theory? To paraphrase James Madison, fourth President of the United States and author of the esteemed *Federalist Papers*: "If men were angels, no government would be necessary; and if angels were to govern men, controls on government would not be necessary." Of course, men and women are not angels and when they control large amounts of resources and are responsible for the fates of others, it is especially foolhardy to expect as much.

## 1.6. Some proposals

Agency theory, we have argued, has brought us a hyper-breed of *homo economicus* as our present day CEOs—individuals who are disproportionately greedy, self-centered, even self-absorbed and who

have little emotional attachment to their companies. The stewardship model, on the other hand, would have its own shortcomings, arguably yielding a population of CEOs who are timid, risk-averse, slow and conventional. Under agency theory, CEOs need to be closely monitored because they are the type—by definition—who will otherwise take all they can for themselves. Under stewardship theory, CEOs are trusted, not closely monitored; but, since they are human, some of them will be flawed; thus, some stakeholders, *ex post*, will regret having been so trusting.

In an ironic twist, current arrangements tend to troublingly merge features of each model. We have already discussed how agency theory has created a cadre of narrowly self-interested CEOs; but, at odds with agency theory prescriptions, most of today's CEOs are allowed to chair their companies' boards (Finkelstein and Mooney 2003). Such CEO-chair duality is called for under the stewardship model of selfless executives who are expected to be at their best when given free rein (Donaldson and Davis 1991). But it seems eminently problematic to give such unsupervised discretion to CEOs whom we distinctly assume to be, and otherwise treat as, self-serving—which then brings about exactly that quality. In essence, we have sought foxes as our CEOs and then intentionally set them loose in the henhouse. It is not surprising that we have seen the corporate misdeeds noted at the outset of our paper; the surprise may be that such misconduct has not been more rampant.

So, what is the solution? Building from our propositions about how the CEO population has changed over the last 30 years, we see two potential ways forward.

The first would essentially acknowledge and accommodate the current breed of *homo economicus* über-agents, but would aim to further minimize the potential for CEO self-dealing. Here, we would install a refined set of agency prescriptions, which we see as more realistic and economically constructive than today's "worst of both worlds" model. Under this approach, *CEOs would be monitored and given incentives to take a long-term perspective*. Boards would consist of independent, dispassionate overseers and would be chaired by someone other than the CEOs. In this scheme, CEOs would not report to themselves. As for compensa-

tion, at least one-half of all incentive payments (and ideally at least one-half of each year's total pay) would be in the form of restricted stock that could not be sold for three or more years.<sup>6</sup> Thus, if a CEO earned a bonus, at least half would be paid in the form of restricted stock. Even if a CEO were to leave the company or die, the restricted stock could not be sold until its vesting date. The three year time limit is, of course, open for debate; it may be that three years is too short a horizon and that four or five years is more appropriate.<sup>7</sup> Our aim, of course, is to promote a long-term view in CEOs and to give them every reason to invest in R&D, enhance their companies' brands, treat customers and employees fairly, take sensible risks and, otherwise, build strong, sustainable enterprises.

Our second idea, more of a long-term proposition than the first, would be to allow for a variety of distinct models simultaneously—which, over time, would lead to greater variety in the CEO population. Under this pluralistic approach, companies would have distinct charters (among a slate of charter types, administered by each state), which would define their missions and philosophies. Among these varying philosophies, some companies would have strictly a shareholder wealth orientation, along with an agency theoretic approach for hiring, monitoring and motivating their executives. Others would have more of a balanced stakeholder model (e. g., Mahoney, this volume, chapter 5), which would extend to a stewardship orientation for selecting and rewarding executives. Yet others might have hybrids or entirely different approaches. In short, a company's charter—and its entire approach to ownership, governance and management—would become part of its corporate identity. In turn, stakeholders—employees, investors, suppliers, customers and others—could freely decide which style of company they want to be associated with.

Discerning readers will recognize that, to some extent, such pluralism exists already. For instance, in the U.S., there are both

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<sup>6</sup> There would be no stock options, as they engender more careless risk taking than is ideal (e. g., Sanders 2001; Sanders and Hambrick 2007).

<sup>7</sup> We thank the participants at the 2011 IESE conference in Barcelona for encouraging us to think more about the appropriate horizon.

stock and mutual insurance companies; there are many forms of cooperative enterprises (especially in agriculture and distribution) and, more broadly, there are many privately-held companies that have distinctive philosophies. Even among publicly-traded corporations, a variety of ownership and governance models exist. For instance, some public companies have multiple classes of stockholders, an arrangement that often confers all or most voting control to a founding family (for purposes of maintaining a distinctive company culture or executive lineage); other investors can buy or sell shares, but have no voting rights.

Our proposal, however, would make such variety more explicit and formalized. By institutionalizing several types of corporate charters and especially by drawing attention to their existence and their differences, this system would encourage stakeholders—and all of society—to conduct their own ongoing assessments of the pros and cons of the various models. The alternative regimes would tacitly compete for public favor; they would overtly compete for stakeholders; and they would collectively provide a rich array of examples—essentially broadly comparative benchmarking data—on what works and what doesn't work.

Foremost, such variety of corporate charters would engender a corresponding variety of corporate leaders. Instead of worrying about the emergence of a single or prevailing breed of CEO, we would be in a position to celebrate a diversity of leadership philosophies. A good match between executive motivations and corporate governance modes is a key antecedent to organizational value creation (e. g., Osterloh and Zeitoun, this volume, chapter 9), and greater variety in governance models would gradually broaden the spectrum of executive personality types occupying positions of power within organizations. Society could enjoy the advantages of having highly talented individuals—of all philosophical and personality stripes—as the heads of their business organizations.

## 1.7. Summary

In this paper, we have argued that the widespread implementation of agency theory precepts has brought about a fundamental change in the CEO population over the past 30 years. The un-

deniable influence of agency theory on U.S. corporate governance since 1980 has dramatically altered the American business landscape and has gradually introduced a population of CEOs who differ markedly from their pre-agency theory predecessors. These changes are neither good nor bad per se; but they do introduce new challenges to protect the well-being of our large public corporations. We have proposed several alternative ways forward that could better accommodate the new breed of CEOs and, ultimately, engender greater variety in the CEO population. It is our hope that scholars will build upon our ideas and explore how the executive population has evolved in recent decades, as well as what these changes mean for organizations and their stakeholders.

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## 2. Some Thoughts on Theory X and Theory Y Economics

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ACROSS a wide segment of current management research and theory there is at least an underlying concern about the future success of U.S. firms and those of other leading nations in the continuously evolving global economy. The primary issue appears to be whether and/or to what extent firms will take full advantage of the growing opportunity for innovation driven by advances in knowledge flowing from a broad spectrum of complex and interdisciplinary scientific discoveries. The concerns usually focus on the extent to which managements within and across firms will be willing and able to do those things necessary to encourage broad knowledge sharing and collaborative behavior at various organizational levels.

As we have addressed these concerns, we have on each occasion examined the values and assumption of managers and come to the conclusion that current managerial values and policies in many leading economies appear to work against collaborative behavior, particularly across firms (Miles et al. 1998; R. Miles and G. Miles 1999; R. Miles, G. Miles and Snow 2005; Miles et al. 2010). Moreover, it seems to us that the values and assumptions managers hold reflect the values and assumptions inherent in the economic models that they and country leaders have espoused and followed across recent decades. Given this, we have become increasingly convinced that the values and assumptions of modern economic models are producing the same limits on firm achievements that

managers' leadership values and assumptions were believed to be created by the management scholars of the late 1950s and early 1960s. Accordingly, the following sections explore how the leadership theory assumptions and policies prescribed by the scholars of that period might be extended toward a macro-economic model resting on similar values and assumptions.

Douglas McGregor's writings, particularly his 1960 book, *The Human Side of Enterprise*, were major contributors to the new leadership models that transformed progressive firms through the decade of the sixties and into the 1970s. While many others (e. g., Likert 1961; Miles 1965, 1975; Argyris 1957), offered contrasting traditional and innovation focused models of management, the common contrasting image was McGregor's Theory X Model of Management versus Theory Y. Theory X began with the assumptions that the average person disliked work and thus had to be controlled and directed to work toward organizational objectives and, indeed, preferred to avoid responsibility and thus welcomed managerial direction and the security it provides. McGregor noted that Theory X had strong roots in western theology and traditional models of motivation. Theory Y, according to McGregor, drew on more recent concepts of motivation that viewed work and the achievements it provides as potentially both materially rewarding and capable of inspiring organization members to increasingly higher levels of creative accomplishments at work and in life generally.

Unfortunately, while McGregor clearly associated Theory Y with superior organizational achievement, he did not explicitly place his theories into a larger economic context. That is, he did not provide either a Theory X view or a Theory Y view of the process by which the firm or the economy in which it participates, does or should proceed with economic wealth creation. Further, he did not question the prevailing measures of economic success such as utility, profits, productive indices, etc., measures, we might add, that continue to drive much of the economic thinking today. While McGregor was seeking to change managerial models and thus managerial minds, however, there was a larger theoretical conflict being waged in the theory trenches of economics. That battle is often pictured as pitting Milton Friedman and the strictly

rational competitive market neo-classicists (cf. Friedman 1962, 1970) against Paul Samuelson and John Kenneth Galbraith and the neo-Keynesians, who acknowledged that human beings were often human, even in their economic behavior (cf. Galbraith 1958).

We can quickly illustrate how McGregor might have joined the economic debate, at least at an introductory level. McGregor's Theory X managerial philosophy, as noted, assumed that workers seek only the pay and security their jobs provide. Such a view of workers is clearly compatible with the Friedman's version of neo-classical economic models, which portray the rational pursuit of maximum personal gain as the force underlying all wealth creating activity. Thus, in the neo-classical model, the firm is designed to produce its goods or services at the lowest possible costs and to offer them at the highest price market demand will bear. Investors, following similar economic theories, evaluate firms based on their current period returns and are prepared to buy and sell equities to maximize their own short term gains. This is a simple model of wealth creation with no explorations of value, sustainability, or the rights of other firm stakeholders and could well be labeled a Theory X Economic Model.

McGregor's Theory Y management philosophy in contrast, challenged conventional views of human motivation and behavior. It reflected what were then emerging new views on motivation, such as Maslow's motivational theory of the normality of human aspirations expanding across life and achievement stages (Maslow 1954). McGregor imagined a world in which it was natural for managers to help those below them grow in achievement and rewards and maximize the utilization of the human factors in the firm. Given this, one can imagine that a 1960 version of a Theory Y economic model would have at least viewed firm and societal aspirations and achievements expanding across wealth creating stages, and might well have even probed around the edges of a societal focus on what Maslow referred to as "actualization", becoming all that a person (or society) could become. Such a view would have fit nicely with the work of Galbraith, who was exploring the possible societal costs of purely production driven material affluence and questioning whether societal goals might



shift as traditional gains accumulated. However, like McGregor, Galbraith raised these concerns but did not lay them out as the proper goal of a Theory Y economy, though he did speculate that “happiness” might well be a more viable and satisfying long term measure of societal wealth than the amount of goods produced. Interestingly, the use of happiness as an indicator of economic success has received significant attention in recent years (cf. Frey 2008; Blanchflower and Oswald 2011).

## **2.1. Expanded thoughts about a Theory Y economic model**

If indeed one searched for an economic policy equivalent of Maslow’s highest human need of self-actualization, the path, as Maslow discussed, would probably lead up through a mature (long term, environmentally sound) satisfaction of the ego (presumably material) needs of a society, with leadership in global goods production as a measure of achievement, and then beyond these to the creation of an economy safely appreciating in material, social, educational, and cultural well being—a wealth creation sculpted “David” of the economic world. Stated in such definitive language, this clearly raises the question whether Maslow’s progression of needs and the policies they might inspire are truly descriptive of normal human motivation stages or perhaps simply the prescriptive wishes of a moral mind. Indeed, various philosophers from Aristotle forward, have imagined similar motives and behaviors from the most advanced of humankind. Whether higher reaches of human motivation may be descriptive or simply moral wishes is of less concern here than the implications for national and firm level economic behavior that they would imply<sup>1</sup>.

Indeed, the pursuit of policies driven by a needs hierarchy such as that envisioned by Maslow, would provide for both firms and the economy, housing them to first satisfy the material, social, and ego needs of their stakeholders, which would include the

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<sup>1</sup> Our position mirrors that of most economists, who have traditionally asserted assumptions about the human motives and behaviors driving economic actions without concern for empirical support.

broader community. If such a Theory Y economic model speculated about possible actualization targets, it would very likely include mechanisms for the gradual but permanent reduction of local and then global income inequalities and the smooth flow of all essentials (however defined) to all segments, sectors and states. Utopian economists imagined some related aspects of this possible goal but never seemed, in most instances, to have a fully global model. Indeed, the simple pursuit of global income equity would seem to be a worthy societal actualization aspiration for multiple generations.

In a world of Theory Y economics with a clear vision of actualization reflecting global economic equality (including all the social goods of education, health, old age security, etc.) the theory of the firm would have to be redefined to focus on wealth creating business models featuring goods and services for an equitable and sustainable global society. Such business models could be pursued by managers and work teams actualizing in their achievements of outputs fitting these criteria. Indeed, the very concept of wealth might be redefined to focus on a variety of social indexes.

For the short run, perhaps economic actualization would simply be to provide opportunities for all stakeholders to satisfy not only ego needs but to begin to satisfy their altruistic aspirations. Interestingly, at the global level, the steps required to pursue happiness for all, as measured by an across the board uptick in societal indexes, may well be clearer than the appropriate goals for each of the most advanced nations. On the other hand, for those in the more mature advanced societies, with personal needs broadly achieved, the substitution of altruistic satisfaction for some material achievements might well occur spontaneously.

In summary to this point, Theory X and Y Economic Models, we believe, build easily on McGregor's Theory X and Y Managerial Models. Both X and Y Managerial and Economic Models as presented, reflect assumptions about human values and motivation and both create behavioral policies in line with these assumptions. It should quickly be noted that in the world of both Theory X and Theory Y Economics, freely functioning markets are equally viewed as the most efficient and effective mechanisms for guiding

the creation and distribution of goods and services, just as the requirement to organize and direct human and material resources to produce products and services is the focus of both Theory X and Theory Y managers. What is different are the wealth creating business models that X and Y firms pursue and their assumptions about the human values and aspirations these models satisfy. As noted, McGregor contrasted X and Y managers in terms of their beliefs about the capabilities and motives of people and X and Y economic models would rest on a similar set of assumptions. Theory X economic assumptions as noted, begin with the belief that all economic behavior will be self-serving. In contrast, Theory Y economic assumptions begin with the view that, beyond sufficient material wealth, people will naturally search for higher levels of human achievement, including the creation of an equitable global society in which many, if not all, can pursue their highest aspirations.

## **2.2. Supporting evidence**

The crucial question at this point is whether there is evidence to support either a Y view of management or a Y view of economic behavior. McGregor turned primarily to the Scanlon Plan firms to illustrate what could be achieved with enlightened firm management, even during harsh economic times. Many of us over the years, including impressive current studies in France (Getz 2009), have documented enlightened Y type management across firms and agencies achieving high rates of returns to all their stakeholders. At a broader level, we (cf. C. Miles, Snow and G. Miles 2007) and others have pointed out historical instances where widely supported exercises of Theory Y like macro economic behavior involving social investments (e. g., the GI Bill in the U.S. and Post WW II regional re-development investments such as the Marshall Plan in Europe and the U.S. assisted economic recovery of Japan), resulted in amazingly high rates of economic and social return. Most of the recent examples of Theory Y economic behavior however, have been carried out through individual service (e. g. Peace Corp volunteers, Doctors Without Borders, etc.), though occasional examples of rich public investments by leading nations

(cf. reports on efforts in Finland by Castells and Himanen 2002) and economic/social actions by the institutions most advanced nations support (e. g., the UN, the World Bank, the Red Cross, etc.) can be found.

An enlightened, expanded Theory Y Economic model however, might well envision a much richer utilization of human wealth creating capabilities in the service of higher visions of the well being of the global society. Such an economic theory for example, would likely guide broad public investments to curtail global warming and to promote the research essential to an extended and expanded vision and practice of global health care. The key question is whether private institutions might follow public sector leads and begin to explore a new vision of private, market linked Theory Y economic behavior.

We have argued elsewhere that advanced/enlightened private economic behavior, based on creative underlying wealth creation assumptions, can and in fact does occur regularly but we have also expressed concern that the ranks of such socially conscious firms have appeared to be shrinking across recent decades. Moreover, we, and other observers, have tended to view these examples of contributions to societal wealth as exceptions to expected behaviors, exceptions variously justified under the general theme of “good economic citizenship to assure long term societal support”. Thus, even among the more sophisticated firms and managements, Theory Y like economic behaviors are not portrayed as an integral part of the wealth creating path the firm is pursuing.

In retrospect, such a lack of integration is fully understandable. In order for the firm to view its Theory Ylike economic actions as central pursuits, they would have to be part of its sustainable, wealth creating business model. Historically, this has not been the case, as most businesses, and business scholars have been implicitly, if not explicitly, following the measures of success laid out in economics many years ago (cf. Samuelson 1937 and Alchian 1953 on measuring “utility”) and captured succinctly in Freidman’s dictate that the business of business is to maximize shareholder returns (1970). While some effort has been made to establish that profits and social responsibility may go hand in hand (see Griffin and Mahon 1997 for a review), most social efforts, as indicated,

are seen as an add on, rather than an integral part of the business model (cf. Hahn et al. 2010).

A firm with a Theory Y business model in contrast, would argue that pursuing societal health across the range of economic and social indexes, including of course, that of its own members, was creating wealth for its stockholders by assuring the health of its other stakeholders, including its consumers. Henry Ford made such an argument in 1914 when he announced the \$5.00—a-day minimum wage for all his employees (along with a profit sharing distribution of some of the accumulated wealth they had helped create). Ford proclaimed the salary not only a just reward for economic contributions but also the recognition of his employees' contributions to society's wealth creating capabilities. In line with a profits and social perspective, Ford also justified the salaries as essential to his firm's sales expansion, arguing that "you have to pay your workers enough to buy your products".

A beginning segment of a Theory Y Economic model for advanced nations and their firms can easily be built on Ford's insight. If under-developed nations can be incorporated equitably in the global economy, their populations become not only more effective producers but also more prosperous consumers, ultimately contributing to further advances across the ranks of those already economically adept. Simply put, there is some salary that is an appropriate minimal payment to all participants in the global economy, a Ford-like daily wage that an intelligent global economy would endorse in order to "pay workers enough to buy global products".

A second segment of a Y Economic model would recognize the importance to long term economic health of investments in global education, health and security. The recognition that aspiring to achieve broad economic and social health is not only a sound investment in long term global survival (satisfying both social and ego needs) but also, ultimately, the achievement of mankind's aspiration to its highest levels of moral fulfillment. Putting these objectives in terminology that fits with other aspirations more easily recognizable as compatible with economic behavior is clearly a challenge, as is visualizing the global economy its pursuit would create and the business models of its firms as they participate in

it. At the base level however, it logically begins, as do all current conceptions of wealth, with statements concerning one's assumptions about value. If current and future global social and physical health, for example, is high on global society's values, its pursuit could be redefined to serve as both a community and a personal good of value in the global marketplace. Thus a green, sustainable, equitable global economy would become evidence of the wealth of all its members.

At this point, it is easy to slip into neo-Utopian visions and language but note that the route up to the highest level is a pure economic pursuit, albeit one with a different view of the definition of wealth creation. It requires only that the players creating the goods and services needed to achieve it, reward all factors of production equitably and make investments based on long term visions of global economic and environmental health, a path insuring long term benefits to all stakeholders. That is, as noted, opening up global markets, providing new demand for advanced goods and services and therefore behaving equitably toward all producers and consumers is simply an investment in sustainability. Thus, firms and economies operating in a global economy guided by Y-type economic assumptions and wealth creating prescriptions would provide for the long term well being of the global society.

### **2.3. A further benefit**

There is, of course, at least one other benefit of exploring a Y vision of economic behavior and that is its compatibility with the expansion of collaborative behavior within and across firms. As we have pointed out in various pieces (e. g., Miles et al. 1998; R. Miles, G. Miles and Snow 2005; Miles et al. 2009) and repeated briefly in the introduction to this essay, the challenge of the 21<sup>st</sup> Century for advanced nations is the extent to which the century's most valuable resource, human knowledge, will be utilized by traditional firms pursuing traditional market goals. As sciences have become richer, we and others have pointed out that knowledge has become more interrelated and interdisciplinary and thus less likely to fit into traditional technologies and market views across existing firms. Thus, we have argued that

scientific interdependence may lead to the creation of a new organizational form built around a community of complementary independent firms collaboratively sharing knowledge within and across the firm community to achieve a much broadened vision of wealth creating innovation.

Such a community, we have maintained, could only exist with something that we now see as approaching a Theory Y economic philosophy, featuring expectations of trustworthy inter-firm behaviors and the common pursuit of equitable treatment to all. Moreover, we have stressed, without attention to its Theory Y implications, the importance of individual firms remaining independent and voluntarily responsible to both their own members and their external stakeholders, including the firm community. Indeed, we have previously argued, without reference to its compatibility with Y type values, that the voluntary pursuit of collaborative interaction would prove increasingly satisfying, both economically and socially over time. It is thus likely that this view, so contrary to current X theories of management and wealth creation, bears the seed of a definition of the ultimate levels of wealth achievable in a Theory Y economic vision.

In sum, when we have explored the likely emergence of new organizational and managerial approaches to the full utilization of the century's expanding flow of knowledge, we have done so within the framework of existing definitions of economic success. Thus, while noting frequently that existing economic views and processes within and across firms are an inhibiting factor, we have not offered a broad economic vision supportive of collaborative firm behavior. It now seems clear to us that just as organizational scholars and managers in the 1960s used alternative philosophies of management to visualize, research and ultimately change approaches to behavior inside firms, economies and the major segments within and across them might well find benefit in a broader visualization of their purpose, researching, and ultimately reshaping, their mechanisms and their approaches that define and measure the results of their wealth creating behavior. Indeed, globally focused communities of collaborating firms equitably serving a sustainable global society seems like an appropriate, first step, objective of a Theory Y economic model.

## 2.4. Related theorizing

The Nobel prize in economics in 2009 was shared by the senior author's Berkeley colleague Oliver Williamson, who have argued that firms arrange themselves hierarchically in order to both manage the resources and production of their goods or services and to minimize the negative effects of the self-serving behaviors of their economic suppliers and consumers, and Elinor Ostrom, whose studies document the essential nature of collaborative allocation processes among individuals and firms operating across limited resource arenas. Interestingly, Williamson may well have provided the classic Theory X description (and prescription) of firm behavior while Ostrom explored at least some aspects of Y like economic behaviors and aspirations supporting sustainability across exploitable resources. Of course, one could argue that Ostrom's observations of economic collaboration were simply documenting enlightened self-serving behavior but that is to some degree our point. Regardless of the initial motivations, such behavior would fit a Maslow-like societal model of ego and actualization need satisfaction and could provide a learning arena for collaborative skills useful across other, perhaps more broadly envisioned, societal actualization resource arenas.

Moving beyond these limited X and Y descriptions of firm wealth creating behavior to consider what actualization behavior might involve at the level of the firm is necessary, however, if one were to seek to explore the possible outcomes of national economies operating at the upper levels of a Maslow-like hierarchy of needs. As noted, one can imagine a firm working first to satisfy its security needs, building a sustainable business model to guarantee its long term survival, and then working through its ego needs of high returns to all of its stakeholders. At such a point, new, economically sound actualizing goals for the firm could well include enhanced contributions to the health and sustainability of its immediate geographic community and all of its broader constituencies, particularly its customers, given that all of these aspirations would presumably have long term positive returns to the firm. Finally, one can imagine the firm building into its strategic objectives intermediate and long term goals reflecting specific



contributions to global societal health and well-being. All of this, of course, would be subject to the constraint that none of these aspirations would detract from the long term economic viability of the firm.

In a related fashion, one can speculate about the possible benefits that might accrue to the members of firms operating at the highest levels of a Maslow-like need hierarchy. Would “actualizing” satisfaction be expected to permeate all levels of the firm’s hierarchy? It seems clear that a firm pursuing Y type economic goals would also be pursuing Y type managerial goals. As such, the firm’s achievements for society would be based on goals built from discussions across all departments and levels, thus bringing satisfaction to all of the firm’s members and all of its external stakeholders.

In sum, we can imagine a Y managed firm urging all of its members to discuss their goals for the future of their immediate, national and global community. Focusing on the goals with the highest levels of support, top management might then ask, as to how the firm could contribute to those goals in a manner which would also provide sustainable benefits to the firm. It is our guess that broadly beneficial efforts could become part of the firm’s strategic plan, thus assisting in actualization across all stakeholders. Indeed, would not such a plan become an appropriate Y Theory of the firm operating in a Y Theory national economy, perhaps even in a Y Theory global economy?

## **2.5. Y economic policy for the national and global economy**

Having commented on the possible pieces of a Theory Y Economic Model for a nation and the firms within its economic system, it is useful to probe a bit more deeply into the implications of such Models/Theories for actual economic policy decisions. Interestingly, one does not have to simply imagine a society and its firms taking such a path because examples of many of the necessary steps toward such an economic model have already been taken and examined in detail. Some of this has come from efforts in countries such as Denmark, Sweden, and Norway (Florida and

Tinagli 2004), but the most extensive and at the moment at least, successful push towards a Theory Y economic model by policy makers and firm leaders, is that undertaken by Finland from the middle of the 1990s to the present.

Indeed, the investments made in Finland's educational, health, and environmental systems have read like Theory Y economic prescriptions for taking a second tier raw materials oriented economy toward the top of the first tier world product innovation ranking. Not only has Finland become one of the top countries on competitive measures (Pyoria, Melin and Blom 2005) but its leading firm, Nokia, is now a household name in the global information processing industry. Not surprisingly, the government's Theory Y economic behavior has been broadly modeled by its leading firms, with individual managers in firms such as Nokia apparently being reluctant to accept outsized individual economic gains and expressing concerns about their equitability. In Finland, at least, Theory Y Economic policies have not only benefited the broad society but have been modeled across the society's firms and individual citizenry.

Given that the outcomes in Finland and some of its geographic neighbors have been the result of them pursuing Theory Y economic policies, the question is what would happen if one or more of the large economic players began to move in such a direction. Snippets of the possible returns can be seen in at least some of the larger economies. One can argue, for example, that ideologically, China has pursued some aspects of a Y model with its commitment to socialist values and its heavy investments in public education and health care. While there are beginning to be some returns to these investments, critics would argue that a true Theory Y approach has not been taken because the gains have come at the expense of China's smaller neighbors and some of its own citizens as well as its physical environment. Perhaps more instructive is the case of Japan, which has been more thoughtful environmentally (though opponents of nuclear power might argue that, given the recent natural disaster). Japan has maintained highly visible vestiges of its feudal past across its economy and society while making enormous society-wide investments with high payoffs in education and health.

In contrast to these efforts in China and Japan, the third member of the global economic big three, the U.S., does not appear to have moved much, if at all, from the Theory X Economic policy roots planted in the 1950's and 60's by Friedman and others that took hold and flourished in the 1980s. While actively involved in world affairs (for good or bad, depending on your perspective), the basic economic approach in the U.S. since at least the 1980s still reflects a mostly self-maximizing view with little concern for others. Thus, it is not surprising that the U.S. leads the world in global goods production and global individual and corporate wealth but trails many societies in most social indices, including a declining middle class, widely disparate health and well being statistics across societal segments and major uncertainty with regard to its future course of public policy toward X or Y goals. Indeed, across the world's more advanced nations, only the northern Europeans and to a lesser extent, the Japanese, appear to be dedicated to the pursuit of something like a limited Theory Y set of public economic policies.

Against this less than bright backdrop, can we imagine the prescriptions a Theory Y Macro Economic Policy theorist would make for the remaining years of the 20s? Clearly the prescriptions would require concerted, collaborative action by the big three and the European Union, which across their socio-economic experiences have ample combined evidence not only that it could be done but that the positive benefits would be enormous for them and the rest of the world. For example, if the U.S., Japan, China and the EU all committed to a shared public education model guaranteeing all their citizens access to free education up to and including advanced degrees (already provided in several societies, notably Finland and Denmark) with access across national lines to assure equity, an enlightened global society would at least begin to emerge in less than two decades. Similarly, a concerted effort could be mounted, with appropriate financial incentives for all parties on such issues as global warming, global food production and global health (including birth control). These issues are, as noted, regularly discussed and debated in such forums as the UN, but they are most often portrayed as involving economic tariffs. Taking a Theory Y rather than a Theory X economic view, howev-

er, suggests such efforts being visualized as economic investment opportunities, with almost assured long term returns for recipient and investor economies. Indeed, stated in this manner, alternative X and Y visions of the global economy begin to come clearly into focus.

## 2.6. Conclusion

We have argued that the assumptions underlying and thus guiding most modern economies, are closer to a Theory X perspective than a Theory Y perspective, given their focus on the purely rational pursuit of traditional economic approaches to wealth creation as measured by comparative measures of goods and services production. We have suggested that a Theory Y economic model would begin by assuming that maturing societies would recognize opportunities for wealth creation beyond traditional goods and services—wealth measured first by domestic improvements across all social indices and progressing toward a focus on enhanced global measures of economic and social health. In so doing, we have followed McGregor's reliance on motivational models that imagine the natural progression of individual, and ultimately group and national, aspirations reflecting thoughtful maturation across physical, social, ego and actualization needs.

It is, of course, easier to speculate on Theory X and Theory Y Economic Models, including their assumptions and principal policies, than to affect national choices between them. In most advanced societies, there are two built in barriers to a move from X to Y economic models. The first is a three decade or more investment in X values (as described in Chapter 1), particularly in the U.S. and those nations most influenced by its policies. X values thrive across current individual and corporate aspirations and the call for a move toward Y values may well sound as revolutionary as Ford's 1914 proclamation. On the other hand, the continuing failure of X domestic economic policies in some leading societies, the U.S. in particular, and the growing cost of protecting X related economies through military means, may suggest an opportunity to begin a serious 1960s type of debate.

Clearly, the next steps involve further defining the concept of wealth and the process of wealth creation for a Theory Y global economy and imagining the indices that firms and firm communities might use to measure their achievements. Such a process is not a trivial task, but it is a necessary one if we are to begin to see investments in such areas as social good or sustainability as part of the fundamental economic system rather than “add-ons” reflective of good corporate citizenship that must be continually justified. “Happiness” has been offered, as noted, as one way of conceiving of the desired societal outcome and a number of researchers have begun efforts to quantify this across various countries. The exciting challenge for both firm managers and societal policy makers, though, involves defining the investment, production and trading policies that create greater happiness. Clearly, imagining a broadened concept of the “humanized” work world that a Theory Y Economic philosophy would imply is a crucial part of this process. For example, it may well be that working toward the creation of Y type firms pursuing Y type goals in a domestic and global Y type economy may be the ultimate goal of humanization and the ultimate generator of the broadest possible scope of human happiness. The issue is, should such an aspiration be offered or would that inhibit more easily achieved shorter term, smaller impact steps? This seems worthy of some debate.

Finally, revisiting all aspects of current organization and management research and teaching topics to explore their underlying visions and implications for a long term, sustainable, Theory Y global economy appears to be a necessary goal. While Paul Samuelson commented in a 1937 article that his measurements and assumptions of “the marginal utility of money income” should not have “any influence upon ethical judgments of economic policy”, the reality is that judgments regarding purpose and value are imbedded in virtually all business and economic models. Occasionally, these underlying judgments are explicitly challenged. For example, some have questioned the ethics of following Porter’s (1980) strategic approaches, because they promote profiting from market failures rather than adding real value to the market (Miles 1993), and Ghoshal and Moran (1996) questioned whether building on the notion of opportunism was “Bad for Practice”. More

recently, a book by Nobel Laureate George Akerlof and Robert Shiller (2009), entitled *Animal Spirits* (acknowledging Keynes reference to the influence of human emotions influencing their economic decisions), offered a reasoned analysis of several aspects of human behavior that they argue affect economic behavior.

In the main, though, the assumptions underlying work in management broadly defined are implicit and seldom acknowledged. The concern is that, without being formally documented, these assumptions influence both analysis and prescriptions to force them in line with Theory X economic views. Further, they create a world view where positive investment in society has to be justified in terms of its influence on short term profits, and efforts to collaborate across firms may never be considered because they are seen as risking current returns rather than in light of future possibilities. Given this, failure to review and question the assumptions underlying research and practice in management and economics is likely to lead to a continued sub-optimizing wealth creation pursuit without consideration of the wealth creation models that other approaches, such as Theory Y economic models, might generate.

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### 3. The Institutional Logic of Great Global Firms

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A classic joke features a scientist pondering an observed phenomenon that he would not have predicted. The joke ends with the punch line that although he sees that it works in practice, he wonders if it can work in theory. That is the dilemma facing management scientists. In practice, the firm is already on a path to humanizing, but theories of the firm have lagged behind.

Theories of the firm have been dominated by a legacy of ideas from early industrialization that pose zero-sum opposition between capital and labor (or capital and nearly everything else), differentiating the economy from society and often posing irreconcilable conflicts.<sup>1</sup> The search for mathematical models has turned the negotiated order of organizational activities, which necessarily include particularistic elements, into abstract generalizations that favor quantifiable variables.<sup>2</sup> As seeing in Chapter 1, an ideal of the primacy of markets and the centrality of finance came to dominate thinking about management, especially in the U.S., where the Ford Foundation helped to create modern business schools and legitimated economic and quantitative knowledge as the core of professional management.<sup>3</sup> Thus, it became inevitable that “shareholder capitalism” would focus on unlocking

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<sup>1</sup> Consider, for example, the classic work of that era, Frederick W. Taylor. *The Principles of Scientific Management*. New York: Norton, 1967.

<sup>2</sup> This quantitative drive was present in numerous schools of organizational studies, including systems theory and organizational economics.

<sup>3</sup> Gerald F. Davis. “The rise and fall of finance and the end of the society of organizations”, *Academy of Management Perspectives* 23 (2008): 27–44. See also Davis, *Managed by the Markets: How Finance Re-Shaped America* (Oxford, England: Oxford University Press, 2009). For the Ford Foundation role, see Rakesh Khurana, “How foundations think:



financial value and reporting mechanisms would come to hold that the only definition of value creation is economic or financial value.

In this archetypal view, firms are impersonal money-generating machines, operating through bundles of transactions and treating employees in instrumental ways as disposable costs and controlled by rules, thus leaving a wake of discontent. Discontent is an empirical truth in some contexts. U.S. studies have shown that about half of employees in large firms are disaffected and disengaged.<sup>4</sup> Other studies from a variety of countries, point to the negative health consequences of work situations involving long hours, lack of control, work-family conflict and socially isolating jobs.<sup>5</sup> However, over recent decades, some firms have responded to the discontent by changing their practices—but not always their logic. Sometimes this has been done in the interest of productivity or cost, having been influenced by studies showing that productivity is higher when workers have more control over their work or that low product quality and high employee turnover increase costs or that pollution and corruption create financial risks.<sup>6</sup> Thus, often the underlying theories still rested on an economic logic: how to get higher valuations in financial markets.

This paper offers another logic, a social or institutional logic to let practice provoke the creation of new theory. It provides examples that show how social logic guides the practices of widely-admired, high-performing companies and why people and society are not an after-thought to be used or discarded but core to the

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the Ford Foundation as a dominating institution in the field of American schools of management," *Harvard Business School Working Paper*, 2011, 11–070.

<sup>4</sup> Ellen Galinsky, James T. Bond, Stacy S. Kim, Lois Backon, Erin Bownfield and Kelly Sekai, *Overwork in America: When the Way We Work Becomes Too Much*. New York: Families and Work Institute, 2005.

<sup>5</sup> Evidence is reviewed in Jeffrey Pfeffer, "Building sustainable organizations: the human factor," *Academy of Management Perspectives* (February 2010): 34–45. Pfeffer suggests that even the focus on job satisfaction or work-family conflict evolved over time to largely consider the implications for organizational performance (profits, costs, productivity), rather than human well-being.

<sup>6</sup> The effect of control on worker productivity was demonstrated as early as the 1970s. See J. R. Hackman and G. R. Oldham, "Motivation through the design of work," *Organizational Behavior and Decision Processes* 16 (2) (1976): 250–279 and R. A. Karesk, "Job demands, job decision latitude, and mental strain: Implications for job redesign," *Administrative Science Quarterly* 24 (1979): 285–308.

purpose and definition of the firm. It builds on in-depth, ongoing global field research on admired companies from four continents, followed in over 20 countries, to derive propositions about the role of humanistic institutional logic as described in my book *SuperCorp*.<sup>7</sup> (Unattributed information or quotes in this paper are from the author's original research.)

Institutional logic holds that firms are a vehicle for accomplishing societal purposes and providing meaning for those who work in them which cannot be calculated only in terms of profits or paychecks. Rather than viewing organizational changes as new ways to extract more economic value, these firms have created a framework for guiding decisions that makes it legitimate to use social value or human values as explicit criteria. The theory-in-practice is that firms have a purpose, as institutions in society that contribute to meeting the needs of all stakeholders through the goods and services they produce, the jobs they create and the quality of work life, how their goods and services impact other aspects of society or are used to provide societal benefits and their financial viability to provide returns to investors and capital for improvements and innovations. This perspective involves internalizing what had once been externalities and defining a firm around its purpose and values.

This social or societal logic is seen as aligned with economic logic but not subordinate to it. For example, in order to carry out its activities and sustain the institution, firms require capital but profit is not an end in itself but rather a means to further investment in continuing returns. This view of the firm is no more idealized than profit-maximizing views. There are well-established firm practices such as R&D and marketing that have become conventional, expected and applauded by stock analysts, which cannot always be tied to profits either in the short or long run.<sup>8</sup> Such investments must be expanded to include employee empowerment,

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<sup>7</sup> Rosabeth Moss Kanter, *SuperCorp: How Vanguard Companies Create Innovation, Profits, Growth, and Social Good*. New York: Crown Business, 2009. See also, Kanter, "Leadership in a Gloablizing World," in Nitin Nohria and Rakesh Khurana (eds.), *Handbook of Leadership Theory and Practice*. Boston: Harvard Business School Press, 2010: 569–609.

<sup>8</sup> On the difficulty in measuring the returns of R&D, see Griliches (1998).

emotional engagement, values-based leadership and related humanistic contributions.

There are a few caveats that provide a lens for viewing the propositions in this paper.

- Institutional tasks are not easy and they must be performed beyond all the technical work that is basic and essential to producing and selling goods and services.
- The companies in my study might not be representative of the vast majority of businesses, although I would argue that they represent the vanguard.
- There are no organizational utopias. No one of the companies or their leaders meets the ideal that the skeptical public holds out for perfect conduct in every respect. Each falls short of its own ideals and prefers to frame ideals as aspirations.
- The new practices can have a downside of unintended consequences or pernicious effects, because size is associated with power, not to mention market domination, large firms are both revered and feared. There is widespread suspicion of the motives of top managers of large entities when they engage in seemingly altruistic activities.
- There are paradoxes and tradeoffs. If firms derive economic benefits from social actions, then their social actions are written off by cause ideologues as cosmetic, but without the financial benefits, the actions written off by economic ideologues as wasting resources that could be put to more profitable ends. You can't please all the people all the time. Perfection is unattainable.

Social or institutional logic will not be unfamiliar to purpose-driven industrialists of earlier eras such as the Houghton family that built Corning Glass and Corning, New York or the Tata family of India. It is certainly even more necessary for non-family-led enterprises operating in today's globalized world. Organizations contend with environments in which many activities outside of the control of top leaders can cause shocks, surprises, and unpredictable change, creating uncertainty and complexity that

cannot be contained in an easily-defined structure or by routine processes.

The era of information-driven globalization is characterized by frequent, rapid and sometimes unpredictable change, both done by leaders and done to them by events in the external world. Globalization increases the speed of change, as more competitors from more places produce surprises. System effects send ripples that spread to more places faster—innovations in one place proving disruptive in others, problems in one economy triggering problems in others. Although geographic diversification is a hedge against local risk, geographic consolidation to gain economies of scope can expose companies to risks that cannot be contained. For example, this is a concern for IBM leaders about consolidating certain data storage or processing functions in fewer places which increases global vulnerability from local events.

Globalization brings more moving parts, more variables in play simultaneously, and more dimensions of interest. There is a rapid flow of people, money, and ideas in and around the organization.<sup>9</sup> An intensely competitive global information economy places a high premium on innovation, the faster the better, as well as the ability to continuously upgrade products and processes. Both rely on tapping brainpower of knowledge workers and also on their collaborations because innovation relies on new connections among previously unrelated elements or entities that now require further integration.<sup>10</sup> Information has a short half-life—“use it or lose it.” So there is more need to get ideas connected to tangible products and services and to connect innovations with applications and users. Mergers and acquisitions add further complexity and their success rests on the effectiveness of integration among the previously unconnected organizations. The important challenges and opportunities lie across boundaries.

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<sup>9</sup> Rosabeth Moss Kanter, *World Class: Thriving Locally in the Global Economy* (New York: Simon and Schuster, 1995).

<sup>10</sup> Rosabeth Moss Kanter, “Innovation: The Classic Traps,” *Harvard Business Review* 84(1) (November 2006): 72–83. See also Michael Tushman and Charles O’Reilly, *Winning Through Innovation: A Practical Guide to Leading Organizational Change and Renewal* (Boston: Harvard Business School Press, 2006).

Furthermore, seeking legitimacy or public approval by aligning with social values has become not just a basic license to operate but a business imperative.<sup>11</sup> Firms that cross borders face questions of cultural fit and local appropriateness; they must gain approval with authorizers and opinion leaders. Their employees are both internal actors and external agents who represent the company to the community.

### 3.1. Propositions

#### 3.1.1. Proposition 1: Conceiving of the firm as a social institution is a buffer against uncertainty and change

As companies acquire, divest, or are acquired; the business mix of globalizing companies changes frequently; and job levels fluctuate across countries. So what exactly is the same that makes us say this is the same company? Bank of America is the surviving name after numerous mergers but the underlying surviving bank is Nation's Bank, which gave up its name but not its headquarters, management cadre, or culture. Where are the sources of certainty that permit people to take action in an uncertain world? "Management is temporary and returns are cyclical. The only enduring thing is our values," IBM CEO Sam Palmisano said, explaining to me why he puts so much emphasis on values and culture.

The answer to the question of the identity of an organization in the future is that it is not the current widgets but it is the purpose and values and that can help find the right new widgets to serve society. For example, Mahindra, a US\$11.1 multi-business firm based in India, with 117,000 employees in 100 countries, proclaims that it is "many companies united by a common purpose—to enable people to Rise. We operate in the key industries that drive economic growth..." including finance, IT, vehicles and several dozen others. This kind of reasoning (or rationalization) is characteristic of conglomerates in emerging markets; although most do not create a common purpose-based culture, it can be argued that the ones that can be counted among great global firms

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<sup>11</sup> David Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* (Washington, DC: Brookings Institution Press, 2006).

have created an institutional logic for their business investment choices.

Globalization seemingly detaches organizations from particular societies only to require the internalizing of society and its needs (many societies) in organizations. Institutional certainty can balance business uncertainty. For example, in the choice to identify health as a central purpose with nutrition, environmental responsibility and talent sustainability as pillars supporting the slogan “Performance with Purpose”, PepsiCo provides direction and motivation for diverse lines of business, some of them more globalized than others in multiple countries. This is certainly strategic. It guides a gradual shift of resources from “fun-for-you” to “better-for-you” to “good-for-you,” in PepsiCo parlance. It provides a rationale for acquisitions and divestitures. It guides a quest for ways to eliminate sugar and sodium in foods and beverages but it also provides an identity for the people who work in the company.

Thus, leaders can compensate for uncertainty by institutional grounding—identifying something larger than transactions or today’s portfolio to provide purpose and meaning. Institutional frameworks permit diverse, self-organizing people to gain coherence. Joel Podolny and Rakesh Khurana, have argued that meaning-making is the central function of leaders.<sup>12</sup> Institution-building involves active efforts to build and reinforce aspects of what is loosely-called organizational culture—but it is also much more than that. Culture, as generally used, is often a by-product of past actions, a passively-experienced outgrowth of history.<sup>13</sup> Institutional work is an investment in activities and relationships that do not yet have an instrumental purpose or a direct road to business results but that instead show what the institution stands for and how it will endure.<sup>14</sup>

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<sup>12</sup> Joel Podolny, Rakesh Khurana, and Marya Lisl Hill-Popper, “Revisiting the Meaning of Leadership,” *Research in Organizational Behavior* 26 (2004): 1–36.

<sup>13</sup> See, for example, the classic definition of organizational culture given in Edgar Schein, *Organizational Culture and Leadership* (San Francisco: Jossey-Bass Publishers, 1985).

<sup>14</sup> Thomas Lawrence and Roy Suddaby, “Institutions and Institutional Work,” in S. Clegg, C. Hardy, T.B. Lawrence, and W.R. Nord (eds.), *Handbook of Organizational Studies* (London: Sage, 2006): 215–254. See also Thomas Lawrence, Roy Suddaby, and

Institutional work is a survival strategy. Globalization increases the likelihood of shorter organizational life cycles as a result of mergers and acquisitions, industry consolidation, and intensified competition driving out weaker competitors. It is plausible to hypothesize that the extent and depth of institutional work can divide the survivors from those subsumed by global change, equivalent to the difference between long-lived and short-lived utopian communities in my earlier research about commitment and survival.<sup>15</sup> A sense of purpose beyond instrumentalism infuses meaning into an organization, “institutionalizing” it as a fixture in society with continuity between past and future. The name can change but the identity lives on.

For example, Banco Real, the Brazilian subsidiary of a European bank, was a high-performer growing in size, reputation, and financial performance. This was widely attributed to institutional work by CEO Fabio Barbosa and other top leaders to infuse the bank with values of environmental and social responsibility that became the core of the bank’s business strategy and the key point of differentiation. These values gave larger purpose to daily work and stimulate innovation to serve customers and society with practices that meet high standards. In 2006, when the European parent, ABN AMRO, was on the auction block, producing enormous uncertainty and anxiety in Brazil, Barbosa turned again to the Banco Real’s culture. He reminded managers that the best protection was high performance stemming from intensified efforts to showcase institutional values. He told them at smaller meetings and larger conferences that certainty came from their knowledge that they were “doing the right things the right way every day” (a slogan he often repeated). In April 2007, a consortium bought ABN AMRO, and ownership of Banco Real, shifting it from the Netherlands to Spain’s Santander, which bought the Brazilian assets to add to the branches they already operated in Brazil. The spirit of Banco Real involved so much more than the assets. Fabio Barbosa was named CEO of the combined en-

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Bernard Leca (eds.), *Institutional Work: Actors and Agency in Institutional Studies of Organizations* (Cambridge: Cambridge University Press, 2009).

<sup>15</sup> Rosabeth Moss Kanter, *Commitment and Community* (Cambridge, MA: Harvard University Press, 1972).

tity and the Banco Real culture and values were to be infused throughout Santander Brazil, combined with Santander's emphasis on financial efficiency. Although Santander Brazil was pressed to increase branch profitability, the parent bank adopted Banco Real's concern for social and environmental responsibility along with its private banking model.

**3.1.2. Proposition 2: An emphasis on the firm as a social institution generates a longer-term perspective.  
Short-term financial sacrifice becomes permissible  
in the interest of positioning the firm for sustainable  
success**

Sustaining the institution requires resource attraction, so financial performance matters but great companies are willing to sacrifice short-term financial opportunities if those are incompatible with institutional values. Institutional values guide matters central to firm identity and reputation such as the quality of products, the nature of the customers being served or attention to by-products of the production process. There is increasing pressure on firms to attend to and report on these matters as well as on financial performance.<sup>16</sup> Banco Real was willing to restrict its market in the interests of signaling and acting on its values. The bank created a screening process for project lending as well as a way to help customers meet higher standards but it walked away from customers that did not meet tests of environmental and social responsibility. Sometimes this is justified in risk reduction terms but it is a signal that the interests of the institution in the long-term transcend short-term transactions. Firms are known for the company they keep and reputation of customers and partners is an asset.<sup>17</sup>

Using a social logic, firms are also willing to make investments in the human side of the organization that cannot be justified by immediate financial returns but that help produce a sustain-

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<sup>16</sup> See, for example, Eccles and Krzus (2010). Another example is the work of CERES to change reporting requirements for companies to include sustainability measures, as outlined in its report "The 21<sup>st</sup> Century Corporation: The CERES Roadmap to Sustainability" (CERES, 2010). A coalition of advocates of new metrics for companies formed the Global Reporting Initiative.

<sup>17</sup> See Vogel (2005: 52–53, 106–107).



able institution. In South Korea, after the Asian financial crisis of the late 1990s, Shinhan Bank set out to acquire Chohung Bank, a much larger and older bank that had been bailed out by the government. Announcement of the acquisition was met by a dramatic protest: 3500 men from Chohung Bank, members of a union that extended into management, shaved their heads and piled the hair in front of Shinhan's headquarters in downtown Seoul. Customers are often lost in the turmoil of changes around mergers and acquisitions anyway; this widely-reported event was certain to do much more damage. Shinhan had to decide whether to go ahead with the acquisition and then, if it did proceed, how to treat the protestors and what to do about Chohung employees—whether to retaliate against this hostile action.

Shinhan, a relatively new bank, had been guided by humanistic values and those prevailed. Shinhan negotiated an agreement with the Chohung union that involved deferring formal integration for three years, providing equal representation of both Shinhan and Chohung managers on a new holding company management committee and internal committees and increasing the salary of Chohung employees to match the higher wages of Shinhan employees. (Shinhan also provided 3500 caps to cover the heads of the protestors). In short, Shinhan increased the cost of the acquisition and appeared to defer returns from it for several years. Moreover, Shinhan decided to invest the equivalent of tens of millions in U.S. dollars in a process the bank called “emotional integration”—a series of retreats and conferences that would not only spread strategic and operational information but would also be explicitly designed to produce social bonding and a feeling of being “one bank”. The first retreat involved taking 1500 top managers, the entire top layers, to a historic city where they climbed a mountain at a famous shrine together and sang a company song. According to a financial logic, the new Shinhan Financial Group was wasting money and jeopardizing shareholder value. According to the institutional logic Shinhan used, these investments were considered the only course of action that would keep the two banks running with continuity from knowledgeable employees who had ongoing relationships with customers.

Here is what happened next. Within 18 months, Shinhan had retained and grown its customer base and neutralized the union which was having a hard time rallying protest against the benign bank. Although no formal merger could occur, Shinhan and Chohung employees were working together on task forces discussing best practices and ideas were spreading that began to make the branches more similar. Branches of one bank often displayed a sign for the other bank. Employees were, in essence, self-organizing. By the third year when formal integration could occur, Shinhan was outperforming not only the banking industry in South Korea but the entire Korean stock market.

To carry out their activities, firms requires labor of a knowledgeable kind, who are trained, committed, and can understand what needs to be done when rules are vague or unspecified. Companies can pass up short-term cost-savings in order to motivate performance, retain and attract employees and managers. When part of a coherent strategy, this can produce superior financial results in the longer-term.

**3.1.3. Proposition 3: Articulation and transmission of institutional values can evoke positive emotions, stimulate intrinsic motivation, and propel self- or peer-regulation as a type of control system**

Instrumental, utilitarian rationality is not the only force governing firm performance and behavior within firms.<sup>18</sup> Emotions play a strong positive or negative role. Moods are contagious, and they can determine such issues as absenteeism, levels of effort and energy or health.<sup>19</sup> People influence one another and either increase or decrease the level of performance, as was shown in my study of teams and organizations on winning or losing streaks

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<sup>18</sup> This humanist insight was provided, initially, by the human resources approach to organizations. See, for example, Douglas McGregor, *The Human Side of Enterprise* (New York: McGraw Hill, 1960).

<sup>19</sup> Social psychology has returned to the study of emotion, and the idea is reaching companies. There are numerous studies of mood contagion; for example, Elaine Hatfield, John T. Cacioppo, and Richard L. Rapson, *Emotional Contagion* (Cambridge, England: Cambridge University Press, 1994); Sigal G. Barsade, "The Ripple Effect: Emotional Contagion and Its Influence on Group Behavior," *Administrative Science Quarterly* 47 (2002): 644–675.

(Kanter 2006). Well-understood shared values and principles can be a source of emotional appeal and help people reinforce their implementation, which in turn can help determine how well a firm succeeds over time.

Having a statement of values has become common, so the issue is not whether a set of words called “values” exists somewhere in the company. An institutional logic makes the regular articulation of the values core to the work of the company on a regular basis. CEOs of companies in my project headquartered in the U.S., Mexico, the U.K., and Japan all allocated considerable resources to breathing new life into long-standing values statements, engaging multiple levels of junior leaders in this institutional task of identifying and communicating values. The point was not the exact words themselves but the living process: to begin a dialogue that would keep the sense of social purpose in the forefront of everyone’s mind and use that as a guidance mechanism for business decisions. That was how Procter & Gamble leaders saw the company’s PVP (statement of purpose, values, and principles); CEO AG Lafley and Vice Chairman Bob McDonald spent much of their time teaching about and discussing the PVP in formal programs and in visits to locations around the world, beginning with the purpose: “to improve the lives of the world’s consumers, now and for generations to come”. As Chairman and CEO succeeding Lafley, McDonald built P&G’s purpose central to the new strategy in 2009: “improving more lives in more places more completely” and made it central to his meetings everywhere, pointing to the need to reach emerging markets and the bottom of the pyramid.<sup>20</sup>

Omron’s new CEO, Sakuta-san, led a restructuring of this Japanese global electronic sensors company from 2002–2006. In an interview with the author for the research for the book *SuperCorp*, he said that he considers something beyond rearranging the busi-

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<sup>20</sup> The emphasis on the bottom of the pyramid represents a current effort to tie values and the need to serve society with profit-making opportunities that might stem from providing goods and services to the underserved, i. e., the world’s poor, thereby improving their lives. The late Prahalad (2004) crystallized this emphasis in his book, *The Fortune at the Bottom of the Pyramid*. See also Kasturi Rangan, Quelch, Hererro, and Barton (2007).

ness portfolio or technical engineering prowess more important to the long-term endurance of Omron: Omron's Principles. The Principles, which had been created many years earlier, were rewritten in 2002 and then transmitted through a massive communication process that could have seemed a distraction from the managerial work of restructuring. It proved instead the glue that helped Omron through business ups and downs. Today, groups of employees begin each work day by reciting the core slogan. Sales people start conversations with customers by talking about the Omron Principles and representatives invoke the Principles first when meeting with companies they are vetting and courting for acquisition (the analogy with religious ritual is apparent). CEO Sakuta-san fully expects that 35,000 people in Omron might have different interpretations—maybe 35,000 different ones—but that the engagement and discussion is the important thing. He said, "Whenever I speak with employees, I tell them your answer should not be a set answer. Please tell what you understood and how you can express it using the language of the Principles. I also promote discussion among peers, colleagues, and teams to share these understandings with each other." He puts this in terms of a very long time horizon: "No matter how different the workplaces are in terms of race, value sets, geographical locations, etc., as long as we can continue this debate and discussion, we are able to maintain our attractive and strong work environment and Principles with a flexible attitude to respond to any changes to come in 50, 100, 200, 300 years. And I believe we will be able to refine the Principles by doing so."

IBM CEO Sam Palmisano's process for refreshing IBM's values for the 21<sup>st</sup> century was itself a dialogue on a scale beyond anything any company had ever done.

By 2000, IBM had outlived others prominent in the industry 25 years earlier but with hardly the same company from a business perspective. It has downsized or sold manufacturing (later selling the ThinkPad, grown in software and services, emphasized the Internet over mainframes, had nearly as many employees in India as in the U.S. and was targeting growth in all the BRIC nations. So what was IBM? One of the early leadership actions that Sam Palmisano took when he became Chairman and CEO in 2002 was to

refresh the IBM values through a unique participative process involving web chats open to over 350,000 IBMers in 270 countries.

When Palmisano presented the plan to the IBM board, one of the directors, a former CEO, questioned him about whether this was “socialism”. He explained that this was the only way to build an enduring institution in which IBMers embraced and owned the values. “It wouldn’t do to create values from the top, like Watson did; today people are too sophisticated, global, and cynical. We want people to connect to the entity in a way that’s relevant to them”. He wanted people to have pride in IBM as an institution, not to be following a leader: “The values are the connective tissue that has longevity”. An IBM sector direction in Latin America concurred: “When you are working for the same company for 20 years, you need to be proud of it. The reason I wake up early every day to come to IBM is because this company has values that we really believe in. This is the reason I’m here, because I really believe in this company. I know we are doing good things for society. Of course we are a business and we have our targets, but we can give other things. And we do it.”

Although I am mentioning CEOs by name, institutional logic suggests that firms cannot operate through a cult of personality because that is not enduring.<sup>21</sup> Thus, while top leaders must exemplify and communicate the values, codified statements of purpose and values reduce vulnerability to the choice of top leaders and dependence on a single charismatic figure. In effect, they routinize charisma so that it spreads throughout the organization. With many people performing institutional work, the entire organization holds emotional appeal and successors can convey the founding ethos and take it in new directions. Leaders must continue to fuel the passion at the heart of institutional work while remaining aware of the distinction between organization and person. They must convey that the institution is larger than any one person, so that people are not following a leader; they are following the values and principles of the institution. Thus, values and purpose

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<sup>21</sup> Rakesh Khurana, *Searching for the Corporate Savior: The Irrational Quest for Charismatic CEOs* (Princeton: Princeton University Press, 2002).

represent an alternative, non-bureaucratic mechanism for de-personalizing work relationships.

When institutional work is done well, the ultimate results might not be apparent for years; survival and longevity can't be known in the short-term of financial reporting periods but the emotional impact can be immediate and powerful and that can be measured by loyalty and commitment in the face of alternative choices, recruitment of others to join, expressions of belief and efforts by individuals to volunteer for institutional tasks, above and beyond their jobs. Institutional grounding in purpose and values might attract and hold customers that are not solely transaction-oriented and if the institution has coherence and an enduring purpose, then the inevitable change of an uncertain world should be less threatening.

**3.1.4. Proposition 4: The need for cross-border  
and cross-sector engagement to tap new opportunities  
requires concern for public issues  
beyond the boundaries of the firm and the formation  
of public-private partnerships in which the public  
interest is weighed along with the business interest**

The thrust of financial logic is to maximize the returns to capital—shareholder or owner value. The thrust of institutional or social logical is to balance returns to capital with considerations of impact outside the boundaries of the firm, internalizing public interests and undertaking new kinds of partnerships.

One paradox of globalization is that it is accompanied by a greater need for deep national and local connections in plural public spheres.<sup>22</sup> To thrive in diverse geographies and political jurisdictions, companies must build a base of relationships with government officials, public intermediaries and customers that can ensure alignment of agendas even as circumstances (and public officials) change. In some places, these external stakeholders are interested in the quality and sustainability of the institution as a local contributor as much as the transactional capabilities of the

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<sup>22</sup> Kanter, *World Class*. See also Pankaj Ghemawat, *Redefining Global Strategy* (Boston: Harvard Business School Press, 2007).

organization. The global organizations themselves want both an extended family of relationships that can endure and a seat at the policy table for matters affecting their ability to do business in the future. So the institutional work of leaders extends outside the enterprise.

Converting arms-length transactions across the supply chain into deeper partnerships as part of an extended family in the business ecosystem has been an increasing emphasis of major companies in recent decades. Public-private partnerships to address societal needs in which the firm might have an interest are somewhat newer but growing in importance. A wide range of services can be performed at various levels, from international activities in collaboration with the United Nations (Procter & Gamble's Children's Safe Drinking Water partnership with UNICEF and other global and national NGOs), large national projects in collaboration with government ministries, products addressing unmet societal needs or leading employees and/or other stakeholders in short-term volunteer efforts (IBM's response to the Asian tsunami, or Cemex's engagement of small distributors in Latin America in community service days). PepsiCo attracted Derek Yach from the World Health Organization as its first Chief Health Officer in part because the company appeared to be heeding the criticisms that WHO had leveled against unhealthful properties of its beverages and snack foods and was now in active conversations about working together. PepsiCo also created partnerships with development agencies to finance new facilities in poor rural areas that would create jobs.

Under an institutional logic, top executives cultivate relationships with top public officials but not as a *quid pro quo* nor for the sake of particular business transactions. They seek to understand and contribute to the public agenda even while influencing it. IBM's CEO Palmisano circumnavigates the globe 6 or 7 times a year to meet with national and regional officials, bringing regional leaders with him, discussing how to help the country achieve its goals. This is not sales, not even marketing, but rather a high level conversation to indicate IBM's interest in being an enduring institution contributing to that country. Such contacts help other IBM leaders get seats at the table discussing the country's

future. That certainly provides an opening for discussion of the company's policy agenda (which is more technical than political) but any instrumental goal would not be achievable without first contributing to efforts clearly benefiting the country.

Institution-building requires effort by many people. Top leaders involve others in leading diplomacy such as representing the company to the community at conferences and civic or charitable dinners and serving communities directly through service projects.

I hypothesize, based on the companies in my research, that the more interested top leaders are in institution-building for the long term, the more likely they are to involve more people in institutional work and reward it with recognition and resources. A Cemex manager in his first country manager post expressed surprise to the chairman, Lorenzo Zambrano, at how much time he had to spend making relationships with government officials and wondered if he should be doing it. "Welcome to top management", Zambrano told me he replied.

Relatively few people hold formal responsibility for these external interfaces as their primary jobs and indeed, institutional work is less effective in terms of impact on external stakeholders when it appears to be "just a job." So instead, many others perform institutional work as volunteers, giving meetings and community service projects a ring of authentic motivation. This is not a hard sell for people either native to the area or long-term residents because there is an emotional pull of place that makes institutional work desirable, so they are willing to volunteer personal time to do it, sometimes initiating efforts and taking others in the company with them. For others whose careers take them across geographies, institutional work is a way to connect their internal roles with the place they now live, making them feel less rootless and more at home.

Leaders from global companies operating in developing countries are often asked to advise on emerging issues where global experience could be useful. That requires special diplomatic skill: being able to appear neutral and interested in the host country, rather than company or home country-interested. A leader in India was typical in presenting the company's agenda to the Minister



of Commerce as a slate of future-oriented issues that would help ensure India's competitiveness.

Corporate diplomacy is particularly important where country interests differ or there is active conflict (or long historical memories—for example, U.S.-headquartered companies in the Middle East or Japanese companies in China). Add to that challenge suspicion of foreigners and concerns about their hidden agendas. Leaders must find ways to show that they act or advise in the interests of society beyond politics as a company that is not tied to a specific government or interest group but serves humanity. If the values are real, then leaders are willing to invest in ways that reflect them not as a quid pro quo but as a sign that they will be locally involved. An Indian company entering Europe faced hostility from some government officials. Company leaders, who could draw from a long tradition of social responsibility, chose to make community investments that heralded their high standards and leaders spoke with officials primarily about their values and how, once in a country, they would remain committed to its prosperity.

When leaders come to see themselves in terms of societal purpose, even across countries, they choose to perform institutional work, including self-initiated unofficial international diplomacy. In May 2007, the chairman of IBM Greater China organized his own diplomatic mission to Washington DC, meeting with Senators, Members of Congress and White House officials on both sides of the China issue to build bridges and find areas of collaboration such as environmental issues because of his conviction that his role in a global company gave him a unique perspective on both countries and a desire to see both thrive as allies.

**3.1.5. Proposition 5: When institutions internalize society, actions to produce societal value are undertaken whether or not they are tied to core functions of producing and selling goods and services and actors consider externalities as part of their internal decision-making**

Claims of serving society are made credible and tangible when leaders allocate time, talent, and resources to national or community projects without seeking immediate returns and when they

encourage people from one country to serve another. Articulating an institutional purpose broader than making money can guide strategies and actions, open new sources for innovation and help people express firm values and their own.<sup>23</sup>

“Corporate citizenship” is a relatively new term to connote embeddedness in society and the obligations that accrue.<sup>24</sup> It might encompass corporate philanthropy but ranges far beyond it into core business strategies and operations. For example, IBM’s approach to corporate citizenship is closely connected to its business competence—to harness the power of technology-enabled innovation to meet social and educational goals of the broader society. IBM employees are expected to look at those broader goals while carrying out their particular tasks. A Latin American executive responsible for the small-and-mid-sized business sector felt that IBMers were increasingly using an external or societal lens to view IBM: “I see a change in the way we think about social responsibility. Twenty years ago, I think the focus was, do the right thing internally. Before, it’s like I see a problem in the society, in the community, and I don’t care because this is not inside IBM, so I have nothing to do with it. The change right now is to leverage the size of IBM and do the right thing outside our organization into the whole supply chain with providers and customers.”

Attention to social needs in particular places can generate ideas that lead to significant innovations. For Cemex, operating by this institutional logic and considering unmet societal needs produced innovations such as anti-bacterial concrete, which was particularly important for hospitals and farms; water-resistant concrete helpful in flood-prone areas; or used tires converted to road surface for countries with rapid growth in road construction. An idea from Egypt for salt water-resistant concrete, helpful for harbor and marine applications became a product launched in the Philippines.

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<sup>23</sup> For a distinct but related argument on the benefits of open innovation, see Henry Chesbrough, *Open Innovation: The New Imperative for Creating and Profiting from Technology* (Boston: Harvard Business School Press, 2003).

<sup>24</sup> For a general overview of the concept of corporate citizenship, see Andrew Crane, Dirk Matten, and Jeremy Moon, *Corporations and Citizenship* (Cambridge: Cambridge University Press, 2008).

Institution-building connects an extended family of partners across an ecosystem. Cemex started Construrama, a distribution program for small hardware stores in 2001 in response to competition from Home Depot and Lowes, U.S. construction product companies that were then entering Latin America. Cemex drew on its values to seek dealers with integrity who were trusted in their communities; the company rejected high growth/high margin candidates whose business tactics didn't meet Cemex ethical standards. Construrama offers training, support, brand recognition, and easy access to products for small hardware stores, including sometimes the first computers and Internet access for these small enterprises. By the mid 2000s this network in Mexico and Venezuela was the equivalent of the largest retail chain in Latin America and it was expanding to other developing countries. Cemex owns the Construrama brand and handles promotion but doesn't charge distributors, operate stores, or have decision-making authority, although service standards must be met. About a third of the Construrama management team at headquarters spends 6–8 months working at the stores. Partners participate in councils on a rotating basis. Among the Cemex values that are disseminated to partners is participation in community-building philanthropic endeavors, for example, contributing people and materials to expand an orphanage or improve a school. A Cemex executive referred to the societal sensitivity that produced Construrama as “understanding the last link in the value chain”.

Widespread opportunities for individuals to use company resources to serve society further institution-building goals. In 2003, when IBM's business emphasis had shifted to On Demand Computing, the company launched On Demand Community, an intranet site for technology tools designed to improve schools and community organizations. Three years later, 75,000 employees (over 20% of the population) had performed nearly 3.5 million hours of service and the number continued to rise in subsequent years. IBMers could clock their community service time and at 50 hours get a certificate of recognition from their country head and be eligible to apply for a grant for that organization based on IBM worldwide standards. According to IBM officials, many people love the service for its own sake and forget to clock their hours.

**3.1.6. Proposition 6: People can be treated as self-determining professionals, coordinating and integrating activities and producing innovation through self-organizing in addition to formal assignments**

Coordination and integration of activities can be more efficiently and effectively accomplished through human relationships and self-organizing.<sup>25</sup> Formal structures or technical systems create pathways for employees to connect information, share or exchange resources and develop innovations. Although employees have formal assignments which require minimum compliance, higher levels of performance stem from the voluntary component—not only which ideas to surface and how much effort to put in but also on going beyond the job to contribute to additional activities. In addition, resource allocation is determined not only by formal strategies and budget processes top-down but also by informal relationships, spontaneous actions and preferences of people at all levels.<sup>26</sup> Consider the Shinhan case described earlier; the two predecessor banks self-integrated over a period of years through social bonds and cross-cutting relationships, far in advance of formal integration.

Thus, to fully understand, a firm requires knowledge of its social life and to optimize performance requires social investments. Perhaps network analysis will one day prove capable of predicting firm performance through quantitative methods but it is also clear that there is an emergent, open-ended quality to the actions of great global companies—one reason that the idea of strategy-as-plan has been redefined as strategic intent. This idea was summarized by IBM's CEO, who wrote that IBM cannot be optimized through organizational structure or by management dictate but requires empowering people while ensuring that they're making the right calls the right way that give support and life to the strategy and brand,

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<sup>25</sup> See, for example, the literature on teams and effectiveness, J.R. Hackman, R. Wageman, T. Ruddy, and C.R. Ray, "Team Effectiveness in Theory and in Practice," in C. Cooper and E. Locke (eds.), *Industrial and Organizational Psychology: Linking Theory with Practice* (London: Blackwell Publishing, 2000).

<sup>26</sup> Joseph Bower and Clark Gilbert (eds.), *From Resource Allocation to Strategy* (Oxford: Oxford University Press, 2006).

concluding “That’s why values, for us, aren’t soft. They’re the basis of what we do, our mission as a company”. Procter & Gamble’s PVP (purpose, values and principles) also proved central to the turnaround of the business in Brazil, which had fallen behind the competition. Managers motivated to save the business developed a new model for conceiving of change to lower costs and reach a mass audience of lower-income consumers (that later became adopted worldwide), then applied it to a leading product category with the involvement of cross-functional teams and external customers, using open innovation to look outside the company for special ink for new packages and using customer partnerships to create major new displays that enabled effective promotion without expensive media. Empowerment was the result of trust that stemmed from clear belief in company values.

Formal structures are too general and rigid to reflect the many multi-directional pathways for resource or idea flows in the best firms. Informal, self-organizing, shape-changing and temporary networks are more flexible and can make connections or connect bundles of resources more quickly.<sup>27</sup> Formal positions come to resemble a home base from which people are continuously mobile in terms of daily tasks, projects, work relationships, group membership and physical location. Matrix organizations, in which individuals report to two bosses representing two dimensions of their tasks (e. g., reporting to a functional head and an industry head or a geographic head) become what I dub a “matrix on steroids”. In a multi-dimensional matrix, people are accountable along many dimensions simultaneously and consecutively with multiple projects and with multiple interfaces that enable them to assemble resources for those projects.

There are large numbers of people around the world who still work under exploitative, low-engagement conditions. Even without counting the abuses such as exploited unskilled immigrants or illegal sweatshops, there is still a drudgery and confinement component to some jobs including in vanguard companies. Ce-

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<sup>27</sup> Ronald Burt, *Structural Holes: The Social Structure of Competition* (Cambridge: Harvard University Press, 1995); *ibid.*, *Brokerage and Closure: An Introduction to Social Capital* (Oxford: Oxford University Press, 2007); and *ibid.* *Neighbor Networks: Competitive Advantages Local and Personal* (Oxford: Oxford University Press).

mex runs cement factories, Publicis Groupe has mass production software programming shops and every company has office support staff who must sit in place for certain hours no matter what.

Information technology facilitates direct access and rewards those who seek and spread information. Open access and communication irrespective of levels are phenomena increasingly apparent everywhere in the world, even in countries with more authoritarian traditions (as evidenced by recent rebellions in the Middle East). Some of this is generational; younger employees, even in elder-revering countries are less hesitant than older employees to email the CEO directly. Thus, leaders tend not to stand “above” on a vertical dimension in practice, regardless of formal structures; they lead by facilitating horizontal, diagonal, or multi-directional connections. The decisions that top leaders retain involve choices about which potential pathways to endow with resources to start them moving—i. e., which broad initiatives to fund or which pieces of the organization to combine formally in order to facilitate closer connections between related parts.

Firms can add to the voluntary component of paid work by entrusting people with choices, including where, when, and with whom they work. Any cost-savings by having fewer offices are offset by the risks of unmonitored action and thus trust and empowerment are key. For example, on any given day, nearly 40 percent of IBMers do not go to an IBM office. Mobile employees are working at home or at customer sites, moving between locations or taking personal leave at a time of their choice. “Giving people more control over how, when, and where they do their work is the core of flexibility”. Ted Childs, former vice president for diversity said at a meeting in my Harvard office reviewing evidence of the changes at IBM. “I’m not saying we solved anything (pointing to the 35% of participants in an IBM global survey who report some work-life difficulty) but people feel we are responding”. IBM’s work at home programs, such as the one started in Japan in 2001, have caught the attention of government officials interested in keeping women with technical degrees in the work force. In some cases, there are allowances to support infrastructure in the home.

“At the end of the day, IBM is more worried about the work being done and how well you do it than, did you work for eight hours or did you work for 20 hours to do your job,” declared a manager in Bangalore, India. He claimed that even if a person in Bangalore turned down a temporary assignment with a client in Mumbai, the manager would work it out with someone else or offer flexibility “but no way that the person, because he or she didn’t go for the project, would be relegated or ignored. We understand the reasons why he or she is not able to go for the project.” A woman professional in China, project director for a high-profile initiative to digitize the treasures of Beijing’s Forbidden City, praised her manager for providing deadlines and then leaving her alone, saying: “Then you know when you need to work overtime and when you can sleep. I like this very much. I hate people telling me to work overtime. But if people don’t ask me to work overtime, I might be working overtime anyway.”

Job descriptions hardly document what people do every day, nor do official performance reviews and salary bands capture the activities through which people might add the most value for the company, because sometimes those “side” efforts are not even itemized in any official data base or system. In some cases, professionals are formally encouraged to spend 15 or 20 percent of their time on projects of their own choosing as a stimulus to innovation.

Some of the most important voluntary activity, in terms of the impact on company strategy and direction, occurs outside of any formal responsibility when people come together to share information. Communities of practice link people with a similar technical expertise. Communities of kind link people from particular groups such as women or minorities. Communities of interest connect people who want to explore particular ideas. Technology enables them to cut across wide swaths of the organization, to grow virally, to cull the best ideas, to build support for action, and to become powerful forces for change. The driving force for self-organized groups is curiosity and interest on the part of the people themselves. The company can try to facilitate them, but they flourish when they involve volunteers.

Self-organizing communities give their members voice. They are also a potent force for change, propelling companies in direc-

tions they might not have taken without the unanticipated voluntary actions of people with no formal mandate to contribute. For such self-forming networks, IBM might have lagged or missed out on two very big business ideas. One is a virtual worlds community that got IBM involved in this new technology area, which burst on the scene in 2003 with *Second Life* and has grown exponentially since. The other is “green computing”, which helps IBM meet environmental commitments for the company and clients. Both of these were among IBM’s top strategic priorities that were crystallized following an Innovation Jam in July 2006, modeled after the Values Jam a few years earlier. The Innovation Jam was IBM’s second global Web-based chat open to everyone in the IBM world. Over 140,000 people contributed ideas, confirming what self-organizing communities were already doing.

The virtualization initiative came together outside of any formal structure at IBM, participants reported. Nearly 200 engineers and professionals who were early adopters of *Second Life* found each other through company chat spaces and created an ad hoc community. They used their free time and acted bottom-up like free-lancers, communicating informally through avatars on new virtual platforms and through weekly phone calls, with the line also open on the virtual world. After about a year, they found an IBM executive to support them as a more official activity. This activity was then designated an emerging business opportunity with official funding for three years.

A different kind of self-organizing group, focused on the environment, drew on worldwide virtual discussions about environmental sustainability but had a more local face-to-face dimension as IBM employees in the U.K. began to take initiative, first by “talking around the water cooler”, an executive said, about how to make the IBM more environmentally friendly. Personal values coincided with corporate responsibility and a perception of a big business opportunity. It ballooned through word-of-mouth (or word-of-screen), and soon there were regular meetings of several dozen people drawn from different business areas, many of whom had not previously met one another despite sharing the building and a steering committee with representation from every business unit, setting guidelines and identifying tasks. Even-



tually, a project manager was assigned. Successful ideas spread worldwide. What started spontaneously, organized by volunteers became business, central to IBM's signature "smart planet" campaign.

### 3.2. Toward joint logics

Social or institutional logic should take its place alongside economic or financial logic in research, analysis, education, regulation, and managerial decision-making. Six propositions have been put forth to advance this direction for theories of the firm and for changes in firm leadership and behavior:

- Proposition 1: Conceiving of the firm as a social institution is a buffer against uncertainty and change.
- Proposition 2: An emphasis on the firm as a social institution generates a longer-term perspective. Short-term financial sacrifice becomes permissible in the interest of positioning the firm for sustainable success.
- Proposition 3: Articulation and transmission of institutional values can evoke positive emotions, stimulate intrinsic motivation and propel self- or peer-regulation as a type of control system.
- Proposition 4: The need for cross-border and cross-sector engagement to tap new opportunities requires concern for public issues beyond the boundaries of the firm and the formation of public-private partnerships in which the public interest is weighed along with the business interest.
- Proposition 5: When institutions internalize society, actions to produce societal value are undertaken whether or not they are tied to core functions of producing and selling goods and services and actors consider externalities as part of their internal decision-making.
- Proposition 6: People can be treated as self-determining professionals, coordinating and integrating activities and producing innovation through self-organizing in addition to formal assignments.

As a starting point for theory that catches up with practice, this paper is both descriptive and normative. Examples have been drawn from the field and the concepts derived from them have a normative flavor, reflecting a sense of possibility for running organizations in ways that increase engagement, both internally in terms of the behavior of organization members and externally in terms of contributing to societal progress.

In some ways, this paper has come full circle. A logic that justifies treating employees as self-determining volunteers—in essence, as professionals—makes it more important to have a motivating purpose and values to provide coherence and common identity. The first proposition enables the last one. Throughout, the connections between the propositions make it difficult to turn the examples into discrete practices that illustrate only one proposition. In the world of practice and perhaps most especially for great global companies, institution-building is not the result of tallying a set of specific items but rather a coherent, holistic pursuit in which elements reinforce one another, are inextricably intertwined and reflect a logic and a style of leadership that permeates the firm as a whole.

Skeptics abound, and firms that present themselves as institutions concerned with serving society often get more scrutiny than others and must withstand criticism about the gap between their stated aspirations and their performance, financially or socially. As stated at the beginning, if they make money while doing good, they are criticized for manipulation; if they do some good but not enough to solve complex problems, they are criticized for lack of courage or commitment.<sup>28</sup> Despite the formation of a small bandwagon of advocates of a new kind of capitalism that finds win-win opportunities for creating value for both the business and society, there is still controversy about the obligations of business. This paper does not try to tackle the question of the proper role of business in society. It simply presents propositions about the ways in which great global firms already use and institutional or social logic to supplement economic or financial logic in guiding and

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<sup>28</sup> See Chapter 9, “Unfinished Business: Confronting the Dark Side of Globalization,” in Kanter, *SuperCorp*, *ibid.*

growing their enterprises. The form that logic takes, and how it is presented and justified to various stakeholders, can vary across firms, industries, and countries.

Economists can certainly try to reduce these propositions to the language of economizing. They would miss nuances and subtleties. They would miss the role played by emotions and the search for meaning as human motivations. They would miss the normative elements that inspire action to improve the nature of the firm—to humanize it. Finally they would miss the mechanisms through which change takes place in all social institutions such as peer group effects. When firms see that the theory they act under is humanistic and gains social approval, they reinforce one another in pursuit of these ends and new models for action are produced.

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## 4. Manifesto for a better management. A rational and humanistic view

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### 4.1. Introduction

We are writing this paper at the end of the first decade of the 21st century, against the background of a disastrous crisis in the world economy, undoubtedly the worst in eighty years, in which the developed countries have been hardest hit. The crisis is creating difficult, or very difficult, situations for many people, some of whom have lost their homes because they could not meet payments on mortgages they should never have been granted, while others have lost their jobs because the companies they worked for are in serious difficulties, perhaps after a burst of completely unjustified optimism and yet, others have seen their income drop significantly in relation to their accustomed standard of living.

The causes of the crisis are many and complex. The reigning economism—a supposedly non-ideological ideology—looks for mechanical causes (such as excessively low interest rates, or the “herd” behavior that created the real estate and financial bubbles, precipitating the present troubles when they burst). Factors such as these may have contributed but human intervention and the mistakes made by the people in charge of many of the affected institutions were crucial. Whole countries, such as Ireland and Greece, are technically bankrupt for completely different reasons

and yet their problems have a common origin in the mismanagement of public and private institutions.

The proponents of the currently predominant practices argue that, despite the crisis, we are enjoying previously unheard-of levels of well-being, even in the underdeveloped world which is slowly starting to develop, and that this is a consequence of those “ways of doing things”. Critics, meanwhile, point out that national and individual bankruptcy has gone hand in hand with excessive enrichment of the few: while a large part of the population have lost their jobs, their savings and their retirement pensions, the executives who bear most of the responsibility for these losses have walked off with multi-million dollar pay awards.

Perhaps paradoxically, management can be responsible both for great successes and for great failures. According to Peter Drucker, without good management there is neither material nor human progress—to which we might add that with bad management there are great failures and great swindles. The fact is that the same word, “management”, covers a multitude of very different concepts.

Some of the fundamental concepts associated with management have been very positive. Examples include the pursuit of immediate effectiveness and the basic techniques for achieving it, the management mentality and systems of objectives and policies. Concepts such as these have contributed significantly to the material and non-material progress of the human species. All excess is bad, however, and adhering to the virtuous Aristotelian mean, proves difficult because by nature the mean tends to be unstable and it cannot be made more stable by formal rules, regulations or laws. Often, there has to be a basic agreement, broadly accepted by society, about what is to be considered fair and honorable. The emphasis on immediate effectiveness in terms of tangible (mainly financial) results—which when it comes down to it, despite assurances to the contrary, always end up being exclusively short-term—as the sole purpose reveals a pessimistic conception of the human being as a creature reacting only to economic stimuli. Such a conception disregards certain elementary truths. As we shall be arguing, those truths can be considered an integral part of good management, and neglect of them led us almost directly

into this crisis. In particular, we have seen a gradual abandoning of prudence in decision-making and implementation.

The concept of management, based on agency theory and elaborated in Chapter 1, which has thus come to predominate in recent times, mainly in the financial field and in executive pay, is perhaps the main cause of the disasters. While modern financial theory has helped build a rigorous, albeit partial, framework that is useful for thinking about corporate objectives and activities, the associated paradigm has oriented the conception of the company towards an exclusively financial point of view, reducing the purpose of the company to that of “making money”. The resulting concept of management has drifted away from the traditional notions and this drift has often been presented as progress. Events have stubbornly reminded us that this putative progress was nothing of the kind, or at least was much less than it could have been.

Finding out what practices led us to this crisis and how it can be prevented from repeating itself should be a priority for management researchers. Our purpose in this paper is to establish the starting points for good management, explain why it is important for society, critically analyze the present economic crisis and the practices and concepts that led to it and propose the foundations of a conception of management that augurs a better future.

In short, we want to speak out against the culture of shortsightedness both as regards the time scale for obtaining results and the kind of results to be obtained. We thus add our voice to that of Philip Selznick (1957), whose arguments have been—and were, perhaps, even in his time—so widely misunderstood. In this paper, therefore, we wish to set forth:

- a) Which concepts of the company and of management are conducive to management practices that are good for society as a whole.
- b) Why management is important for the development of human societies in general.
- c) What is good and what is bad about the theories and practices currently dominating the world of management.
- d) How to ensure that theory and practice evolve in the right direction and that bad practices or bad applications of good



theory (which up to a point are inevitable) do not seriously influence the broader trends.

## 4.2. Management: Basic concepts

In Anglo-American literature, the concept of *management* has always been clear. Wikipedia defines it as “getting work done through others” without any economic connotation. Thus described, it is simply good team work carried out in the context of an organization of whatever type.

### 4.2.1. Firms

In what follows we take a firm (the most common type of organization) to be “a group of people who coordinate their efforts to achieve certain objectives<sup>1</sup> in which, in principle, they all have an interest, though quite possibly for different personal reasons”. Moreover,

- The objectives generally have to do with the production of goods and services for other people (customers), with the aim of helping to meet their needs (solve a problem for them) in exchange for fair compensation (price), which they are willing to pay. Thus, every company wants to “be useful to” (serve) someone and, at the same time, to generate income (earn). Carlos Llano (2010) would say that if we are talking about companies in the proper sense, we should exclude the extreme cases of institutions that “earn without serving”, “serve without earning” or “neither serve nor earn” and concentrate on those that “earn while serving” or “serve while earning”.
- From this perspective, companies help to create economic value for society.
- The quality of their contribution to the distribution of the said economic value in society, which may influence the ac-

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<sup>1</sup> To exclude pathological cases, we shall assume that said objectives are lawful and morally acceptable, and that one of them consists of producing enough profit to ensure the company’s long-term survival.

tual value created, is a separate issue. This paper has partly to do with this issue.<sup>2</sup>

- The activities that are necessary in order to achieve the objectives invariably involve interactions between people and communities in the company's immediate environment, in particular employees, customers, suppliers, financiers, the communities (town, region, nation) in which the company operates, other companies and individuals and so on.
- Companies also create value that is not strictly economic or, at least, not directly convertible into economic quantities. Examples would include technological or organizational know-how. The depositaries of this value, in the first instance, are the persons involved, mainly through learning, both internally within the company and in their dealings with the environment.

#### **4.2.2. The concept of *management***

In this context, *management* refers to the activities that have to be performed in order to:

- Define an organization's objectives.
- Select the actions most likely to achieve those objectives.
- Organize to implement those actions, assigning tasks, duties and responsibilities to specific people and using appropriate management systems to obtain the greatest possible benefit from the available resources, whether actual (mainly material and knowledge resources) or potential (by developing new knowledge through learning).
- Coordinate the implementation of these tasks and responsibilities.
- Ensure that the tasks and responsibilities contribute to the desired objectives and correct any deviations that can be corrected.

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<sup>2</sup> By this, we mean to suggest that, generally speaking, the value created is not independent of the process by which it is created, partly because the people involved are essential agents in that process. In particular, the result of the process may be better if those people find meaning in their participation than if they do not.

- Provide an atmosphere in which people can work together satisfactorily.
- Take steps to ensure that the process facilitates learning—in the broad sense—to people involved, including moral improvement, which requires the development of virtues.
- Create therefore a working environment which is effective and positive for each individual, ultimately enhancing the effectiveness and efficiency of the whole.
- Compensate the people involved fairly<sup>3</sup>, not only through strictly economic remuneration.

In this context, managers are responsible for undertaking all this in companies<sup>4</sup>. They do it through management acts, which include both decision-making and implementation. By their nature, management acts:

- a) materially determine management effectiveness,
- b) fundamentally involve interaction with other people (whose work and activities they coordinate),
- c) are subjective and, precisely for these reasons,
- d) call for the exercise of leadership by the person who manages.

It is not our purpose in this paper to explain the nature and need for leadership in this sense. Suffice it to say that true leadership is founded on the trust a good leader is able to inspire in his “followers”, a trust which goes deeper than simple charisma or even power of persuasion or “eloquence” and has a lot to do with the sharing of values, so that the followers trust that the leader’s acts will tend to be good for them. This implies, of course, that a

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<sup>3</sup> “Fair” understood, once again, in the broad sense. That is, not only in the sense of matching the “market” wage, which in fact is defined considering only the strictly economic aspects of what has come to be known as the “labor market”. Compensation for a personal effort thus comes to be considered in the same aseptic way as, say, a contribution of financial resources. From the previous discussion it follows that when there are people directly involved, the implications go much further. See also footnote 6.

<sup>4</sup> How a person earns the right and accepts responsibility for becoming a manager is a question we do not propose to discuss here but which may not be irrelevant to that person’s subsequent effectiveness.

manager's power to lead is easily dissipated if he ceases to inspire trust.

A fundamental consequence is that management acts cannot be judged solely on their results. The underlying process and intentions are more important in management than in other professions because they *directly influence* what other people—and, by extension, society in general—learn (whether by accident or design) from management acts. This element of learning is crucial for the development of vicious or virtuous circles, as we shall discuss later.

Summing up, what sometimes is denoted by the “management function”<sup>5</sup> can be understood as that which, through a company's day-to-day activities, seeks to:

- a) establish the company's future in terms of its business,
- b) develop a framework for “working together” which enables people to relate to one another and do what has to be done in order to make that future a reality, and
- c) establish an “institutional set-up” in terms of governing bodies with the stakeholder participation considered appropriate, in form and content, at any given time.

Consequently, as we shall argue in more detail below, management is of capital importance in the functioning and development of society.

### 4.3. The importance of management

There is no doubt that management is one of the most important phenomena in today's world. Historically, it was related to companies. Since the beginning of the 20th century, however, when management theory started to develop, many of the classic authors have realized that management is equally applicable to any kind of organization, including non-profits and political organizations.

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<sup>5</sup> Ideas put forward by Valero and subsequently organized by him and Lucas (2007) in a way that is very consistent with the (more theoretical) approach of Pérez López (1993).

Just as organizations affect all of us, so does management. Like it or not, all people belong to various organizations, which sooner or later play an important role in their lives. A person is affected by the way these organizations are run, i. e., by their management, in the sense described in the previous point. Let us look at some fundamental reasons why this is so.

#### **4.3.1. Creating economic value**

Companies in particular, but also many other organizations, create economic value for citizens in general. That is to say, they produce useful goods and services to satisfy people's needs, for which people are willing to pay more than it costs to produce them (basically because people could not produce the same goods and services for themselves from the same inputs).

If organizations are crucial for producing economic value, so too is management, which brings together and coordinates productive resources to obtain the end product. Management thus consciously coordinates human activities, which is a function that economic theory attributes to organizations, complementing the unconscious work of coordination done by the markets. Managers are responsible for coupling resources and ensuring that each fulfills its function at all times. According to the more conventional conception of microeconomic theory, management is responsible for ensuring that economic variables function as they should.

However, the "production function" which conventional microeconomic theory takes as given (in terms of available technology) is not in fact "given". Production may be more or less efficient, depending on the company (i. e., different companies may need different amounts of inputs to produce the same outputs). The "efficient frontier", where the currently available technology is used to maximum effect, is not reached automatically. Whether it is reached or not depends to a large extent on the quality of a company's management. The number of people required, the amount of raw materials used and the quality of the end product depend on how particular people carry out the necessary tasks. They therefore naturally depend on management. Whether a company is able to cross the efficient frontier, through innovation, also depends on management.

It should be noted, however, as an introduction to what follows, that not everything that is socially useful and desirable has economic value and that not all economic value is socially desirable. There are socially desirable things, such as education, culture or art, which as individuals we do not value sufficiently before we consume them because we do not appreciate *a priori* the real value they can have for us. There are other things whose value for society goes beyond their value for the individual concerned. For any person, for example, there is clearly value in having a neighbor who is highly educated.

Similarly, there are sources of economic value which may not translate into greater well-being for the people who help to create that value. Consumerism, impulse purchases later regretted, misleading advertising which creates a sense of deception in the purchaser—these are all examples of a supposed economic value which turns out to be illusory.

#### **4.3.2. Fostering the well-being and development of people**

Generally speaking, people spend a large part of their active lives at work. Therefore, if we want to help people achieve not only greater economic value but also greater well-being in every aspect of their lives, we need to recognize that their well-being at work depends to an important extent on the quality of the management that coordinates their activities and ultimately is responsible for their development, both professional and personal.<sup>6</sup>

In accepting this, we effectively deny that purely economic remuneration is sufficient to compensate those who perform the activities that must be performed in order for a company to function as it should. To argue that “everything has a price” and that “a present inconvenience or discomfort can always be compensated by a convenience or comfort at some time in the future” is to assume that the problem of well-being at work can be solved by regulating the level of economic compensation so that it is fair

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<sup>6</sup> As we stress later, both developments have to do with the learning that people acquire in companies. Operational learning is at the origin of professional development. On the other hand, the influence of people’s activities on their personal habits (the raw material of the virtues) leads naturally to genuinely ethical considerations which the responsibility of the manager cannot ignore.

and allows employees to buy the well-being they want outside the company. Management thus offloads the problem and neglects its responsibility, because we all know that there are things that money cannot buy, yet, irresponsibly, many managers think this way and so do many employees.

There are various aspects to well-being at work. First, a job can be considered “decent” or fit for a person, in either quantitative or qualitative terms. Quantitatively speaking, the job must be humanly doable, in a reasonable number of hours, with proportionate effort and in return for a decent pay that is sufficient to live on, in line with the standards of the person’s social environment. Qualitatively speaking, nobody is proud of a botched job, which is why it is so important that people feel proud of what they do and how they do it. Making this possible to an acceptable degree is the responsibility of management.<sup>7</sup>

With regard to remuneration or compensation, two points need to be made clear. First, there are certain minima, common to all human beings everywhere, below which a wage is unacceptable. Second, we should not apply the standards of a developed country to a developing country and *vice versa*. Prices and wages tend to be higher in developed countries, giving room for maneuver which may not exist in a developing country. The technological advances available in developed countries make work easier and enable higher productivity, making it possible to pay higher wages.<sup>8</sup> However, this should not be taken as an excuse for consenting to unfair working conditions in developing countries. A competent business owner or manager must be capable of finding better solutions than either superhuman effort or subhuman pay. If not, he should take up another profession and let someone else take his place, because he is not doing his job as a manager.<sup>9</sup>

<sup>7</sup> In a sense, it is a matter of structuring the activities that have to be performed for a company to function satisfactorily in such a way that the employees are more than just “labor”; see Llano (2010).

<sup>8</sup> In a developing country, a demand for wages equal to those of a developed country may give rise to an insoluble problem and make the company unviable. In a developed country, by contrast, paying developing country wages will be both immoral and inefficient.

<sup>9</sup> In other words, there are certain minima below which a wage violates the dignity to which every human being is entitled. These minima are part of the “rules of the

On the other hand, the dignity of labor does not mean avoiding effort or accepting low standards. It is obvious that continuously working very long hours will not enhance a person's well-being, but people are not, as a rule, averse to effort or hard work (as economic theory often assumes they are, e. g., in agency theory). In high-level (especially management) jobs workaholics are by no means an exception. Similarly, while nobody likes to be supervised too closely (nor does such close supervision make sense from a management point of view), likewise nobody likes it if even the most perfunctory performance is considered good enough or if serious effort to do the best job possible receives no more recognition than simply ticking boxes.

Implicit in what we have just said is the idea that a decent job must be of at least some minimal interest to the person who does it. This minimum is relative to the person's skills and abilities. In particular, the job must give the person scope to progress and improve as a worker and as a person.

Lastly, the treatment an employee receives must be in keeping with his dignity as a person. Specifically, an employee must not be treated as "labor", i. e., as a mere tool of another person who thinks for both, but as a person who has his own initiatives and his own way of seeing things and making decisions, which as a rule will be as valid as that of his boss (sometimes more so, as he is closer to the problem).

The above conditions, though not part of a person's economic wealth, are nonetheless important components of his well-being and depend crucially on management. We shall argue later that to posit an inevitable contradiction between economic value creation and personal well-being—i. e., to claim that the same variable (work, effort, or whatever) which adds to profit, necessarily subtracts from the utility of people considered as workers and consumers—is to accept a primitive and simplistic view of how people and organizations actually work. What is more, an important function of management is to ensure that things are not like that. Not even to attempt that—or to accept uncritically the con-

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game", which are non-negotiable by their nature.



trary view—can become a self-fulfilling prophecy which damages everybody and benefits nobody.

#### 4.3.3. Creating models for society

Companies, and organizations in general, do not exist in a vacuum. On the contrary, every company is embedded in a society that influences it and is influenced by it. What happens in either of the two is partly the cause and partly the consequence of what happens in the other. Because a large part of people's lives takes place in the organization in which they work, people end up regarding what happens in that organization as "normal" (or even desirable), regardless of whether it actually is or not. Eventually, this leads to a culture in which people accept the status quo.<sup>10</sup> Insofar as that culture is positive and rooted in society, this is a desirable contribution. Otherwise, clearly it is not.

But it is bound to be one thing or the other. In the long run, all this leads to a situation where society implicitly or explicitly adopts certain values which eventually are taken for granted. An example would be the way wealth and material goods are accepted as measures of a person's success in life, often without considering how they were obtained. Another would be the way the overwhelming power, that some shareholders<sup>11</sup> have over companies and corporate decisions, is accepted as "normal" to the point where it is even enshrined in companies' articles of association. In reality, this is a rather arbitrary choice, taking the contribution of capital to have

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<sup>10</sup> Examples of the practices we are referring to include the various forms of remuneration (e. g., strong incentives based on indices of measurable variables, a fixed salary or various mixed formulas), the types of contracts people are offered (fixed, stable, temporary, junk contracts), the way people are treated and the response to their initiatives, people development policies of any kind and many others, as we shall see in the following sections.

<sup>11</sup> It is important to distinguish here between *entrepreneur* shareholders and *investor* shareholders. It is typical of investor shareholders to demand economic value in purely financial terms without having a deep knowledge either of the business (a knowledge often limited to what might be termed *industry* parameters without distinguishing between individual companies) or of the particularities and complexities of its management. *Entrepreneur* shareholders tend to behave in the opposite way, committing even their personal wealth, so that for them the option of "getting out of the business fast" is much less feasible. For that reason, in this paper, *entrepreneurs* are not considered to be included in the term *shareholders*.

priority over the contribution of labor, which is deemed to be “sufficiently remunerated by a market wage”.<sup>12</sup>

The classic argument here is that workers “can always find another job” whereas shareholders “cannot find other money”. If there ever was a time when this argument had some truth to it, it is not now. Today, capital can change hands very easily<sup>13</sup>, whereas a worker who has invested in specific training for the company by which he is currently employed will have difficulty finding another job in which that training is recognized at its full value. An employee who puts time and effort into training for a particular job thus becomes “hostage” to the job.

#### **4.3.4. Other impacts on society**

The actions of companies and organizations have an impact on society beyond the transfer of business practices. If in the 1920s and '30s, in the large urban centers where the social control that used to exist among the inhabitants of small towns had been lost, large companies were already affecting the way people lived (as described by Elton Mayo, see Exhibit 1), the changes brought about in the last three or four decades have been even more substantial.

Changes in the way people live due to different working hours, the effect of working hours on personal and family life and the consequences of temporary employment and job instability—all

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<sup>12</sup> Or perhaps not so arbitrary after all. This is a subject of great consequence in the sense that in order to treat people as people, management should strive to conceive the organization's business in such a way that the fundamental contribution, by its very nature, is the contribution made by people (e. g., as depositaries of the company's competitive advantages). In that case, the priority would automatically lie further from capital; see also footnote 7.

<sup>13</sup> To almost unimaginable extremes: today many financial transactions take place through electronic communications literally at the speed of light, which a human cannot possibly keep up with, simply because his “natural pace” is slower and does not change significantly. This is creating problems in the cadence of these transactions, which increasingly are generated and executed by software that not only administers the transactions but also tries to “apply criteria” so as to (mechanically) “understand” the objectives of other pieces of software with which it “transacts” in the “market”. It is hardly surprising that proposals have been made to “artificially slow this pace”, so that it is intelligible to the people involved (who ultimately are the only ones genuinely responsible) and so that they can react before a (long) series of mishaps occurs that must then be “reversed” which can be a mammoth task (Coy 2010).

these have important social consequences. Whether things in a particular company are done one way or another depends largely on management. Managers' sensitivity to these problems, and their willingness and ability to find solutions, can have a decisive impact on the way a society develops.

Likewise, there are times when, due to exceptional circumstances, the lives of a company's employees are seriously affected, which will obviously be reflected in the company's results. If a company's employees are badly affected by a natural disaster (an earthquake, flood or volcanic eruption) and management is sensitive to the problem and does everything in its power to end or at least alleviate the suffering, there will be an increase in well-being well beyond anything that can be measured economically. Once again, therefore, the result, both inside the company and in its immediate social environment, will depend on management.

Drucker, perhaps the best known of all management authors and possibly the one who has shown most commonsense and practical wisdom, came to the same conclusion from his pragmatic humanistic perspective, though he expressed it in very different terms. He thought that management was possibly the most important social institution of the 20th century. In 1954, in one of his key works, he wrote:

The manager is the dynamic, life-giving element in every business. Without his leadership the "resources of production" remain resources and never become production. In a competitive economy, above all, the quality and performance of the managers determine the success of a business; indeed they determine its survival. For the quality and performance of its managers is the only effective advantage an enterprise in a competitive economy can have. (...) The emergence of management as an essential, a distinct and a leading institution is a pivotal event in social history. Rarely, if ever, has a new basic institution, a new leading group, emerged as fast as has management since the turn of this century. Rarely in human history has a new institution proven indispensable so quickly; and even less often has a new institution arrived with so little opposition, so little disturbance and so little controversy. Management will remain a basic and dominant institution perhaps as long as Western civilization itself survives. (...) Only superior management competence and continuously improved

management performance can keep us progressing, can prevent our becoming smug, self-satisfied and lazy.

With a few qualifications, these words are as relevant today as when they were written:

Outside the United States management has an even more decisive function and an even tougher job. Whether Europe regains her economic prosperity depends, above all, on the performance of her managements. Whether the formerly colonial and raw material producing countries will succeed in developing their economies as free nations or will go Communist, depends to a large extent on their ability to produce competent and responsible managers in a hurry. Truly, the entire free world has an immense stake in the competence, skill and responsibility of management.

For all these reasons, it seems reasonable that society should demand the highest professional standards from managers and be willing to recognize and reward them appropriately (we shall try to be more precise in this regard in the next section).

#### **4.4. The ills of today's management**

We already mentioned in the introduction some of the causes of the present crisis, which had to do with the actions of the people in charge of many of the institutions affected by the crisis—with their bad management, we could now add. Because just as good management brings benefits to society, bad management is generally pernicious and can give rise to intricately counterproductive situations from which it is difficult to recover and from which also it is difficult to learn, as a society, to avoid similar episodes in the future. In a word, we are talking about incompetent managers (Sahlman 2009).

In the economic events of the first decade of the 21st century, many practices and institutions have been dysfunctional. Without aiming to list them all, we can cite at least the following:

- Credit rating agencies, which recommended investments that should not have been recommended, underestimating

- certain risks or putting their own interests ahead of the supposed “neutrality” of their assessments.
- Investment banks, which invested where they should not have invested, inducing their customers to do the same.
  - Banks, which extended loans to people unfit to borrow, aggressively inducing the financially incapable to borrow, contrary to the industry’s conventional and traditional standards of prudence, claiming that this was the “modern” thing to do; in some cases taking advantage of the ignorance of people whom they had genuinely deceived.
  - The academic world, mainly the economics departments, which justified ridiculous management practices with the excuse of preserving the free market.
  - Also business schools, which should have known better but which in recent years have become mere mouthpieces of the economics departments and have applauded any practice however absurd, which could show some short-term financial success, often forgetting the governance needed to put business strategy into effect by coordinating the activities of multiple actors.
  - The change in company ownership, from individual business owners (or groups of owners) who are committed to the company’s mission and customers, to institutional investors who are mere speculators and have no interest in either.
  - Builders and property developers, who launched far more projects and developments than would have been reasonable given the population and the population growth rate and, therefore, the real need for homes and other buildings, confident that they would find willing customers, thus starting a spiral that led to the bubble and so contributed to the current situation.
  - Managers in general, who uncritically designed and used management systems—in particular, perverse incentive schemes—that enabled, motivated and reinforced all these behaviors; in particular, patterns of bad practices leading to vicious circles, sustained by a perverse spiral in which managers and regulators joined forces to benefit one another, to the detriment of (various) others.

- And the arrogance, or hubris, of some managers, who thought themselves better than everybody else, encouraged by the approval of society at large and business schools in particular, mainly because of “good” short-term financial results.
- As a result, the discontent of a large proportion of the population with their jobs and lack of trust in their bosses. Many people are unhappy with their jobs for reasons that are plain common sense and yet are in no position even to disapprove of what they see, less do anything about it.

It cannot be said that there were no warnings or alarm calls beforehand. When the dot.com bubble burst, Ghoshal spoke loud and clear, both in the general press (*Financial Times*) and in academic journals (special issue of *Academy of Management Learning and Education*, 2005, published posthumously). In the same special issue, dedicated to him, others were just as outspoken. Mintzberg, Pfeffer, Hambrick, Ross and Gapper were equally critical of the state we were in. These authors had voiced criticisms earlier, which is probably why they were asked to contribute to that special issue.

In fact, by definition, in management history there have always been academics and professionals who were critical on the way of doing and thinking which dominated the contemporary world. From Mary Parker Follet to Drucker and the authors just mentioned and others, people have questioned the most commonly used and widely cited “paradigms”.<sup>14</sup>

#### 4.5. The conceptual bases of the problems

But there have also always been others who have defended them in academia and in the business world. In recent decades there has been a strong bias in this direction. At the root of these attitudes are five negative tendencies, which unfortunately have become well established in recent times.

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<sup>14</sup> We put the word “paradigm” in inverted commas because we do not feel that what we have in management is anywhere close to a paradigm in the Kuhnian sense. A paradigm needs a minimum of structure and rigor, which is something only the economic paradigm (without quotation marks) has. We discuss this below.

1. Economism, which consists of taking economic and financial variables as the primary, or even exclusive, consideration.

The economic attitude, or ideology, is grounded in the idea that the price system is such that, if companies maximize their profits they automatically make the greatest possible contribution to social welfare. But as Adam Smith already realized more than two centuries ago, this is only true if business owners are “enlightened” profit maximizers (Jensen 2001) and have a view to the long term. But that is not always the case, as the present crisis shows. When we talk about profit, it is impossible to prevent its being taken to mean short-term profit.

The modern version of profit maximization, designed to emphasize the long term more explicitly, is usually expressed in terms of maximizing shareholder value. To start with, this is technically incorrect: one should attempt to maximize total firm value instead, but, besides, it is a fallacy, in practice, the market value of a company’s shares is determined largely by short-term results (often as short-term as quarterly earnings), as assessed by financial analysts and investment banks.

There is more to it, however. In the words of Alejandro Llano, “the disturbing thing about economism is that (...) the model (...) prevents workers from knowing (...) the meaning of their work (...) [and] (...) deprives them of their very humanity”:<sup>15</sup>

Thus, the real world consequences obtained from models that are based on oversimplified or even false assumptions and consider the only valuable dimension to be the one that can be measured in financial terms, end up becoming normative, while all reference to those initial assumptions is lost. Unfortunately, the simplicity of this normative recommendation has encouraged widespread adoption. As a result, it has become a self-fulfilling

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<sup>15</sup> The complete quote: “The strange and disturbing thing about economism is that it reduces us to seeking possession of the only goods that we cannot possess: material goods. I can use, hold, own, sell, or buy a rug, a vacuum cleaner, a car, a high-interest account, etc. But I do not possess any of this. None of it is mine. I have it, but it is not me. The only thing I can really possess, or make mine, is what economism ignores: the stuff of my living world, that is, what I know and what I love. If an organizational model prevents workers from knowing and wanting the purpose, or meaning, of their work, then it is not depriving them of a thing: it is stripping them of their very humanity” (Llano 2010).

prophecy, confirming the apparent effectiveness of the model and making it seem increasingly appropriate, because managers implicitly tailor their actions to it. Hence, the model's normative recommendation therefore tends to end up being seen as a "natural truth".

Beyond the value of the firm, the economic approach and the models it uses have other serious limitations:

- a) They do not go into the details of what companies are—i. e., the context in which management takes place—or how they work. They do not open the "black box". They reduce companies to "production functions" which express the technologically possible combinations of inputs and outputs. All management considerations are therefore dispensed with. It is surprising that many business schools should base their approaches on this conception.
- b) In particular, they do not use concepts such as "competitive advantage" and "distinctive competency" (Selznick 1957; Pérez López 1993) to explain how companies obtain "above normal" profit, even though developing, using and maintaining such advantage and competency (i. e., deploying the necessary learning) is very typically a management activity.
- c) They therefore implicitly accept that the "normal" profit of companies is the minimum required return on capital,<sup>16</sup> as, under open competition, given the homogeneity of their production functions (i. e., essentially, their costs and their products), all companies will sell at the same price. For management, the aim is precisely to move as far away as possible from the balance to which the economic approach gives rise in order to obtain a higher return.
- d) They accept, without solid justification, an unequal distribution of the economic value created, to the advantage of business owners. This is another of the reasons that have led to the mistaken but, sadly, commonly accepted conclusion

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<sup>16</sup> What books on microeconomics call "zero" profit.



that “creating value for the owners” must be companies’ main purpose and achieving it, therefore, the fundamental task of those who manage them.

2. Self-interest as the only driver of management, indeed, of all human action, as opposed to the “higher ends” that Khurana refers to (2007). Moreover, that interest is attributed in equal measure to all the parties involved, without any nuance or dynamic (such as would arise if, say, the possibility of learning were included).

Ghoshal (2005) attributes the emphasis on self-interest to a pessimistic view of the human being, put forward by Milton Friedman (1962) in his famous book *Capitalism and Freedom*.<sup>17</sup> The rise and growth in importance of incentive systems over the last forty years are closely related to the hypothesis of self-interest as the only driving force in the economic world. If this hypothesis is true, only an incentive system can align the company’s objectives with the interests of its members (including managers) and the interests of the members among themselves. Persuasion, a sense of mission, the meaning of work, friendship, companionship, etc.—none of this is important. All that matters is self-interest and, above all, economic self-interest.

3. Consistent with the previous two points, an instrumental conception of the human person emerges in which people are mere instruments of companies as producers of shareholder value.

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<sup>17</sup> According to Ghoshal, “In Friedman’s words, ‘a major aim of the liberal is to leave the ethical problem for the individual to wrestle with’. In other words, it can and, indeed, must be excluded from social theory. The way to do so is to base all theories on the assumption of homogeneous human behavior based on self-interest. And ‘the liberal conceives of men as imperfect beings (...) and regards the problem of social organization to be as much a negative problem of preventing bad people from doing harm as of enabling good people to do good...’ And, given that much of social science until then had focused on the second part of the problem, the agenda of social scientists thereon, that is, for the last 40 years has focused on the first part, that is, on the negative problem. Hence the pessimism, the ideology-based gloomy vision. (...) While within individual fields, such as organization theory and strategic management, authors can and do publish research grounded in very different assumptions and traditions, Friedman’s version of liberalism has indeed been colonizing all the management-related disciplines over the last half century.”

If the firm is merely a production function designed to enrich shareholders; if labor is simply an input—one of many—that is purchased in a competitive market (and, therefore, in which there is no product differentiation except in terms of specialty, i. e., one administrative worker is the same as any other administrative worker; one sales representative, the same as any other sales representative, and so on); and if employees can only be motivated with incentives, then the concept of the person as an instrument follows logically.<sup>18</sup>

Consistent with the concept of the person-as-instrument, the possibility of learning is not considered. Management techniques are repetitive and largely mechanical, as it is assumed that the people using and experiencing them do not change. If there is any concept of learning, it is purely machine-like and even follows a certain mathematical formula: an improvement of skills which brings a reduction in operating costs.

As instruments, people can have neither intentions nor a sense of purpose. They must limit themselves to doing what they are told (once again, Taylor springs to mind) and the company's management simply does what all other managements do. New institutional theory, one of the dominant trends in organization theory, has contributed to this concept of the person-as-instrument. It has even gone one step further, leaving institutions without a purpose of their own other than to legitimize themselves by doing the same as others (*mimesis*).

4. If there is no learning, managers and the people who interact with them cannot improve or deteriorate as people (i. e., other than as instruments) as a result of their interactions. This fundamentally excludes ethical considerations from man-

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<sup>18</sup> Unfortunately, the conception of people as instruments goes back a long way, to before the colonization of management by economic theory. It was more or less the conception held by Taylor and his followers in the early 20th century. According to March and Simon (1958), Taylor and his followers considered people as “adjuncts to machines”, that is, as instruments, possibly even in a lower category than machines. Although nowadays, in developed societies, most of the jobs that Taylor studied are done by machines, the concept has changed very little. Administrative, commercial and even operational jobs are done by people who, it is assumed, take the objectives as given, who must be as efficient as possible, without any motive or creativity, and who are assessed using supposedly objective measures, on which incentive systems are based.

agement activities, as ethics is concerned with the mediation between a subject and its acts, in the sense that any act of a person gives rise to a structural modification of the person, precisely as a result of having acted. A person learns to serve customers better by persevering in serving them, just as a person who steals regularly, even if obliged to do so, will learn to be a competent thief.

5. A management research methodology that we can describe as *naïve* empiricism, which accepts only empirical evidence as proof of any “scientific” statement<sup>19</sup>. This empiricist view is related to the more radical versions of logical positivism or empiricism, though it does not have their logical rigor. Today, logical positivism is not accepted even in natural science, as its demands are considered excessive. All the more reason to reject it in the social sciences, especially for analyzing and understanding management phenomena:

- a) Often, subjects are analyzed using approaches and methods properly intended for other types of phenomena. For instance, researchers look for patterns such as are found in the physical world (“physics envy”, as it has sometimes been called), using statistical analysis, on the implicit assumption that people always react in the same way. This is highly unrealistic when researching the behavior of human beings, who learn and, as a result, change their behavior—unlike basic particles or stars.
- b) There is what Hayek, in his Nobel Memorial Lecture (1974), called “the pretence of knowledge”, meaning a disregard for the limits of human capabilities. On the one hand, social events are “phenomena of organized complexity” and any application of scientific methods to these phenomena “is often the most unscientific, and, beyond this, in these fields there are definite limits to what we can expect science to achieve” (Hayek 1974; see also Feldman 2006). From a practical point of view, this has serious implications as re-

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<sup>19</sup> This is the equivalent, at the extreme, of accepting a premise of the kind “all cats are black” simply because of having seen a lot of black cats.

gards determining whether a person can ever know for sure what needs to be done at any given time in a particular company.

- c) One consequence of all this is a tendency to accept overly simple explanations and models, which in the end merely confuse matters because they oversimplify and omit fundamental aspects of management phenomena. As Mencken said, “there is always an easy solution to every human problem—neat, plausible, wrong”.

#### **4.6. Some practical implications of these problems**

Many of these counterproductive conceptions are regularly taken for granted in everyday management practice, both in general management and in the functional areas into which managerial decisions and acts have traditionally been organized. Without aiming to be exhaustive, Exhibit 2 provides some examples under two broad headings: 1) Lack of an administrative point of view, and 2) Problems related to the functional areas.

#### **4.7. Foundations for a renewed conception of management**

The above analysis has important implications for management theory and practice. Ideally, one would first develop a solid theory and then put it into practice. Judging by what has happened in the other sciences, however (e. g., in the most developed one, namely physics), it takes a long time to develop a good theory and integrated models that allow us to put every real phenomenon in its place and so deduce what has to be done in order to achieve the desired outcome.

Fortunately, the above critique already contains some ideas that can be applied to management practice immediately. At the risk of repeating ourselves, we shall list them here, not exhaustively (which would be impossible without first developing a theory) yet systematically. After that, we shall sketch the foundations on which, we believe, a good theory that will allow us to solidly ground management practice should be built.

#### 4.7.1. Which way ahead for management practice?

1. It must be based on the idea that companies are made up of people who work, organize themselves, manage, produce goods and services, sell, etc., with certain objectives—both individual and collective—in mind. These people and their interests are heterogeneous. Therefore, their non-homogeneous role in ensuring that companies perform their functions must be an important factor in the design and functioning of companies.

2. Consequently, most of a company's activities (including management activities) must involve people (either members of the company or people belonging to its immediate environment). To be realistic, we must consider companies from this point of view. That is to say, it is not appropriate to consider the work that people do as something strictly mechanical that requires no specific training or information, no identification, enthusiasm or learning, no attitude development, and in so doing rob their work of any meaning (Llano 2010). By reducing work to a form of merchandise, the suppliers of which are paid a salary and an incentive, economism ignores meaning and fails to recognize that missions motivate, whereas monetary incentives do not (George 2003).

3. In other words, organizations, which are the context in which “management acts” take place, must be communities of people who interact on the personal level (Pfeffer 2005) and so evolve over time, fundamentally through learning. They cannot be considered as impersonal collections of contracts, protocols and rules of conduct which exist and perpetuate themselves independently of their human members. As Alejandro Llano (2010) says, “The basic fabric of a company is not the regulations or economic exchanges, but the vital *ethos*, the web of relationships that bind the people who make up the company”.

4. Management must therefore explicitly acknowledge that it is at the service of people, rather than people being at the service of management, or of particular managers. In establishing the objectives of organizations, the main concern must therefore be to satisfy the objectives of the people who will work in them or enjoy their products (which obviously includes their customers). In particular, care must be taken not to rely exclusively on

contemporary financial theory and the associated objective of maximizing shareholder value, which has had such harmful consequences, as we have mentioned. The objectives will therefore culminate in company missions and purposes that transcend the (necessary but not sufficient) goal of creating economic value in the short term.

5. In this respect, it is important to recognize that people have certain characteristics that are neither exclusively nor directly economic, including friendship, loyalty, identification, enthusiasm, motivation, and so on. Insofar as organizations are made up of people, the purposes of organizations can on no account be exclusively economic, regardless of the variables used to measure them (share price, added value, or any other economic or financial dimension). That economic objectives are important for companies, even non-profits, is not in question, however.

6. Therefore, we need more than just behavioral theories that confine themselves to explaining the existence of certain phenomena in sociological terms, without deducing from them any rule for action or for making a better future for the human species, thus negating the rationality, intentionality, learning and sense of purpose and initiative that are distinctive traits of persons.

7. Learning is particularly important because it leads to changes in persons themselves, their way of seeing things, even their desires. That is why employee careers in companies need to be carefully thought through, explicitly considering what all those involved, including those who initiate interactions—i. e., in most cases, managers themselves—will learn (and not only on an operational level). Consequently, at any level but especially at management level, high self-expectation, in terms of learning from the results of one's actions, is fundamental. It is at the origin of "business ethics", which from this perspective is consubstantial with the management profession and which essentially means that management, even when apparently centered on purely technical issues, is by nature never neutral in this sense.

8. Precisely because management has such important social implications, we need to establish in society an expectation of professional excellence in managers, in dimensions beyond those of immediate effectiveness: moral integrity, treatment of people,

people development, and so on. This requires a shared value system that is difficult to achieve. That managers' status in society should be founded almost exclusively on financial results and remuneration, regardless of how achieved, is highly dysfunctional.

9. Thus, just as economism has produced a self-fulfilling prophecy from a fallacy, a management based on the principles we have indicated should have the same effect, but in reverse. In other words, it should help to develop in organizational members motives other than economic ones, including those mentioned in the previous points, assuming they have them.

10. For all these reasons, it should be understood that the purpose of a company is not a direct and exclusive consequence of the forces of the environment or of a "nature of things" that inexorably determines predefined institutional behaviors. On the contrary, that purpose is the result of the actions of specific, boundedly rational people who have a sense of purpose and intention. The purpose only becomes inevitable if people neglect their share of responsibility in the company's activities (in which case, we might add, they will have deserved it). The phenomena we are concerned with are therefore elusive by nature and occur in contexts of organized complexity, in which people act. By organized complexity we mean a complexity that is not simply a result of the number of variables or of the mathematical complexity of the relationships between them, but a complexity deriving from the fact that the context involves the actions of people, with their implicit and explicit intentions. From a complementary point of view, as Hayek realized, the above implies that organizations need the active cooperation of those people; and they need the cooperation to be all the more active—ideally extending to enthusiasm—the greater the complexity of the tasks. All this implies a fundamental interdependence between a company's *business plan (strategy)* and its *implementation*, precisely because people play such a role in putting it into effect. This interdependence must be taken into account in order to exercise a professionally responsible management.

11. Another consequence is that it is inappropriate for companies to have arbitrary and discriminatory compensation systems which ignore the fact that, as we said, it is much easier for

a shareholder, by selling his shares, to sever relations with a company than it is for an employee who has made a personal investment in specific knowledge, learning, cultural fit, etc. (which are at least as necessary, for the company to function satisfactorily, as the capital contributed by shareholders) (Ghoshal 2005). It is often argued that managers deserve their astronomical pay awards because they have “all the merit” of results to which many other people, unfairly treated as passive instruments later on, have actively contributed. These systems need rethinking from the ground up, basically because they violate the primary concept of management, namely getting things done with and through other people.

12. Any attempt to measure performance or the result of actions, even imperfectly, is positive if the measure is used sensibly. But it is important to bear in mind that accurately measuring the excellence or quality of a management act in one dimension is impossible because management acts have so many different aspects, including their results, which by their nature are of different types and cannot generally be offset against one another.<sup>20</sup> In fact, the aspects that are most important at any given time tend to be the most difficult to measure, which means that any indicators we use will be imprecise at best. This means it is impossible to automate management acts, which by definition are largely discretionary (i. e., involving non-trivial amounts of honest, responsible subjectivity).

13. The previous point invalidates the kind of management which assumes that those who happen to be “at the top”<sup>21</sup> at any given time are omniscient, as if a great Moloch in the form of

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<sup>20</sup> Also, there are always certain aspects that must be respected “to the maximum”; in this sense, they are genuinely non-negotiable. An extreme example would be: will we murder a customer to win an order, however large the order?

<sup>21</sup> Incidentally, it is interesting to consider what justification there is, in each case, for their “being at the top”. In the context of what we have said so far, considerations such as “because of their performance in some other organization” or “because the shareholders trust them” are inappropriate because such considerations are based on almost exclusively economic assessments, both for judging results and for “granting decision and governance rights” in organizations. This is something that, in general, we have accepted uncritically, merely because it has been presented as a simplifying hypothesis in some widely used models, or is taken as an absolute truth based on results obtained using these models, often without even knowing the initial assumptions.



results (measured only approximately, who knows how) to which they have (privileged) access, were above all else, without the people who are affected by their management acts being able to learn from them. This kind of management, based on scorecard variables, is essentially contrary to the concept of management we are trying to define here.

14. What is needed is a management that has commitments (above all to the people affected) and a sense of mission beyond the immediate and necessary objective of generating financial results. Such a management is contrary, for example, to advertising that is blatantly false (e. g., products claiming curative properties they do not possess) or that has nothing to do with the company's product or service.<sup>22</sup> The aim is to understand potential customers' real needs and make every effort to satisfy them through the company's products and services at a cost that the customers are very willing to pay, without deception, subterfuges or unfair small print.

15. The preceding points do not mean that good management is based on tolerating any kind of behavior and accepting incompetence and shirking. On the contrary, it is based on adequate performance, which is absolutely indispensable but does not mean treating people like animals (or things), or demanding more and more in return for less and less.

16. Lastly, the efforts of business schools to educate and develop managers would be more effective if they explicitly took the above points into account. Thus way we would avoid falling into the trap that Leavitt (2007) describes as follows:

Currently, our business schools encourage students—implicitly and sometimes quite explicitly—to envision the treasury troves of wealth, status, and “success” that await them out beyond their degrees. But shouldn't we teachers and trainers also be forewarning them of the enervating, often disillusioning psychological traps that lie out there? Shouldn't we pointing out, too, the perhaps *irreconcilable conflict between those organ-*

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<sup>22</sup> For example, a car competing in a downhill slalom, or dairy desserts that develop the body's natural defenses, like so many other tricks simply designed to “sell” the product to consumers in order to meet sales targets, pulling the wool over their eyes if necessary.

*izations' values and the ones our parents taught us? Our universities purport, after all, to be truth-seeking institutions, not pre-recruiters for corporations. Sooner or later, our students will surely encounter a host of organizational situations that will try their souls and test the depth of their decency—unless our systemizing educational efforts will already have erased their rectitude. They will encounter cruel and incompetent bosses, arbitrary and unjustified punishments, overly competitive peers, hurtful family/organization stresses, and wrenching decisions that seriously affect the lives of their “subordinates”. (Our emphasis)*

It would also help to develop a better “social *ethos*”, along the lines described by, among others, Gintis and Khurana (2008):

By abjuring professional standards for managers in favor of a culture of greed, it is likely that business schools that have promoted the neoclassical model of stockholder-manager relations have so undercut the culture of professional honor among managerial personnel that the mechanism of informal third-party punishment and reward has sunk to dramatically low levels, thus contributing to a deficit in moral behavior on the part of contemporary managerial personnel.

#### **4.7.2. Which way ahead for management theory?**

1. First of all, we need a well constructed theory of management, i. e., using elementary concepts that it does not define and elementary principles or statements that are taken as truths for the chosen purpose, on which basis the rest of the concepts are defined and the rest of the truths are proven, reducing any ambiguities to those there may be in the elementary concepts and statements; all this in the best tradition of classic axiomatic systems.

Likewise, the theory must have a normative purpose, indicating the direction it proposes should be taken, and why, in order to improve things.

2. Second, it must be built on a concept of the human being as a whole person, that is to say:

a) As a subject of rights and as the end of any human action.

- b) As guided by a purpose or intentions that are the expression of the goals that human beings see as explicit, much broader than mere self-centered self-interest. We must see the theory as something positive, not as a means of solving the negative problems of organizations (Hirschman 1970, quoted in Ghoshal 2005); and also in the spirit of Amartya Sen (1998), when he says that:

...in acknowledging the possibility of a prudential explanation of apparently moral conduct, we should not fall into the trap of presuming that the assumption of pure self-interest is, in any sense, more elementary than assuming other values. Moral or social concerns can be just as basic or elementary.

- c) With bounded rationality, which is rationality and is bounded in (a) its intentions and purposes (which may not be what human beings really need), (b) the means it provides for achieving them (which may not be the most appropriate ones), and (c) the way they are used (which may not be the best way, including the impossibility of optimizing the value of one or other of the variables).
  - d) As a subject of learning, both in the sense of learning to want what he really needs and in the sense of learning what means are necessary to achieve it or what trust he can have in other people.
3. Third, it must be built on a rational concept of organization, that is to say:
- a) With a particular organizational purpose and trying to provide the means to achieve it. The purpose is always multidimensional and will include explicit short-term results, the development of distinctive competencies, and the development of identification with the organization, which guarantee long-run effectiveness.<sup>23</sup> These dimensions cannot be reduced to one, largely because of the bounded rationality

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<sup>23</sup> See Pérez López (1993).

of those who make the decisions. A much more realistic objective is to achieve a “satisficing” minimum in each dimension.

- b) Knowing that the persons who take part in the organization: a) are boundedly rational and may make mistakes, and b) may have objectives that are not aligned with the organization’s explicit purpose, including, in some cases, a hypothetical “ill will”, which can range from misuse of power by those who have it, to management acts that run counter to the organization’s best interests.
- c) Acknowledging that these problems are complex and highly uncertain and so, call for great expertise, which sometimes leads organizations to imitate one another.
- d) Realizing that organizations must satisfy all kinds of motives in their members, both extrinsic (pay and suchlike), intrinsic (the interest of the job itself) and transcendent (meeting the needs of others).<sup>24</sup> Therefore, to consider, in decision-making, only the criterion of immediate effectiveness and to neglect people’s development (not only on a professional level) and their other needs is a serious error that must be avoided.

#### **4.8. Conclusion**

By way of a conclusion, we would like, on the one hand, to say that it is disheartening to find that most management research does not proceed along these lines, even though in recent years there has been notable progress and various authors have raised some of the issues dealt with in this paper. On the other hand, there is perhaps more encouragement to be gained from business practice. Many companies and managers, perhaps without a solid theoretical basis, are quietly and effectively practicing quite a bit of what we are preaching here. With this paper we hope to contribute to progress in this direction both in theory and in practice.

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<sup>24</sup> See Pérez López (1993).

It will be a difficult battle and we never can say that it is won completely, as the pressure of immediate effectiveness will always be a temptation, sometimes too strong, but that is how human progress has always come about and probably always will: imperfectly, with occasional steps backward, but moving forward overall. We trust that, that is what will happen also in the field of management in the future.

### **Exhibit 1—Elton Mayo and the “Hawthorne Experiments”<sup>25</sup>**

Some classic management authors anticipated the importance of management in social affairs. Elton Mayo, a Harvard Business School professor, reformer and social scientist, is one example. A cordial, affable type and a good communicator who cared about what others thought and about the well-being of people in general, Mayo realized that management needed to concern itself with the specific circumstances of workers. To a large extent, his attitude was shaped by the famous “Hawthorne Experiments” at Western Electric.

In his view, these experiments had shown that people’s performance at work depended not only on (physical and organizational) circumstances but also on personal and social problems which could generate imbalances. The company could influence all this decisively, in a positive or a negative sense. Workers who had come to the United States from rural Italy, where the surrounding society exercised an immediate social control, found themselves in large, “soulless” urban agglomerations or dormitory towns, where any personal problem could easily be amplified, producing a state of “anomie” (a concept taken from the French sociologist Durkheim), or lack of purpose and objectives, that led to inferior work performance. Therefore, to improve company earnings (and there are other reasons, as we have been arguing),

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<sup>25</sup> The “Hawthorne Experiments” are perhaps the most famous experiments in management history. Although the core of the experiments were conducted over several years in two specialized test rooms, each with five workers, they also included 20,000 interviews with Western Electric employees (Mayo 1933).

management must also concern itself, as far as possible, with improving the lives of workers. As Mayo puts it (Mayo 1933; 165):

Certain of the sources of personal disequilibrium, and specially the low resistance to adverse happenings in the ordinary workroom, must be attributed to the developing social disorganization and consequent anomie which is in these days typical of living conditions in or near any great industrial center. This developing anomie has changed the essential nature of every administrative problem—whether governmental or industrial. It is no longer possible for an administrator to concern himself narrowly with his special function and to assume that controls established by a vigorous social code will continue to operate in other areas of human life and action. All social controls of this type have weakened or disappeared—this being symptomatic of the diminished integrity of the social organism. The existing situation, both within the national boundaries and between nations, demands therefore that special attention be given to restatement of the problem of administration as the most urgent issue of the present.

This lack of social control and the consequent “anomie” are clearly pernicious in themselves but also because of the impact they have on the company. Mayo thus, has two types of reasons interwoven with one another. Believing that management is important. One, that social disorganization and lack of cohesion and purpose induce imbalances in people that are bad for society in general and for the individuals concerned in particular. Two, that these same imbalances make people’s performance at work clearly worse.

### **Exhibit 2—Some practical implications of the problems of today’s management**

Below are some of the counterproductive conceptions referred to in general terms in the text. As a rule, these conceptions originate from the academic world and then cross over to the business world, where their implementation is quite variable (in other words, there are quite a few real companies that are very well managed and that have not fallen into the trap of these conceptions). The following examples are illustrative.

**A2.1. A lack of an administrative point of view  
and a failure to consider sufficient criteria  
when making decisions**

Any problem that arises in an organization has to be understood in its context, making explicit what is to be achieved by solving it. Not all organizations—nor all companies—are the same nor are all companies in the same industry the same. In fact, if a company has a clearly defined strategy, by definition, that strategy makes it different from any other company in its industry. The differences lie in a multitude of details regarding both the conception of the product or service and the target market or value chain structure or “organizational structure” in a broad sense. Unfortunately, this is commonly overlooked. The problem is seen in isolation from everything else and a “technical” solution is applied, perhaps one recommended by an outside expert as an off-the-peg option, which may solve part of the problem, while making another part of the problem bigger. This lack of an administrative point of view manifests itself in particular in the following four aspects:

*A2.1.1. An overspecialization and a lack of a “general management view”*

Both in teaching and in practice, management problems are often seen as small technical problems that can be solved easily enough using the (informed) judgment of a specialized expert or by applying standard techniques. If there is a financial problem for instance, it tends to be assumed that a financial markets expert will be able to make the decision, isolating it from the business context in which it has arisen. All that is needed is to apply the appropriate theory and see what it recommends. If there is a production programming problem, it is simply a matter of applying the appropriate programming technique, nothing more. Any link between the problem and a view of the company and its strategy as a whole is conspicuous by its absence. The application of the solution is colorless, odorless, bland and aseptic. Furthermore, the impact the supposed solution is likely to have on other aspects of the company and possible implementation difficulties are not taken into account.

*A2.1.2. A mechanistic view of persons as “something”  
that does not change or learn*

What people do and the stimuli they respond to, particularly economic incentives, are taken as given, regardless of any learning that may take place—which inevitably does, changing people’s responses as we have already emphasized. This view justifies the approaches described in the previous points. What makes management problems interdependent is precisely the fact that they affect people, often *the same people* from different angles. And again, what makes a “general management point of view” necessary is people, who ultimately bring the company’s strategy to life and make it a reality which by definition would make no sense in an “impersonal” environment (although at present there is an unfortunate tendency to “depersonalize strategy” in this sense).

*A2.1.3. Strategy formulation understood as something  
mechanical, almost exclusively, the result of passive  
industry analysis*

For decades, strategy was understood as something specific to each company and, though obviously conditional on the peculiarities of the sector, it would nevertheless take full account of the company’s internal circumstances, particularly its weaknesses and strengths for tackling a particular strategy.

The progress in industrial economics from the 70s onward brought about a change in this conception. In what was supposed to be a clear step forward, intuitive industry analysis was replaced by more formal tools. As a result, “objective” factors relating to industry participants, industry structure and feasible competitive positions came to be understood as the only thing to be considered when designing strategy, giving relatively less (if any) importance to specific detailed knowledge of the company’s customers, the needs to be met, and the distinctive competencies available to do so.

*A2.1.4. The virtual disappearance of strategy “implementation”,  
except for incomplete indicator systems*

In a recent article, Joseph Bower, a well known professor of strategy at Harvard Business School, summed up very clearly the



history of general management courses at his school and specifically, of the Policy Implementation course, which at Harvard traditionally followed the Policy Formulation course. Essentially, it used to be thought that once a strategy had been designed, it had to be put into practice through an appropriate organizational structure, instilling in employees the necessary motivation. This course started from a conceptual framework that Bower summarized as follows:

The leader of the firm was a general manager whose most fundamental responsibility was for the formulation of purpose (Barnard), institutionalization (Selznick) and the building of organization and systems for its implementation (Chandler), in a way consistent with market needs (Barnard) and societal demands (Selznick).

Unfortunately, a few years later (Bower 2008):

Across academia—Harvard Business School included—work in competitive strategy gained increasingly economic rigor. At the same time, the role of managers in the course began to disappear, especially the general manager...

One may agree or disagree with this description, especially the details but what is beyond doubt is that, the role of the general manager used to be considered important and that both students and professors used to think that the general manager role afforded a crucial point of view for addressing real-world problems, which, in turn, highlighted the general manager's responsibility and professionalism as a manager. Today, this view has virtually disappeared. Whether this is because the real world has turned its back on this type of problem or for the opposite reason is debatable. The fact is, however, that the two things coincided in time.

### **A2.2. Problems relating to functional areas**

If we carry out a brief and systematic (though not exhaustive) review of the various functional areas, we find a long list of problems or false solutions, as follows.

*A2.2.1. Misuse of accounting and management control systems,  
mainly in relation to performance assessment  
and measurement, and policy on performance-based pay*

Accounting has always sat uneasily with management. On the one hand, it is a technical and legal requirement; on the other, it is very useful for decision-making. It has always had a significant utilitarian component, i. e., as an input for decision-making. Because accounting has to be standardized to ensure consistency between companies, accounting data have become “hyper-technical”. Moreover, they are often used mechanically. For instance, if the aim is to meet customers’ needs (which normally is), instead of thinking about the customers and how their problem can best be solved, an indicator is established (e. g., a questionnaire on supposed customer satisfaction). This indicator is called a *metric* to give it a false air of exactitude<sup>26</sup> and immediate incentives are applied, depending on the degree of achievement of targets set in relation to this *metric*. Management as such—i. e., any attempt to assess the whys and wherefores (which, we repeat, will inevitably be subjective) and any boss-subordinate debate, any attempt to learn for the future—is left out of the picture.

*A2.2.2. A finance function that either turns into ideological  
microeconomics or becomes “hyper-technical” and turns  
into applied EXCEL. Absence of financial policies*

The financial function is important in any company. Finding out where (short or long-term) funds can be raised, what type of funds can be raised and how they can be invested is perhaps one of the most important financial problems, both for society in general and companies in particular. It is not at all a *technical* problem. Discovering where to invest requires a thorough knowledge of the business and in-depth study of the alternatives that present themselves. In fact, the alternatives do not usually present themselves on their own accord; often they have to be created by man-

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<sup>26</sup> *Metric* is a term used in mathematics with a very precise and specific meaning and with certain characteristics that cause the variable to have certain properties. Performance indicators, which are often called *metrics* in current theoretical and professional literature, have none of these properties. The widespread use of the term is unfortunate and shows the lack of rigor of some management literature.

agement. Once they have been created, there is still the question of where to obtain the funds to invest in them. Another important decision is what sources of funds are available and which source is the best one to use at any given time. Again, there is nothing *technical* about this, especially if the company has no funds of its own; and if it does, there is always at least one other possible use for them, which is to give them back to shareholders.

This very brief summary of financial decisions reminds us that such decisions are often given over to *technical experts*, thus stripping them of their management component, which is rightly a part of them. Long-term decisions (equity and debt issues, investments, dividend policy) are sometimes presented as irrelevant, based on certain theoretical models, while short-term decisions (sources of working capital and how to use it) are treated as if they were a matter of knowing how to use EXCEL.

People often fail to distinguish between finance as such, as the basis of financial decisions and financial economics which is the formal analysis of markets, without any reference to specific decisions. Financial decisions are as uncertain and prudential as any other type of decision. The trivialization of risk assessment, leading in many cases to systematic risk underestimation, accompanied by insistent approval of leverage as a sales technique for winning customers or as a financial technique for achieving better results for shareholders, has had lethal effects, which have contributed to the current crisis.

*A2.2.3. A concept of marketing which considers customers as passive entities whose behavior is fully captured by statistics, and which forgets that its fundamental goals should be to meet customers' real needs and create consumers*

The most popular version of marketing is the one that sets out to persuade customers by any means to buy something—through advertising, mechanically trying to determine what consumers respond to; and through sales, chasing them with all kinds of tricks, looking to see when they “take the bait” and when not, and with cheap psychology about “what makes consumers tick”.

The classics of management literature express a very different view. Here we shall cite just two. First, in what is perhaps his best

known work, Peter Drucker (1954, 37) says that the purpose of business is to create a customer, because:

Markets are not created by God, nature or economic forces, but by businesspeople. The *want* a business satisfies may have been felt by the customer before he or she was offered the means of satisfying it (...) but it remained a potential want until the action of businesspeople converted it into effective demand.

Philip Kotler (1984, 29), perhaps the best known author in the field of marketing, proposes what he calls “the societal marketing concept”, which states that:

The organization’s task is to determine the needs, wants and interests of target markets and to deliver the desired satisfactions more effectively and efficiently than competitors in a way that preserves or enhances the consumer’s and the society’s well-being.

In either case, the emphasis is on satisfying human needs, not on increasing sales. Going back to Drucker (2001, 20):

Despite the emphasis on marketing and the marketing approach, marketing is still a rhetoric rather than a reality in far too many businesses.

*A2.2.4. A mechanical production which forgets that those who must actually do the producing are human beings who know more about the real production process than their managers*

Oliver Sheldon, at the beginning of the 20th century, distinguished between things he thought could be treated scientifically (materials and mechanical operations) and people, which could not. “There can be a science of costs, of transport and of operations, but there cannot be a science of cooperation”, he said. Mary Parker Follet criticized this point of view at the time because she thought that the two things (materials and mechanical operations on the one hand and people on the other) were inseparable (Follet 1927).

Nowadays, with the progress that has been made in information and decision support systems, it is partly possible to have greater decentralization and “on the fly” decision-making. What often hap-

pens in practice however, is that human judgment is replaced by indiscriminating mechanical systems that can only impoverish both the decision-making system and management acts in general.

*A2.2.5. An organizational behavior that: a) is merely descriptive as far as organizations are concerned, and b) considers people as mere instruments of organizations*

Very early on in the development of management theory, it became apparent that problems relating to people's behavior reached beyond purely mechanical and economic factors. The famous Hawthorne Experiments are the classic reference. What has changed substantially in recent years, however, is the objective and emphasis of behavioral research. On the one hand, it has become supposedly more scientific in its efforts to measure unmeasurable variables and demonstrate relationships between them using statistical methods. On the other, it has become more instrumental, trying to find ways to use those measurements to influence people so that they serve the "interests of the company" (which in reality tend to be the interests of a few senior managers), losing the genuine concern it initially had for the well-being of all those involved.

*A2.2.6. An economic analysis that puts ideology before facts*

Economic analysis, which abstracts from non-economic variables and presents itself as rigorous analysis (which it cannot be by definition as it omits other variables that are crucial for the purpose of managing), is often taken as a paradigm of virtue, as perfectly immune to ideology and as a solid foundation of analysis that cannot be questioned from merely intuitive viewpoints that is very superior to them. That is why we earlier described it as a supposedly non-ideological ideology because it conceals a highly ideologically charged way of seeing things—a way of seeing things that tends to permit any economic behavior, however much it undermines the fundamental rights of people seen as entities of a not exclusively economic nature, possibly in the name of freedom.

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## PART TWO

### BUILDING BLOCKS FOR A NEW THEORY OF THE FIRM





## 5. Towards a Stakeholder Theory of Strategic Management

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THE two fundamental questions in the history of economic thought concern the theories of economic value and the distribution of this value (Schumpeter 1954). These questions are also—or, arguably should be—the two fundamental questions concerning strategic management. This paper focuses on the first of these two fundamental questions based on a property rights foundation for a *stakeholder* theory of the firm.<sup>1</sup>

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<sup>1</sup> There are many definitions of stakeholders in the governance literature, based in part on the economic salience of these stakeholders (Aoki 1984; Coombs and Gilley 2005; Freeman 1984; Frooman 1999; Jawahar and McLaughlin 2001; Jones and Wicks 1999; Kassinis and Vafeas 2002; McWilliams and Siegel 2001; Mitchell, Agle and Wood 1997; Rowley 1997). Stakeholders have been defined broadly as those persons and groups who contribute to the wealth-creating potential of the firm and are its potential beneficiaries and/or those who voluntarily or involuntarily become exposed to risk from the activities of a firm (Clarkson 1995; Post, Preston and Sachs 2002). Thus, stakeholders include shareholders (preferred and common), holders of options issued by the firm, debt holders (Parrino and Weisbach 1999), (banks, secured debt holders, unsecured debt holders), employees (especially those investing firm-specific human capital) (Blair 1996), local communities (e. g., charities) (Morris et al. 1990), environment as “latent” stakeholders (e. g., pollution) (Buyse and Verbeke 2003), regulatory authorities (Post, Preston and Sachs 2002), the government (as tax collector) (Brothers and Bamossy 1997), inter-organizational alliance partners (Dyer and Singh 1998), customers and suppliers (Freeman 1984). These stakeholders often gain substantially when the firm does well and suffer economic losses when the firm does poorly. Bowman and Useem state that: “To exclude labor and other stakeholders from the governance picture (...) is theoretically tidy and empirically foolhardy” (1995, 34). The current paper focuses on stakeholders (and for illustrative purposes labor) in which firm-specific investments have been made (Blair and Stout 1999).

### 5.1. Property rights theory

Classical property rights theory defines ownership as residual rights to income (residual claimancy) (Alchian and Demsetz 1972; Demsetz 1967) while modern property rights theory equates ownership with residual control rights (Grossman and Hart 1986; Hart and Moore 1990). Effectively, aligning residual claims mitigates *ex ante* contractual problems while the appropriate allocation of residual control rights mitigates *ex post* contractual problems. Residual claimancy and residual control (*ex ante* and *ex post* contractual) issues are at the heart of a definition of ownership (Milgrom and Roberts 1992).

The strategic management research literature has begun to utilize and develop both the classical and modern property rights theory in recent years (e. g., Argyres and Liebeskind 1998; Chi 1994; K. Foss and N. Foss 2005; Kim and Mahoney 2010; Liebeskind 1996; Miller and Shamsie 1996; Oxley 1999). However, the implications of property rights theory for stakeholder analysis are still at a nascent stage of development (Aguilera and Jackson 2003; Asher, J. M. Mahoney and J. T. Mahoney 2005; Blair 2005; Grandori 2004; Osterloh and Frey 2006). See also Chapter 9 in this volume.

The strategic management discipline has made conceptual and empirical progress concerning the question of economic value creation primarily from a shareholder wealth perspective rather than from a broader stakeholder perspective (Blair 1995).<sup>2</sup> The current paper considers the question of economic value creation based on property rights theory and from a stakeholder perspective.

Developing a property rights theory of the firm enables strategic management's primary theory —i. e., resource-based theory (e. g.,

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<sup>2</sup> The shareholder vs. stakeholder debate has been ongoing for at least the last nine decades (cf. Clark 1916). Berle (1931) argued for what is now called “shareholder primacy”—the view that the corporation exists for shareholder wealth maximization. Dodd (1932) argued for what is now called the “stakeholder approach”—the view that the proper purpose of the corporation also included more secure jobs for employees, better quality products for consumers and greater contributions to the welfare of the community. Stout (2002) documents the intellectual progress made over the years concerning the Berle-Dodd debate.

Penrose 1959; Peteraf 1993; Rumelt 1984; Wernerfelt 1984)— to expand the concept of sustainable competitive advantage based on whether resources are valuable, rare, inimitable and non-substitutable beyond a shareholder wealth perspective (Barney 1991; Coff 1999), and to consider the market frictions that influence the realized economic value and not just the potential economic value (Kim and Mahoney 2005; Mahoney 2001, 2005).

This paper emphasizes that it is no longer tenable to regard shareholders as the only residual claimants, where residual claimants are defined as persons or groups whose relationship to the “firm” gives rise to a substantial residual interest in the firm’s success or failure.<sup>3</sup> Further, it is a residual interest that is not *ex ante* contractually bargained over and it is not *ex post* perfectly allocated. The current paper maintains that property rights considerations enable an economic foundation for stakeholder theory.

#### 5.1.1. What are property rights?

Property rights refer to any sanctioned behavioral relations among decision makers in the use of potentially valuable resources; such sanctioned behaviors allow people the right to use resources within the class of non-prohibited uses (Libecap 1989). This definition emphasizes both the legal aspect of property rights and the social conventions that govern behavior, such as corporate culture and reputation (North 1990). Property rights include social institutions that define or delimit the range of privileges regarding specific resources granted to individuals. Private ownership of these resources may involve a variety of property rights including the right: to exclude non-owners from access; to appropriate the stream of economic rents from use of and investments in the resource; and to sell or otherwise transfer the resources to others (Libecap 1989). Conceptualizing property rights to have multiple dimensions implies that different people can hold parti-

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<sup>3</sup> Clark (1985) notes that much of the economics literature discusses “firms” rather than “corporations” and does not distinguish sharply between closely held business organizations (whatever their legal form) and publicly held corporations. Clark goes on to note that: “For a number of reasons, failure to make this distinction clearly can be a source of almost fatal confusion” (1985, 55). The “firm” as used throughout the current paper refers to a publicly held business corporation.

tions of rights to particular facets of a single resource (Alchian 1965; Eggertsson 1990).

It is useful to think of resources as “the bundle of rights” rather than physical entities (Coase 1960). Thus, resources that a firm “owns” are not the physical resources but rather are the property rights. The firm is viewed as a “method of property tenure” (Berle and Means 1932, 1) in which each stakeholder has certain property rights (e. g., managers may have stock options and decision rights over organizational resources and workers may have property rights concerning severance payments and pension benefits).

Property rights (and transaction costs) theory can be useful for analyzing the economic value of resources. In particular, it is emphasized here that asset specificity is a source of potentially appropriable quasi-rents (Williamson 1985) and bundles of property rights allocations can help attenuate inefficient appropriation and inefficient investment. For example, reducing such problems can be a source of potential economic value creation since investments in complementary and/or co-specialized assets are promoted (Teece 1986). Thus, property rights theory complements resource-based and dynamic capabilities research (Mahoney and Pandian 1992; Teece, Pisano and Shuen 1997).

Resource-based theory has made little use of property rights research in contexts of both positive externalities such as complementary and co-specialized resources (Helfat 1997; Teece 1986), and negative externalities, such as the lack of oil field unitization for migratory oil (Kim and Mahoney 2002; Libecap 1989) and hence, cases where property rights resources are not secure<sup>4</sup> often fall outside of its analytical framework. Property rights theory enables us to relax the implicit resource-based premise that property rights to resources are secure and thus, takes into account, processes where there are struggles in establishing property rights that

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<sup>4</sup> While undefined and poorly-defined property rights may lead to an overuse of resources in commons problems (Ostrom 1990), resources may be underused in anti-commons problems (Heller 1998) when multiple owners which have a right to exclude others from a scarce resource and no one has an effective privilege of use—as can be found, e. g., in biomedical research (Heller and Eisenberg 1998) and in semiconductors (Ziedonis 2004). Buchanan and Yoon (2000) discuss the symmetrical nature of commons and anticommons problems.

can reduce the gap between potential and realized value creation (Kim and Mahoney 2005).

## **5.2. Linking property rights—and resource-based—theories**

This paper suggests three primary reasons why a connection between property-rights theory and resource-based theory is now more than ever needed. First, changes in the (reconstructed) conceptualization of the firm is needed because the nature of the firm in practice is changing with increasing importance placed on intellectual property rights and knowledge-based resources and capabilities (Itami and Roehl 1987; McEvily and Chakravarty 2002; Nelson and Winter 1982). Such resources are fraught with market frictions. In particular with the increasing relevance of intangible resources and knowledge-based capabilities, dealing effectively with potential property rights problems due to asymmetric information and distribution conflicts becomes increasingly important.

A second reason for proposing new connections between property rights—and resource-based—theories is that business enterprises that historically could be usefully understood in large measure as leveraging physical resources to achieve both economies of scale and economies of scope (Chandler 1990) are now becoming increasingly dominated by firm-specific human and organizational capital (Wang and Barney 2006; Williamson 1996). Human capital and technology firms, whose main resources are key employees with firm-specific (technological) knowledge, challenge our understanding of the nature of the firm, where economically valuable human resources (Helfat 1994; Lado and Wilson 1994) are often operating with commodity-like physical resources. Such fundamental economic changes call for changes in governance in terms of the constraints on management, compensation and/or board representation (Hillman, Keim and Luce 2001; Luoma and Goodstein 1997).<sup>5</sup>

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<sup>5</sup> Indeed, if the defining dimension of the firm is that it substitutes authority for the price mechanism in determining how decisions are made (Coase 1937; Williamson

Property rights theory will take on even greater managerial significance as resource-based theory is extended to studying economic value creation in transitional economies and intellectual property (Takeyama 1997). Where there are positive transaction costs, an important source of value creation stems from reduction of the dissipation of economic value in the exchange process (Barzel 1997; K. Foss and N. Foss 2005).

There is another important sense in which resource-based theory and property rights theory are complementary: the more economically valuable the resources the more economic incentives there are to make property rights of such resources more precise and the more precisely delineated the property rights of these resources, the more economically valuable resources become (Libecap 1989; Mahoney 1992). The process of making property rights of resources more precise can be another way of looking at the economic value creation process. Systems of property rights are conduits upon which value-creating activities are fostered so that resources can be channeled to higher-yield uses (Kim and Mahoney 2002).<sup>6</sup>

A third reason for connecting property rights—and resource-based—theories is the need to address more precisely the fundamental question of economic value where the economic maximization of a single residual claimant is becoming increasingly tenuous. The stakeholder view requires that the *entire* economic value of the firm be considered so that it is not only shareholders who extract economic value from the firm beyond their oppor-

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1985), what are the decision control rights of shareholders in a firm that consists of economically valuable human resources operating with commodity-like physical resources? In such a firm, should workers also be allocated decision control rights (Blair 1995)? Such corporate governance issues can already be witnessed in medical practices, investment banks (especially “boutique” banks), law firms and advertising firms (Zingales 2000). Furthermore, along these lines, one of the more tangled thickets in corporate law concerns the proper interpretation of corporate constituency statutes at the state level and the question of to whom, exactly, do the directors of the firm owe their fiduciary duty. Consistent with the stakeholder approach, these statutes typically require directors to consider the “best interests of the corporation” as a whole (Blair 1995).

<sup>6</sup> However, asymmetric information and distributional conflicts may limit resources from being channeled to these higher yield uses. Consideration of distributional conflicts and the (imperfect) evolution of property rights are essential for a more complete resource-based theory of (realized) economic value creation (Libecap 1989).

tunity costs (Coff 1999). In the case of collective action or small-numbers bargaining, the balance of bargaining power to extract economic value may reside in suppliers, customers (unionized) labor or other stakeholders, whose benefits beyond their opportunity costs must be taken into account to capture fully the firm's entire economic value creation (Blair 1995). While this advocated approach for strategic management is economically sensible, this stakeholder perspective is clearly at odds with the traditional shareholder wealth approach used in most finance textbooks which identifies the economic value of the firm as the value of all market claims outstanding.

Whether this shareholder wealth approach or a stakeholder approach is justified depends on what theory of the firm we hold. Towards this objective, we next consider more closely the modern property rights research literature.

### **5.3. Two property rights perspectives**

Here we consider two prominent contractual theories of the firm from a property rights perspective. First, the theory of the firm as a nexus of explicit (and complete) contracts is analyzed. Second, the theory of the firm as a nexus of explicit and implicit contacts (and incomplete contracting) is developed.

#### **5.3.1. The firm as a nexus of explicit contracts**

The currently dominant (agency) theory of corporate governance in strategic management—and a conceptualization of the firm prevailing in corporate finance—can be traced to the seminal articles of Alchian and Demsetz (1972) and Jensen and Meckling (1976). This conceptualization defines the firm as a nexus of contracts. Sometimes this definition includes only explicit contracts and is typically studied from a (*ex ante*) complete contracting perspective (while allowing for asymmetric information and divergent goals between principal and agent). From the mathematical principal-agent model (e. g., Holmstrom 1982) the only residual claimants are the shareholders and thus shareholders warrant the decision control rights. In fact, in the principal-agent model—especially in its more formal mathematical form—there are no



residual rights of control by definition, since the nexus of explicit contracts are posited to specify *ex ante* all the future economic payoff-relevant contingencies. Only shareholders carry a residual risk in this model and should therefore have the residual income and the residual decision rights. Thus, the economic basis for shareholders' supremacy is established.<sup>7</sup>

Zingales (2000) comments, however, that to accept this conceptualization of the firm at face value, one has to take a very narrow view of contracts. A firm's decisions typically influence the economic payoffs of many other members of the nexus, sometimes even to a greater extent than that of the shareholders. The claim that shareholders are the firm's only residual claimants is not typically the case in almost all real-world circumstances (Stout 2002). First, employees are important residual claimants when firm-specific human capital is involved. While shareholders can effectively eliminate idiosyncratic risk by holding a diversified portfolio of stocks, employees typically have this value invested in one firm (Cornell and Shapiro 1987). Second, creditors and communities can be important residual claimants. Third, complex network relationships among suppliers and customers produce interdependencies and can lead to important residual gains and losses.<sup>8</sup>

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<sup>7</sup> The firm-level goal in agency theory is to maximize shareholder wealth. The fiduciary duty of the managers acting as agents for the principals (i. e., the shareholders) is to maximize the firm's stock price. The nexus of explicit contract perspective posits that only shareholders bear risks from discretionary decisions made, and thus the firm should be governed to maximize shareholders' value by maximizing net present value (NPV). Finance texts typically assume an NPV of zero for all stakeholders (other than shareholders) in competitive input markets. Thus, maximizing the firm-wide NPV is exclusively in terms of shareholder value. A similar logic from the first fundamental welfare theorem of economics is that with perfect and complete markets, symmetric information, and perfect information, the allocation is Pareto efficient if firms maximize shareholder wealth. If any of these premises do not hold, then it is no longer clear that shareholder wealth maximization leads to efficiency and it may be the case that stakeholder management can correct for market imperfections.

<sup>8</sup> The assertion that shareholders are the sole residual claimants in corporations not only does not hold in practice, it also does not hold as a matter of law (Stout 2002). Shareholders of a corporation cannot set the level of dividends nor can corporate law treat the shareholders of the corporation that is not in bankruptcy as "residual claimants." It is also unclear that shareholders enjoy the standing of residual claimants even when the corporation is in bankruptcy (PoPucki 2004). The assertion that shareholders "own" the firm may no longer be considered technically accurate even in the economists reconstructed model of the "firm." For example, the assertion that even the single controlling stockholder "owns" the firm is questionable. As Black and

It should be noted here that the complete contracting approach is not necessary to defend the shareholder value maximization criterion for the firm. For example, one line of argument in favor of shareholder value maximization in a world of incomplete contracting is that shareholders have less contractual safeguards than other stakeholders (Hansmann 1995; Sundaram and Inkpen 2004). While respecting this important insight, nonetheless, bounded rationality, potentially opportunistic behavior, uncertainty, asset specificity, and asymmetric information can lead to inadequate contractual safeguards for those, rather than the stockholders (Simon 1978; Williamson 1985).

Another line of argument maintains that stakeholder theory cannot provide a specific objective function for the corporation and that involving only shareholders in corporate governance enables both corporate decision-making costs and managerial discretion to be reduced (Hansmann 1996; Jensen 2001). Roe submits that: “a stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer nor national wealth but only their own” (2001, 2065).

To be sure, there are potential problems in moving to a stakeholder perspective, including potential increased discretion on the part of management and increased costs of corporate decision-making (Tirole 2001). However, there are potential benefits of moving towards the stakeholder view which are highlighted in this paper. To balance these potential costs and benefits may require case-specific analysis: There may not be “a single ‘best’ governance structure” (Zeitoun and Osterloh 2008). While we should not abandon the shareholder as an important claimant, we should also at least allow the consideration of other claimants. There may be cases where the results from a shareholder-only perspective will

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Scholes (1973) make clear, once the firm has issued debt, it makes just as much sense to say the debt-holders “own” the right to the corporation’s cash flow but have sold a call option to the shareholder, as it does to say that the shareholder “owns” the rights to the corporation’s cash flows but has brought a put option from the debt-holders. Financial options analysis clarifies that bondholders and equity shareholders each share contingent control and bear residual risk in firms.

coincide with the results from a stakeholder perspective. However, there will likely be many other cases where the results from the two perspectives will not coincide. It is warranted to hold open the possibility that the *ex ante* and *ex post* inefficiencies that flow from shareholder primacy may turn out to be worse than the increased agency costs that may occur using a stakeholder approach.<sup>9</sup> This question ultimately cannot be answered except on the basis of empirical evidence.

### 5.3.2. The firm as a nexus of explicit and implicit contracts

The relative neglect of stakeholder theory by corporate finance and strategic management is a primary reason why the current state of theoretical development of the theory of the firm and the theory of economic valuation require improvement. What to do? In answering this question there are hopeful signs in recent years where there has been developing within industrial organization economics and corporate finance a new conceptualization of the property rights theory of the firm, which considers both explicit and implicit contracting (Baker, Gibbons and Murphy 2002; Zingales 2000). This seemingly minor change in premises has profound consequences for how we are to understand the theory of the firm and the economic valuation of the firm in its entirety. When considering both explicit and implicit contracts in assessing the economic value generated by the firm, one needs to assess the economic surplus captured by all stakeholders be they financial claim-holders (e. g., holders of equity, debt or options issued by the firm) or non-financial ones (e. g., employees, key customers, and suppliers).<sup>10</sup> From this perspective, firm governance can be defined as a set of contracts shaping the *ex post* bargaining over the joint output of firm-specific investments (Osterloh and Frey 2006; Zingales 2000), and unless *ex post* bargaining positions are

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<sup>9</sup> Agency costs in the shareholder model have also proven to be substantial (Philips 2003).

<sup>10</sup> Blair (1995) reports that accounting profits may represent less than sixty percent of the total economic rents generated by U.S. corporate activities in 1993. The remainder of the rents went to employees as returns for specialized human capital. Blair (1995) notes that it is rare that this specialized human capital is considered as one part of what the corporation as a whole should be trying to maximize.

protected, stakeholders will under-invest in firm-specific investments (Baker, Gibbons and Murphy 2002).

The current paper maintains that modern property rights theory (initiated by Grossman and Hart 1986; Hart and Moore 1990) will lead to a revitalization of a stakeholder theory of the firm. In recent years, the firm has become understood as a nexus of both explicit and implicit contracts, which are understood from an incomplete contracting perspective (Aghion and Bolton 1992; Baker, Gibbons and Murphy 2001). Thus, the firm is no longer simply the sum of its components readily available on the market but is rather a unique combination of potentially complementary and co-specialized assets that can possibly be worth more (or less) than the sum of its parts.

For example, consider a firm with the reputation for upholding the “implicit contract” of not expropriating “quasi-rents” that have been generated by employees investing in firm-specific human assets (Klein, Crawford and Alchian 1978). Relying on such a non-tradeable reputation (Dierickx and Cool 1989), the employees may be willing to make firm-specific human capital investments that are greater than they would have been willing to make in the marketplace, where complete explicit contracting is not feasible. If such firm-specific human capital investments are economically valuable and could not have been elicited by explicit contracting, then the firm’s non-tradeable reputation adds economic value and represents an organizational asset.<sup>11</sup>

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<sup>11</sup> Some have reinterpreted the modern property rights theory of the firm of Grossman and Hart (1986) and Hart and Moore (1990)—the GHM model—to support the shareholders’ wealth maximization approach (Shleifer and Vishny 1997). However, such an interpretation misses the key point of the modern property rights approach that it might be efficient to allocate formal control rights to the stakeholder who has a lot of *de facto* power, as is the case for key workers who can easily leave (Blair 1995; Zingales 2000). This alternative view supports Donaldson and Preston’s comment that: “The theory of property rights, which is commonly supposed to support the shareholder theory of the firm, in its modern and pluralistic form supports the stakeholder theory of the firm instead” (1995, 88). One might draw a similar conclusion based on Boatright’s statement that: “The present system of corporate governance appears to sanction, indeed mandate, that managers externalize [externality] costs wherever possible” (2002, 1849). It should be noted that modern property rights theory supports a narrow, rather than a broad, definition of stakeholders emphasizing those who make critical firm-specific capital investments (Blair 1995; Hart 1995).

At least two major challenges face managers in attempting to build and maintain a reputation for fair treatment of stakeholders in an implicit contract (Bosse, Phillips and Harrison 2009). First, the managers of the firm are subject to periodic shareholder vote so that a future management team that does not share the current management stakeholder philosophy may replace the current management team. Second, managers that currently embrace the stakeholder focus may reconsider their approach if the firm faces financial difficulties; for example, the only way for the firm to survive an economic downturn may be to renege on promises embedded in previous implicit contracts.<sup>12</sup> Thus, even if a management team embraces the stakeholder approach, it could have difficulties ensuring that these “time inconsistency” problems do not undermine their efforts (Shleifer and Summers 1988).

From an incomplete contracting theoretical perspective, other contracting parties besides the stockholders are not fully safeguarded by explicit contracting, thereby undermining the foundational premise of shareholders’ supremacy (Blair and Stout 1999). From this view, Zingales inquires: “If many members of the nexus are residual claimants, why are shareholders necessarily the ones affected the most by the firms’ decisions? Even if they are, are they the party that benefits the most from the additional protection granted by the control rights?” (2000, 1632).

It is not clear whether decision rights should reside exclusively with shareholders because the unfettered pursuit of shareholders’ value maximization may lead to inefficient strategic actions such as the breach of valuable implicit contracts. While in theory, discretionary financial contracting can be desirable (Ayres and Gertner 1989; Boot, Greenbaum and Thakor 1993), it is often troublesome in business practice. For instance, hostile takeovers can be a means of reneging on implicit contracts and a breach of trust (Shleifer and Summers 1988). Thus, rather than share price increases reflecting efficiency gains, such increases might reflect redistributions from stakeholders (e. g., employees and

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<sup>12</sup> Werder (2011) extends this focus on opportunism by emphasizing the concept of stakeholder opportunism in which each stakeholder can bear risk of opportunistic behavior by other stakeholders. Therefore, all stakeholders of a corporation are connected by opportunism interdependencies.

subcontractors) to shareholders. In particular, hostile takeovers sometimes result in the takeover firms, terminating defined benefit pension funds mid-stream to enable economic transfers from workers to shareholders (Shleifer and Summers 1988).<sup>13</sup>

Moreover, the presence of implicit contracts makes it impossible to identify precisely the entire economic value created by the firm. As a result, stock price changes are not reliable arbiters of social welfare changes even when financial markets are perfectly (strong-form) efficient (Demski 2003).

#### **5.4. Suggestions for possible research agendas**

In the economics literature, Masten put forth the argument that: “legal rules establish an institutional basis for the advantages and limitations associated with internal organization” (1988, 181). A fuller development of Masten’s (1988) key insight reached fruition in Blair and Stout (1999), which joined economic reasoning and legal scholarship in a seminal contribution to the governance research literature.

Blair and Stout’s (1999) team production theory of corporate law offers a cogent stakeholder paradigm. Blair and Stout (1999), along the lines of Rajan and Zingales (1998), go beyond the team production model of Alchian and Demsetz (1972) by considering that numerous corporate stakeholders may make firm-specific investments and that a “mediating hierarchy solution” requires team members, in their own rational self-interests, to relinquish important property rights—including property rights over the team’s joint output and over team inputs such as firm-specific human capital—to a legal entity created by the act of incorporation.

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<sup>13</sup> Pontiff, Shleifer and Weisbach (1990), in their sample of 413 takeovers, find that pension funds were reverted by 15.1% of acquirers in the two years following hostile takeovers compared to 8.4% in the two years following friendly takeovers. These reversions—in which employers unilaterally terminate pension plans and transfer the surplus resources in these plans into the corporate coffers—tended to occur when the potential for wealth transfer was the greatest. These empirical results are consistent with the view that hostile takeovers sometimes do (and may in some cases well be primarily intended to) breach implicit contracts between firms and employees. Economic efficiency losses will occur because stakeholders who anticipate opportunistic behavior will be reluctant to enter into implicit contracts with the firm.

Thus, corporate resources are not “owned” by shareholders but by the corporation itself.<sup>14</sup> In this perspective, corporate law protects the whole corporate coalition rather than a single group of stakeholders.

Blair and Stout (1999) insightfully join: property rights theory (Rajan and Zingales 1998); transaction costs theory with special attention to asset specificity (Williamson 1985) and measurement theory with special attention to “nonseparabilities” in team production (Alchian and Demsetz 1972).<sup>15</sup> In business circumstances where it is impossible to draft complete contingent claims contracts that deter shirking and opportunistic rent seeking among

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<sup>14</sup> In this regard, Clark comments that: “Corporate officers, like the president and treasurer are agents of the corporation itself; the board of directors is the ultimate decision-making body of the corporation; ...neither officers nor directors are agents of the stockholders; but both officers and directors are ‘fiduciaries’ with respect to the corporation and its stockholders. A review of elementary corporate law shows that this power of the principal to direct the activities of the agent does not apply to the stockholders as against the directors or officers of their corporation. By statute in every state, the board of directors of a corporation has the power and duty to manage or supervise its business” (1985, 56). As a matter of statutory law, stockholders decision control rights in a public corporation are quite limited. Clark (1985) challenges the Alchian and Demsetz (1972) and Jensen and Meckling (1976) description of the firm as a “nexus of contracts,” asking whether “Is it realistic or useful to view the modern public corporation as consisting only, or even principally, of a set of contracts? I think not. This extreme contractualist viewpoint is almost perverse. It is likely to blind us to most of the features of the modern public corporation that are distinctive, puzzling and worth exploring. To see this, we must first consider the notion of contract, and then note the extent to which the corporation, considered as a multitude of legal relationships, consists of non-contractual relationships” (1985, 60). Most corporate case law deals with alleged breaches of fiduciary duties by managers and these duties are highly unlikely to have been the result of any actual (explicit or implicit) voluntary consent or understanding between manager and investor. Therefore, the legal relationships among participants in the modern public corporation are not primarily the product of actual (explicit or implicit) contracts. Clark maintains that: “Economic analysis could help a great deal in the study of the law’s special concept of the fiduciary, but a militantly contractualistic approach may make it difficult to realize this contribution. With some exceptions, agency costs theorists to date have done little to explain the concept of the fiduciary, to develop positive theories as to why fiduciary law have developed its particular doctrines and characteristics and to assess whether particular fiduciary doctrines are efficient or sound” (1985, 62).

<sup>15</sup> Considering Williamson’s (1985, 24) “Cognitive Map of Contract,” one can interpret Blair and Stout’s (2002) team production theory of corporate law as a hierarchical mediating stakeholder approach to corporate governance through an efficiency lens, and offer a research agenda for the Strategic Management discipline in joining corporate finance (e. g., Rajan and Zingales 2001), economics (e. g., Williamson 1996), law (Hansmann 1996), and organization theory (e. g., Godfrey 2005; Margolis and Walsh 2003).

various corporate “team-members,” it can be comparatively efficient to substitute the institutional solution of the law of public corporations. Specifically, Blair and Stout (2002), maintain that public corporation law can offer a second-best solution to the team production problem under conditions of high asset specificity because it allows individuals to gain sufficiently in team production by attenuating shirking and rent seeking through voluntarily choosing an internal governance structure or “mediating hierarchy.”

Within the corporation, a mediating hierarchy exercises decision control rights over these resources. This hierarchy has responsibilities to: coordinate the activities of team members, allocate the resulting output and mediate disputes among team members. At the peak of this mediating hierarchy is a board of (non-stakeholder) directors that has decision control rights (i. e., authority) over the use of corporate resources and that should not be under the direct control of either shareholders *or* stakeholders. This theory is consistent with the legal protection afforded to board members to be independent of individual team members and to act as trustees to do what is best for “the firm.” For example, the basic structure of the rules of fiduciary duty insulates directors from most claims of breach of duty of care, even when the directors deliberately sacrifice shareholders’ interests to serve other stakeholders. In fact, an independent board of directors is one of the most important characteristics distinguishing public corporation from other forms of enterprise (Blair and Stout 1999).<sup>16</sup> Such independence is essential

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<sup>16</sup> It is noteworthy that a truly independent board may be an anomaly under the principal-agent paradigm, which regards the governance mechanisms evolving towards minimizing agency costs. It would be an anomaly precisely because increased discretion afforded to the board of directors will, in all likelihood, increase agency costs. However, Blair and Stout (1999) provide an efficiency explanation where the independence of the board of directors encourages firm-specific investments essential for team production. Thus, the primary function of the board of directors is not to protect shareholders *per se*, but to protect firm-specific investments of all members of the corporate team including shareholders, managers, and key employees. Blair and Stout’s (1999) team production theory of corporate law challenges the principal-agent theory of corporate governance (Hansmann and Kraakman 2001) because it not only offers an alternative efficiency explanation for understanding our “institutions of capitalism” but also because in comparison to the received wisdom of agency theory, the mediating hierarchy approach of corporate governance is more consistent with the way a corporation actually works. For example, empirical results from a survey of 2,361 boards of directors in the United States



as co-investors who make substantial sunk cost investments need mutual lock in (Blair 2005; Castanias and Helfat 1991; Rajan and Zingales 1998) and thus voluntarily choose to place decision control rights into the hands of a board of directors who have neither the economic motive nor an easy opportunity to profit by withdrawing resources from the corporation.

In this mediating hierarchy model of the modern corporation, the firm is frequently not so much a “nexus of contracts” as a “nexus of firm-specific investments” (Blair and Stout 1999; Lan and Heracleous 2010). Members who voluntarily enter into the mediating hierarchy agree not to specific terms or outcomes—as in a traditional contract—but to participation in a process of internal goal setting and dispute resolution. Indeed, one of the important characteristics of effective (mediating) hierarchy is that it assumes and effectively discharges certain quasi-judicial functions (Williamson 1975, 30).<sup>17</sup> Osterloh and Frey (2006) thus propose that: (a) the greater the percentage of firm-specific human capital *vis-à-vis* financial capital, the greater the percentage of insiders relative to outsiders on the board of directors; (b) those inside directors would be elected by and responsible for those employees of the firm making firm-specific knowledge investments and (c) a neutral person should Chair the board to oversee other directors’ contributions to the firm’s collective good and to make sure that board members refrain from rent seeking.

Building on this framework, we need more empirical work to determine the extent of firm-specific human capital<sup>18</sup> and the extent of the problem of under-investment in such capital (Wang and Barney 2006). Also, how much more agency loss would there be when using stakeholder governance rather than shareholder gov-

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found that the vast majority viewed their roles from a stakeholder orientation and viewed their responsibilities as protecting the interest of *the firm* (Wang and Dewhurst 1992). Further, while the systems of governance vary widely in such countries as Austria, Denmark, Finland, France, Germany, Japan, and Sweden, they have as a common objective the inclusion of stakeholders into firms’ decision-making processes.

<sup>17</sup> Fauver and Fuerst (2006) find that prudent levels of employee representation on corporate boards can increase firm efficiency and market value in industries that require high levels of coordination within the firm.

<sup>18</sup> See for example Groysberg, Lee and Nanda (2008), Helfat (2004), Huckman and Pisano (2006), Sturman, Walsh and Cheramie (2008) and Toole and Czarnitzki (2009).

ernance (Tirole 2006)? Can the extra agency costs of the stakeholder approach still be better when the under-investment in firm-specific human capital is large? Should firms with low firm-specific investments use the shareholder governance model and firms with high firm-specific investments consider the stakeholder model?

#### 5.4.1. Other avenues of research

In addition to the team production approach to corporate law, there are other avenues of research in stakeholder theory that look promising. In further developing the stakeholder perspective, a useful distinction is offered by Berman, et al. (1999) between an “instrumental approach” (McGuire, Sundgren and Schneeweis 1988; Ogden and Watson 1999)—in which concern for other stakeholders is in the enlightened self-interest of shareholders (A. Mackey, T. B. Mackey and Barney 2007)<sup>19</sup>—and an “intrinsic commitment” view—concern for stakeholders as ends and not merely as means (Agle, Mitchell and Sonnenfeld 1999; Donaldson and Dunfee 1994). A more fine-grained and potentially useful classification has been offered by Donaldson and Preston (1995), which offers three interrelated but distinct aspects of the stakeholder theory: descriptive accuracy (does the theory describe or explain characteristics or behaviors observed in the world of experience?), instrumental power (can the theory be used to identify connections between stakeholder analysis and traditional corporate objectives?), normative validity (can the theory be used to guide managers in the moral or philosophical decisions to be

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<sup>19</sup> Empirical research studies frequently focus on stakeholder issues in terms of the bottom line to shareholders (Harrison and Freeman 1999; Hillman and Keim 2001; Mezner, Nigh and Kwok 1994; Waddock and Graves 1997). For example, product recalls generate negative market returns (Davidson and Worrell 1992); product innovations through R&D are generally shown to be positively associated with market stock price (Sougiannis 1994); and improved customer satisfaction measures are found to be value relevant to shareholders (Ittner and Larcker 1997). These empirical papers suggest an “instrumental approach” (Jones 1995) in which concern for other stakeholders are in the enlightened self-interest of shareholders. Indeed, as Freeman, Harrison and Wicks state: “The very idea of managing for stakeholders is predicated on the fact that the process of value creation is about finding the intersection of interests for primary stakeholders (customers, suppliers, employees, communities and shareholders). ... Profits shouldn’t cause conflict with other stakeholders; they are the scorecard that tells us how well we are managing the whole set of stakeholder relationships” (2007, 52).

made in the corporation?). Donaldson (2012) identifies and analyzes an epistemic fault line that separates positive and normative concepts underpinning theories of corporate governance in order to show the importance of clarifying normative assumptions in governance models.

In terms of an intrinsic commitment view, a theory of justice (e. g., Rawls 1971) can be applied to consider the distribution of economic value among stakeholders. One cannot sidestep the fact that stakeholder (or stockholder) theory requires value judgments and dialogue about the purpose of the corporation (Donaldson 1999). As Andrews noted: “Coming to terms with the morality of choice may be the most strenuous undertaking in strategic decision” (1980, 89). Similarly, Barnard (1938)—a seminal management book providing the foundations for a stakeholder theory of the firm—maintains that executive leadership requires the personal capacity for affirming decisions that lend quality and morality to the coordination of organized activity and to the formulation of purpose—see Miller (1992) for an economic reconstruction of Barnard’s (1938) writings—.

Ansoff (1965, 35-36) noted that the Carnegie School’s Behavioral Theory of the Firm (Cyert and March 1963), which emphasized firm-level objectives derived from a negotiated outcome by subgroups, has much in common with stakeholder theory. Moreover, the “inducements-contributions model” in which each participant (e. g., entrepreneur, employee, customer) is offered an inducement (e. g., revenue from sales, wages, goods and services) for participation in the organization and in turn makes a contribution to the organization (e. g., costs of production, labor, purchase price) was an early seminal research framework from the stakeholder perspective (Simon 1952).<sup>20</sup>

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<sup>20</sup> In addition to highly influencing the Carnegie School (Cyert and March 1963; March and Simon 1958; Simon 1947), Barnard (1938) also influenced Selznick (1957). Selznick writes that: “This process of becoming infused with value is part of what is meant by institutionalization. As this occurs, *organization management* becomes *institutionalized leadership*. The latter’s main responsibility is not so much technical administrative management as the maintenance of institutional integrity. (...) The building of integrity is part of what we have called the ‘institutional embodiment of purpose’ and its protection is a major function of leadership” (1957, 138–139).

If property rights systems are conduits through which resources can be channeled to their highest-valued uses, several empirical implications emerge. Countries in which the legal regimes of property rights are more poorly protected will find it harder to attract financial capital or develop specialized human capital (North 1990). Examining and learning from the cross-national diversity of corporate governance and institutional environments are highly warranted (Aguilera and Jackson 2003).

Furthermore, within a given legal regime, industries that rely on resources that have attributes that are inherently more difficult to specify completely (*ex ante*) in a standardized contract (e. g., it may be more difficult to contract on intellectual than on commodity-like outputs), will find it necessary to develop relational contracts between the firm and the specialized resources (Macneil 1978). Within an industry, firms that are innovators in specialized relational contracts will be able to attract financial capital and will be better positioned to outperform their non-innovating rivals. A unique building and handling of network linkages and stakeholder relationships can be a firm-specific capability and a source of sustained advantage (Coff 1999). Firms may currently be on a learning path towards adopting a broader stakeholder oriented view as stakeholder relations are an important source for gaining and sustaining knowledge-based advantages (Post, Preston and Sachs 2002; Sachs and Ruhli 2011).

Property rights from a stakeholder approach sheds light on well documented but poorly understood strategic management decisions and processes. For example, the Saturn car division of General Motors' original mission, governance structure, and internal processes fit the key criteria of a stakeholder firm. Employees establish themselves as influential stakeholders who contribute to problem solving, conflict resolution and quality improvement (Kochan and Rubenstein 2000).<sup>21</sup>

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<sup>21</sup> Other exemplars of stakeholder management include: Ben and Jerry's, British Telecom, Cisco Systems, Costco, Cummins Engine, Dell, Hitachi, Lincoln Electric, Marks and Spencer, Merck, Motorola, Philips Electronic, Royal Dutch/Shell Group, Saturn, Starbucks, The Body Shop, and Tom's of Maine (Freeman, Wicks and Parmar 2004; Kaufman and Englander 2005; Post, Preston and Sachs 2002).

## 5.5. Conclusions

The governance literature in strategic management over the past two decades has been dominated by agency theory and its conceptualization of the firm as a nexus of complete explicit contracts. Improvements in the scientific rigor within journal publications, however, have come at a high price in terms of relevance. The main point here is that it is far superior to have a reasonably accurate understanding of the right (stakeholder) issues in the discipline of strategic management than rigorous and perhaps even precise answers to less relevant questions. Indeed, scholarship from the complete contracting approach (which essentially suppresses economic problems stemming from bounded rationality and limited information processing) often finesses difficult stakeholder questions that managers typically face.

The intellectual heritage of the discipline of strategic management owes much to what used to be called business policy (e. g., Andrews 1971; Ansoff 1965). This early business policy perspective was unabashedly dedicated to a stakeholder perspective—which made the subject of management within the business school differentiated from the stockholder wealth perspective of industrial organization economics and corporate finance. However, in recent years, the discipline of strategic management, perhaps due in part to the pursuit of greater academic standing and scientific legitimacy, has significantly retrenched from the stakeholder perspective (both in research journals and major textbooks) and has gravitated toward the shareholder wealth perspective, where stock price data are readily available.<sup>22</sup>

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<sup>22</sup> At the beginning of the current paper, we noted that Berle (1931) was a major proponent of the shareholder primacy view of the corporation. Berle offered the following account of the Berle-Dodd debate concerning the shareholder supremacy versus stakeholder approach: “Twenty years ago the writer had a controversy with the late professor E. Merrick Dodd of the Harvard Law School, the writer holding that corporate powers were powers in trust for shareholders while professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of professor Dodd’s contention” (1954, 169). Blair and Stout (1999) note that Berle’s (1954) retreat is supported by a series of mid and late-twentieth-century cases that have allowed directors’ decisions to sacrifice shareholders’ profits to stakeholders’ interests when necessary for the best interest of “the corporation.” Case law interpreting the “business judgment rule” often explicitly authorizes directors to sacrifice shareholders interests to protect other

This paper maintains that the modern property rights perspective of incomplete contracting and implicit contracting provides an economic foundation for a revitalization of a stakeholder theory of the firm in strategic management. In order to make progress in strategic management an improved (conceptual and empirical) understanding of implicit contracting is needed (Bradley et al. 1999). Currently, a firm's resources are certainly understated by the economic value of the implicit contracts with a firm's employees, when valuable firm-specific human capital is excluded from the balance sheet (Blair 1995; DeAngelo 1982). The same can be said for the economic value that other stakeholders bring or the loss in economic value these stakeholders suffer when decisions are made strictly on the basis of shareholder value. For example, financial distress can create a tendency for the firm to take actions that are harmful to debt-holders and other non-financial stakeholders (Opler and Titman 1994). If the goal is to maximize total economic value, and this value is to be allocated among those contributing to/gaining from this economic value, then one needs a property rights stakeholder theory which recognizes the role each of these groups plays in the creation and distribution of that economic value.

Finally it is worth noting that new research opportunities are opening for the next generation of resource-based research in Strategic Management. Indeed, the resource-based view of imperfect factor markets in combination with the incomplete and implicit contracting approach predicted here, will provide an economic foundation for a stakeholder theory of the firm in strategic management.

Currently, our finance, microeconomics and strategic management textbooks lack transparency in laying out for our students how difficult the problems of economic value creation, and the distribution of that value, really are.<sup>23</sup> We may never have definitive answers to all our stakeholder questions but we can do better in educating our students.

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stakeholders. Stout comments that: "Half a century after Berle's concession, academics continue to argue the merits of the [shareholder primacy] versus the [stakeholder] model of the firm. The business world continues to prefer the [stakeholder] model of the firm" (2002, 1209).

<sup>23</sup> I thank James Mahoney for suggesting this idea to me.

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## 6. A New Theory of What? Humanizing the Firm in the Time of the Precariat

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### 6.1. Introduction

As our Conference's Call indicates, we should understand firms better than we do; why they exist, what they are, and how they do business and impact others' lives. This is not a purely academic agenda, the pursuit of knowledge for its own sake, for firms matter greatly to all of us. We live in a capitalist democracy wherein the private firm is a crucial component. Academics and politicians proclaim firms the "lever of riches" or "engines of capitalist democracy", essential to our socio-economic growth and citizens' human flourishing.

(Mokyr 1990). The goods and services they generate meet our varied needs. Firms compete for our attention and spending-power as we choose what to purchase, filling our lives with different choosable life-styles. Consuming goods and services leads to personal satisfaction and, on occasion, social identity. Firms generate jobs that provide work, livelihood and occupational identity. No question, their activities have lifted millions from ignorance and poverty (McCloskey 2006, 2010; Sen 2008). Firms bring new life and possibilities to towns and regions and are wooed for that reason. Sometimes they pay taxes and contribute directly to the education, healthcare and defense infrastructure. Sometimes they provide us with investment opportunities that are better than us buying our houses or lending to the government. Clearly firms are many-tentacled entities deeply entwined in our capitalist democracy, sometimes holding it together, sometimes threatening it, but always deeply reflecting our hopes for it.



In spite of centuries of commonsense evidence of firms' nature we still have no theory of the firm that explains what they are, why they exist, how they add value or why they disappear (Coase 1991; Demsetz 1988; Williamson and Winter 1991). It follows; we change them at our peril for, acting in ignorance and the outcomes are often unanticipated and unintended. We have no definitive theory of managing them—something that might worry business school faculty more than it appears to (Demsetz 1988, 1991; Foss and Klein 2005b; Walsh 2011). This is more than a trifling failing, for firms' impacts go far beyond their financial consequences, especially as they do not always seem to be working for the public benefit and sometimes have distinctly negative impacts (Harr 1996; Lewis 2010). History shows that at the end of the 19th century, as the private sector expanded rapidly, there was widespread public anxiety about firms and their doings (Strum 1995). The problematics that define our discipline were born of this anxiety (Guillén 1994). It was hoped that the new objectivity and rigor would penetrate commerce's puzzles and reveal its truths—how it might be organized and regulated best, how firms should be managed, how fitted into the socio-economy and so on. BSchools were founded in increasing numbers, in part, to help research, understand and thereby, perhaps, professionalize business management as well as boosting it (Khurana 2007; Spender 2008). Scientific Management was a non-academic practical response, driven by engineers around the world as they took the managerial initiative (Spender and Kijne 1996). Its problematics were administrative control and productive efficiency rather than marketing, contrasting with the previous dominant business strategy—the pursuit and maintenance of monopoly profits. While Scientific Management still provides management thinking's principal metaphors, what most managers mean by “getting organized” (Shenhav and Weitz 2000), it maintains uneasy relations with the BSchools and was, for many, the theory to be dismissed in favor of more psychologically sound or humane principles (Kanigel 1997; McGregor 1987).

National anxiety about the private sector and its doings declined after WW2, in part because of the economy's rapid expansion, in part because of the 1960s ideological turn to “market forces” and “free enterprise” (Amadae 2003; Amadae and De Mesquita 1999;

Hounshell 1997; March 2007; Tinker, Merino and Neimark 1982), in part because of the widening sense of “it’s about the economy, stupid!” that subordinated political discussion to that of national prosperity. Thus, the private firm’s legitimacy remains unquestioned by all bar the “lunatic fringe”, even though our discipline’s grasp of what firms are and do has not advanced to the point it has had any significant impact on managers’ activities (Hambrick 1994). Likewise, micro economic theorizing has had little direct impact on management practice, though it has had great impact on government policy and firms’ regulation. Recent events have reawakened the public anxieties about firms that earlier led, for instance, to the Anti-Trust legislation of the 1890s or the finance industry’s Glass-Steagall legislation in the 1930s. The main impulse behind the present humanizing agenda may be the sense that we have to deal afresh with these anxieties and with re-understanding the firm as a socio-political artifact.

In our capitalist democracy private firms like private citizens, have been granted considerable freedom of action and their individual-like-ness is the basis of corporate law (Horwitz 1992; Maitland 1900). As a result, the firms’ powers and freedoms lead to problems when their exercise of private power runs against the interests of others—be they competing firms, disappointed governments, badly treated customers or simply bystanders affected by, say, plant effluents (Coase 1960). Effective means of controlling private firms are neither obvious nor uncontested. Berle and Mean’s analysis of the “modern corporation” followed Veblen’s earlier theorizing (Veblen 1965) and took off from the observation that even though firms’ activities have considerable social impact, neither their Boards nor their managers are as accountable to the citizenry as are politicians (Berle 1954; Berle and Means 1968; Bratton and Wachter 2008). Without a viable theory of the firm and of its place in our capitalist democracy, how are we to know whether, or how, to analyze or act on these matters?

The Conference’s humanizing agenda implies some kind of intervention to change or keep private firms’ behavior within the boundaries established by corporate law and uncoded societal expectations. We should therefore seek a theory that provides a sense of how the public might both (a) intervene and (b) justify

that intervention, given the private firm's legally-established freedom of choice. The non-political part of our project is academic about developing arguments that others with legitimate political powers might use to debate and justify intervention in the private sector, be they politicians considering or resisting new legislation, investors wondering whether or not to lend to "green" enterprises or individuals choosing employment with this firm or that. We also intervene as teachers, helping shape the language of the debate, proposing some ideas as more worthy, ethical, efficient or tenable than others.

In general we see two modes of intervention; "direct" and "persuasive". No firm is an island. Public officials, acting on behalf of the electorate, intervene directly using the available controls, especially those of corporate, labor and environmental law, to change the firm's legal situation and thereby its range of legitimate action choices and/or punishments. This is to act directly on the firm as a socially embedded entity. Taxes, such as a "luxury tax" on yacht-buyers, impact the firm's overall financial performance directly as environmental and safety legislation acts on its production processes. "Persuasive" means acting on those individuals whose strategic and operational choices affect the firm's behavior, looking behind the firm as an entity to the individuals who comprise and direct it.

The distinction is muddy, for the process of changing corporate legislation is open to lobbying, publicity, countering actions and so on, involving individuals and private interests. Likewise persuading individuals often involves social norms, political principles, and so on that act on whole cultures, industries and sectors rather than on individual firms. The distinction's essence lies in the relationship between those people outside the firm, in no sense parties to its choice processes and those within, who are—a distinction that is central to stakeholder theory (Freeman et al. 2010). Direct intervention implies little attention to or respect for the opinions of those within the firm, while persuasive presumes some meaningful interaction with them—debate, negotiation, pressure, education, etc. In this sense much of the corporate governance discussion trends to the directive end of the spectrum. Those who developed the Sarbanes-Oxley legislation,

for instance, paid little attention to the views of those it would impact most directly. At the other end of the spectrum perhaps, are business schools' (and the AACSB's) attempts to raise the private sector's "ethical standards" with courses in "corporate social responsibility" (Bénabou and Tirole 2010; Carroll and Shabana 2010; Dahlsrud 2008; Davis 1960; Epstein 1999; Garriga and Melé 2004; Warren, Sampson and McFee 2011), reconsideration of management's real function (Carrera and Quiroga 2008; Ceja and Tàpies 2011; Jensen and Fuller 2002) or citizen actions such as demonstrations and boycotts.

Academics working the humanizing agenda span the spectrum; typically arguing one type of intervention as more effective or promising than some other. Irrespective of whether they are right or not, all unavoidably appeal to some theory of the firm (ToF) that relates the firm's inputs to its outputs—and wider impacts—and shows where interventions are possible. Here I am less immediately concerned with the available modes of intervention than with the underlying ToF that makes an intervention argument seem reasonable. The lack of a widely agreed ToF ensures several different ToFs are in play (Morgan 1986; Rosanas 2008, 2009). Each relates the firm differently to (a) its socio-economic or legal context and (b) its constituting people and non-human resources. Directive measures focus on (a)—the firm's context—where the firm is defined in terms of what it is free to do, though, in practice, this is generally specified in terms of prohibitions and constraints and what it may not do. Persuasive measures focus on (b), especially on persuading the firm's directors and managers to think beyond their immediate responsibilities to the firm and think more as social individuals who appreciate the embedded firm's purposes, mission and impacts go far beyond mere conformance to legal directives and its shareholders' interests. It follows the meaning of "humanizing" is contingent on the ToF adopted.

The ToFs in play range from those like the micro economists' production function or self-organizing systems theory, that focuses on "objectified resources" and have no "real people" within them, to sociological, political, or behavioral models that both admit people and treat them as the firm's basic constituents. We can think of directives acting on the firm as if it is a rational decision-

making device and, in the absence of any accounting for the social costs its operations incur, legitimately maximizing its profit as an isolated entity. In practice firms incur social costs all the time, whether through privatizing public goods at a fraction of their cost to the taxpayer (as do most Silicon Valley firms, for instance), or by internalizing the benefits of others' private investments in their capabilities or "human capital" (engineers, programmers, even law school and BSchool graduates). It follows that the embedded firm is one whose profit is always contingent on social directives that might alter its social accounting. For example, firms might be directed to bear more of their social costs via a "carbon tax", a training levy, or mandated health benefits. Persuasive measures might also treat the firm as a whole and encourage a changed organizational rationality, perhaps to follow the nationwide trend to provide *pro-bono* administrative assistance to local charitable organizations, presupposing an organizational culture and climate homogeneous across the firms. Persuasive efforts can also influence ToFs that presume the organization's internal characteristics; thus we might promote a culture of openness, fairness and respect across the wide differences in the firm's employees' skills and remunerations believing that improves productivity. The ToF implied is one far removed from the micro economists' maximizing production function.

In general, change proposals can make no sense until the ToF in question is surfaced. How does culture affect productivity? Does it step up when FCB wins? Can we be sure an organizational climate of fear does not do more for profit—given the evidence many managers believe it is the better route? It is one thing for academics to speculate about the viability of their chosen ToF, quite another for powerful outsiders to use their thinking as the basis for intervening in real firms, to apply their theories. In particular the "make nice" route to greater productivity is one of the oldest canards in our discipline's literature—unsupported after decades of research (Blood and Hulin 1967). The main point being that the project to humanize the firm is incoherent until we know what the firm is or more precisely, the ToF underpinning our proposal. Until we know what we mean by "the firm" the idea of humanizing it is not likely to be persuasive.

Humanizing is about people, so there are political dimensions to the project. Clearly my implicit model of the individual is political. This is not to deny the emotional, moral, religious, and so on dimensions of our condition. Rather it is a simplifying assumption that leaves me some prospect of connecting workable notions of society, firm and individual in a coherent discourse. While it seems tempting to jump past the political issues raised here and propose a more ethical model of the individual, it is not clear how to integrate her/him into a discussion of the economists and management theorists' problematics. The micro economists' firm is an a-political abstraction that hangs between supply and demand functions that are also presumed to be a-political abstractions; hence it follows that trying to humanize this ToF, to bring it into relationship with the political lived world, is to misunderstand its nature and presuppositions, which is Friedman's point. The human being implied by most micro-economic thinking is "rational man" (RM)—*ex definitio* unconcerned with culture, history, ethics or politics. Humanizing this model of the individual (MoI) will not humanize neoclassical economic theory; it is to propose a different kind of analysis altogether—and it is certainly not economics. As we know from the work of Simon, a critique of RM is fundamentally a critique of microeconomics, and generally engages political issues—but how are we to theorize this?

Here is the nub of our difficulty—what non-economic ToFs are available that would let us make pertinent and tractable proposals about humanizing managing? The microeconomic approach has its own notions of society and individuals built in one of its many strengths. Its objectives are crisp and easily identified—maximization in a society of maximizing individuals for whom maximization is the greatest virtue for whom real-world politics is not an issue. It is already fully humanized—according to its own lights. Its individuals, firms and society are aligned, integrated and coherent; and to criticize it is to envisage an utterly different kind of individual and society. In practice, directive approaches often gloss the task of surfacing and defining alternative ToFs, presuming the firm of microeconomic theory can be readily re-directed from maximization towards non-maximization, that it can be made "better" or "more social" with-

out stopping to articulate in what way, how measured, or how brought about. This exposes much of the humanizing and CSR literature to the charge that it is “incoherent” (Sternberg 2000, 2009) even as it bounces off the “Friedmanite” armor (Kemper and Martin 2010). Ultimately humanizing the firm calls for us to specify some politically, sociologically and psychologically compatible notions of firms, society and individuals; no small task. We are challenged to imagine a humanized ToF embedded in a humane socio-economy comprised of humane individuals, all of which takes us very far from RM and microeconomics.

As the Call for Papers reminded us, there is new urgency and as management theorists and educators, we might yet play a part in helping the public deal with its new and increasing anxieties. Khurana showed that our role is not clear but it may be greater than we care to admit. We teach, we change peoples’ ideas of working and managing and we help contrive and legitimate the language the public uses to advance their differing interests and resist others’. Our task clearly begins with thinking carefully about what firms are and what they do—and what we conclude determines what we mean as we write and teach. Preparing for, securing and doing paid work in firms absorbs much of contemporary life and we educators, help shape what this means for an increasing part of the population—for instance, one in five U.S. college students is studying business and listening to the BSchool story about the world.

At the same time employment prospects are grim everywhere and getting worse. A distressing proportion of graduates either finding no work, or doing work unrelated to their studies. In this sense we may have lost sight of what business education is for. Perhaps it would be more valuable if it were less about preparing students for employment in firms and more about preparing them for life in an unstable capitalist democracy. Likewise we remain in doubt about what managers can or should do—beyond rigorous analysis and computer-like rational decision-making—and remain unsure about firms, their nature, process and place in our society. Given, especially, how some private sector managers profited from the public sector’s bail-out of otherwise bankrupt firms, what should we tell well-informed students about managing or the real

practices of democratic capitalism? What are the “teachable moments” of our recent history or in the flood of castigatory literature it has provoked (Partnoy 1997; Sorkin 2009)?

In short, the humanizing project must start from a critical review of the ToFs presently available. We can dismiss those that cannot be related to our present situation and then explore how alternative non-neoclassical ideas and non-RM models of the individual might be articulated into a practical theory of the embedded firm. If we cannot find a ToF suitable to these objectives, we have to develop a new one. Initially, though, the humanizing project becomes a critique of most of the current theorizing around the firm, deeming it inadequate to the increasingly urgent task of explaining our capitalist democracy to itself.

## 6.2. Is it all politics?

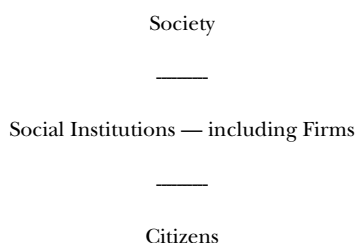
There is some confusion of labels, so by firm I mean an organization in the private sector. Public sector organizations are linked, perhaps not tightly enough, to the national political system as instruments of the public will and they have their own governance processes. In principle they are directly accountable to the electorate whereas the private firm is not—Veblen’s point and Berle & Means’s. Every nation has its own history on this but in the U.S. the history of corporate law shows that the origins of the firm had little to do with today’s ideas about economic individualism or “rights of enterprise” (Canals 2010; Horwitz 1992). Rather, citizen’s associations and private firms were allowed into existence expressly to balance, compete against and pressure the U.S. States’ post-revolutionary public sector commercial operations—to keep them “honest” and “efficient” at a time when the new Republic was struggling to stay alive and was utterly dependent on growing its economy at full tilt. From its beginnings the U.S. private sector had a social and political duty only indirectly related to maximizing its firms’ shareholder wealth.

The firm is an inherently historical and political notion that draws attention to the distinction between the public and private sectors. Thinking of the socio-economy as comprising three levels—the State, firms and citizenry—(figure 6.1) helps disentangle



directive and persuasive interventions, though we should be cautious of the hidden assumptions in Parsons's or Coleman's multi-leveled legacy (Coleman 1974; Parsons 1951). There may be no ontology to match the commonsense of superior and subordinate entities with a government or Leviathan at the top and private citizens at the bottom—perhaps with “precariat” or another disenfranchised people in semi-darkness below (Bodnar 2006; Standing 2009, 2011; Tari and Vanni 2009). Non-governmental social institutions like firms, professional associations and collectives comprise the middle layer of this three-layer model of capitalist democratic society, the emergent social structure that marked the end of the feudal era (Coleman 1974). These “levels” have different processes, so we open up three types of route to a more humanized ToF.

**FIGURE 6.1: Socio-economic levels**



We might presume the priority of the “upper” societal level, that firms exist to serve society by supplying its various needs for goods, services, employment, investment, socialization, and so on (Canals 2010). Democratic politics is the chosen process at this upper level, so humanizing means debates about directing firms towards greater social benefit—as the political process defines that. Sarbanes-Oxley and Dodd-Frank are examples. The debate is about public administration, about managing the socio-economy, albeit using firms as instruments of public policy rather than managing as we teach it in our private sector-oriented BSchools. Public officials might direct and constrain the private firms’ or a sector’s activities using their legal and normative instruments (Self 1972; Waldo 1953). But how might the resulting performance be

measured? Lacking the sophisticated metrics of public administrators, we BSchoolers assume profit as a workable proxy for social benefit—so presume, perhaps, that bankrupt firms should be removed from the economic pool and their resources dispersed. Yet an obvious humanizing initiative at the macro-level is State intervention to protect employment such as the TARP investments in GM and Chrysler.

As so often our commitment to the ideology of market forces and “free trading” leads us to ignore the real story of our private sectors and the degree to which, for instance, “infant industries” were protected using arguments that can be seen as humanizing initiatives at the upper level (Chang 2002). This history aside, while legislation clearly has a hand in how profits are calculated, we expect firms to make a profit through freely chosen market operations. That some firms continue to invest in sectors or industries with historically low ROIs is not immediately a matter of concern even though yet, if profit is the thing, this should be sub-optimal for the nation. The politics is quite different. Economic variety matters and a macro-level humanizing project might be tied up with finding ways to promote a more beneficial mix of activities—ensuring that promoting corn for ethanol, while reducing our dependence on imported oil, does not inadvertently increase the price of everyday foodstuffs or precipitate a shortage of some other crop. Likewise we might try to re-engineer a region’s economy away from declining industries and towards those with more of a future by promoting “innovation”—science parks and the usual mix of high-tech and bio-tech boosters. Our socio-economy is heterogeneous, comprising more than one industry and market, so one of the penalties for over-emphasizing “hands off” control by market forces is under-emphasizing the politics of heterogeneity and the macro-humanizing implications of changing mixes.

There is also confusion about the relationship between firms and markets—and not having a theory of the real-world firm implies we also lack a theory of real-world markets. Even as we speak about “the economy” and “market forces”, preferring the market as the appropriate means of controlling private firms, Simon reminded us of the predominance of organizations and their admin-

istration. He argued that if we cared—or dared—to look closely we would see our socio-economies are comprised of managed organizations rather than free market operations (Simon 1991). Real world markets are simply multi-threaded social processes that link organizations, governments, the public sectors, competitors, suppliers, employees and so on. Markets are just ways of speaking of these interactions and may have no ontology of their own. Private firms are likewise no more than multiple obscure processes that stand between individuals and society, clouding the notion of personal responsibility. Consequently the public and private sectors present different moral and ethical challenges. A public official's accepting a bribe may seem different from a salesman bribing for business, for corruption is a grave threat to the political fabric while private sector bribes shade off into commission payments and may be no more than a cost of doing business.

In spite of their initiating social duty to keep the public sector honest, firms have hugely extended their freedoms as they became instruments of private interests. The “innovation” of the limited liability company, a huge step in the development of Western capitalist democracy, helped institutionalize this trend. The modern firm is an update on an ancient form of collaboration that was significantly advanced during the Dutch Republic (1581–1795). The Netherlanders' firms became property-owning entities legally, normatively, and socially distinguishable from their shareholders, employees, customers, suppliers and so on (Cook 2007; de Vries and Van der Woude 1997; Gelderblom 2010). They were given a presence or identity at law so they could buy and sell things, be sued and otherwise held responsible for failures to conform to corporate laws or for offenses against the general weal. The private firm is obliged to have a charter (certificate of incorporation), a legal article of incorporation that commits it to specific operations as part of seeking its government's permission to exist—along with a capital investment that gives it fiscal substance. The charter bounds the freedoms granted. Modern firms are predominantly of limited liability, allowing investors to participate without risking their entire wealth. Incorporation separates the firm and its social context, setting up questions about the degree to which the legal, social and political constraints that act on

citizens also act on them as employees of the firm or whether they are relieved of these responsibilities by those who employ them. The separation also raises questions about the employee's "decision to participate" that match the investor's decision to invest (Barnard 1938; Simon 1947).

To understand the public impact of the private firm—beyond their being instruments of public policy—means distinguishing the firm's private returns from the inevitable public "spill-over" returns its operations cause (Spender 1997; Tassey 1992). The originating idea of pressuring the public sector prioritized the public returns and left these private returns to one side. It was the entrepreneur's return and of no political interest. Even without knowing how to measure public returns to private firms' activity, the history of corporate law shows there was always a degree of regulation as society's macro-level management of their impact (Horwitz 1992). Firms' structure and function inevitably reflects and is partially defined by the regulatory instruments used, primarily legal, institutional and infrastructural, though some are cultural and less fully spelt out. Entrepreneurs start out opportunistically exploring what is permitted. Thus, there are differences between firms, partnerships, public agencies, NGOs and so on—different instruments and political ideas shaping each. There seems to have been little research into how alternative structures bear on the humanizing agenda, though those arguing for cooperatives or German-firm style co-determination see ToFs they consider more stable and effective than the U.S. private firm.

At the macro-level a newly humanized theory of the firm simply implies new legislation and regulatory tools. Today there are armies of lawyers, accountants, and regulators—and lobbyists—working on "reforming" the existing panoply of U.S. corporation-defining instruments. The Obama administration called for major reforms, especially in the financial services industry. While there are continuing debates about what contributed to the financial collapse in the U.S. in 2008, there is widespread agreement that the 1999 roll-back of the Glass-Steagall Act of 1933 opened the doors to egregious destructive speculation. The temptations and moral hazards exposed apparently proved irresistible to many—managers, investors, house-buyers, etc. It was clearly widespread,

even systemic, certainly not just a few “bad apples” or Bernie Mad-offs. Reform might mean reinstating Glass-Steagall or, at minimum, ensuring the 2010 Dodd-Frank Act retains its few teeth.

What new theory of the firm is being proposed, given the bitter political resistance to even these modest reforms? Is the regulative battle simply proxy for the politics of setting laissez-faire capitalism against another more liberal model or, as we say in the U.S., more socialist vision of society—the spoils being tax-breaks for a few rather than broader productivity and employment? The point being that a “new theory of the firm” might be focused on new ways of governing the socio-economy within which the “new” ToF would be no more than a minor instrument of a new political theory. No doubt that many are calling for new corporate oversight, arguing that our current approach is failing nationally and globally. Some commentators, such as Zbigniew Brzezinski, go further and argue that it is not simply about governing firms but about re-inventing democratic capitalism as a practical political philosophy for today’s world. He and others argue that the rapid global flow of information, demand, production, capital and goods has led to a geo-political instability that is mankind’s gravest challenge, that the economics-oriented system is threatening rather than promoting humanity; an urgent argument for new political thought, not merely a new view of the firm.

Rather than knowing what firms are and calling for our challenge stems from our failure to grasp the essence of the firm as it is already—and therefore what we might urge others to change. Our poor understanding of the firm also undermines our notions of management as well as any grander attempt to deal with *Das Ziggy-Problem* of global instability. Sennett’s analysis of the culture of the new capitalism of “outsourcing” and the “hollow corporation” shows how most of the post-WW2 economic institutions have become unstable (Sennett 2006). The changes have led to an expanding global class of temporary and part-time workers, labeled the “precariat”, whose economic existence is tenuous, who live hand-to-mouth, and who have no prospect of retirement pensions and in most cases, no health-care either (Standing 2009, 2011). Our college graduates are increasingly headed into the precariat as student debt spirals upwards. While there have always been

temporary workers especially in developing nations, the precariat's recent growth and increasingly central place in the developed economies has major economic, educational and political implications.

Purposive collaboration is probably mankind's most significant social, cultural and practical achievement, what most clearly distinguishes us from the other species with whom we share this planet—not that they do not collaborate but we seem to collaborate more frequently and consequentially. There is nothing new or radical here and there are many echoes in Catholic Social Teaching and its acceptance of the pivotal role of the entrepreneur (Stackhouse et al. 1995; Zimmerli, Richter and Holzinger 2007). In a capitalist democracy much of politics is therefore about determining which economic collaborations are legitimate—such as SMEs—and which are not—such as the Mafia. Legitimizing the private firm means accepting its existence and activity and the entrepreneurial activity that brings it into being and sets it in motion. We can distinguish Cantillon's notion of entrepreneurship from Jean-Baptiste Say's—the former looking for economic or arbitrage trading opportunities, the later focused on articulating them into the economy (Cantillon 2010; Hayek 1985). There were precursors to our modern economy in China, India, and many other nations; so while it is clear that the firm, as a socio-economic artifact was known to many before it became central to our democratic capitalist society, it must be analyzed in terms of its current historical and political context (Chamberlain 1976; Chaudhuri 1985; Kennedy 2007). Thus the call for a new theory of the firm is implicitly a call to improve our understanding of politically embedded purposive human collaboration.

The comments above present democratic capitalism as a three-tiered activity—and firms as pivotal instruments of national policy. At the model's upper level we see humanizing agendas to “engineer” a more humane socio-economy—creating more wealth, more economic growth, better employment, producing society-improving products, minimizing pollution, generating funds for the public sector and infrastructure, providing healthcare and education, home-help for working mothers, etc. At the bottom or third level, that of the citizenry, there are similar policy issues.

Thus we debate whether welfare leads to dependency or teaching business students neoclassical economics is an anti-social form of social engineering (Bach 1958; Bach and Kelley 1984; Ferraro, Pfeffer and Sutton 2005; Ghoshal 2005; Ghoshal and Moran 1996; Hambrick 2005; Teece and Winter 1984).

Note that neither the upper-level nor the lower-level discussion is a critique of the neoclassical ToF *per se*. It is about deploying social power to re-direct firms in ways that are not directly related to the firm's own activities and objectives and a specific ToF is not implied, yet deciding what we mean by "the firm" is a necessary part of operationalizing any political decision. For instance, many presume that moving a firm away from profit maximizing reduces its profit and its shareholders' wealth, but until the specific ToF has been surfaced there is no way to justify this conclusion. As ecological activists show, a firm may make no less profit when it takes steps to reduce its anti-social effluents (e. g. carpet making). There are few generalizations here, each case differs and, absent a specific ToF, profit maximization should be considered orthogonal to social benefit, as many proponents of "green business" and "win-win solutions" argue (Spender 2011b). The analysis is not viable until the levels are connected together for we know a useful ToF has implications at all three. Only then can we deal with the principal discourse around the humanizing project—responding to the neoclassical theory of the firm. The groundwork above shows that once we accept the legitimacy and regulation of the private firm as currently articulated and its contractual freedom to act in whatever way it chooses within a set of externally determined constraints, the question is not how to intervene but how to rewrite the contract to justify intervention.

There are two main arguments; at the upper level, around social costs and benefits, at the lower level, around human rights. The U.S.'s anti-trust legislation (the Sherman and Clayton Acts, for instance) had its origin in trade policies that go back to the Roman Empire and beyond. Its purpose was to resist practices that were held to work against democracy and the public interest. They extended the notion of social costs beyond direct externalities like pollution to include monopolistic profits judged inappropriate. Humanizing then means their elimination or at least

developing a keener sense of the social benefits and costs of the private sector's activities. These arguments are obviously many dimensioned and complex. At the lower level, even as private firms have been granted the freedom to choose their own form of internal organization, establishing a "mini-society" legally walled-off from society at large, this freedom has been subject to considerable legal re-specification and limitation. Child labor figures large in the history of labor law but there has been a proliferation of such laws—racial discrimination, sexual harassment, minimum wage and so on. At both upper and lower levels, the humanizing project is about modifying the freedom of private sector managers to do whatever they wish, to embed the firm's activities into the legal, social and institutional fabric. The public's rights to intervene are not grounded in "natural law" but are socio-historically contextualized in the specifics of each State's democratic process and prospective acceptance of the private sector.

In the next section I consider today's inventory of ToFs. Some, such as the neoclassical firm are not able to relate all three levels so long as we see society as unlike a perfect market. Other ToFs are more useful. Stakeholder theory, for instance, attempts to relate richer models of society, firm, and individual. Behind the analysis lies a methodological question—whether our project presumes a single unifying theory of the firm that would position the items in our inventory of ToFs as special cases. If this theory were found it would obviously be a basis for a theory of the fully humanized firm. On the other hand, if it cannot be found, then one aspect of the humanizing project must be the choice of ToF to underpin the debate around justifying intervention into the private firm's legitimate domain. The discussion will be political, contrasting the public's notion of humanizing with management's right to choose, probably central to their notion of humanizing.

### **6.3. Theories of the firm**

Our discipline has long accepted a multiplicity of private sector ToFs. Morgan's classic presentation proposed eight. Scott suggested three categories of ToFs; rational, natural and open. Rosanas focused on two; agency theory and institutional theory. Micro econo-



mists have their handful; production function, TCE, principal-agent theory, property rights, team theory, RBV, dynamic capabilities, etc. (Demsetz 1991; K. Foss and N. J. Foss 2005; Foss and Klein 2005a, 2005b; Foss and Knudsen 1996; Foss and Knudsen 2003). Strategy consultants and theorists have their handful too; SWOT, BCG matrix, 5-forces, value chain, etc. for these are ToFs too. There are also organization theory's favorites, bureaucratic, systems, and behavioral theories. Rather than going through this long list haphazardly, theory by theory, to see how they are each constructed and how their notion of humanizing might differ, two questions seem relevant; (a) why so many theories, and (b) can they be categorized in ways that illuminate their essential differences?

Theories of the firm address four basic questions: why firms exist, why their boundaries are as they are, why their internal structure is as it is and why their performance is so varied (Kraaijenbrink and Spender 2011). So one way of sorting the inventory is in terms of the different problematics they address. TCE, for instance, addresses the boundary question while not having much to say about why firms exist. Team theory, on the other hand, addresses existence without paying much attention to internal organization. The Diamond-Divbig theory is precise about why banks exist but says nothing about other questions. Adam Smith's notion of the division of labor and the "value chain" are focused on internal heterogeneity without stressing administrative structure. Bureaucratic theory stresses administrative and productive structure without considering why firms exist—and so on. There is no clear path here.

The contrast between these various theories of the firm and neoclassical economic theory is still illuminating. Neoclassical theory clearly stands as a boundary or limiting condition in what sociologists might call an ideal type. The firm is a "perfect" link between supply and demand markets or functions, leading to the commonplace that the theory of the firm is really a theory of markets; the firm's perfect rationality renders it transparent and it disappears from the analysis. Simon's observation that under total rationality there would be no need for a science of administration or, by implication, a ToF, restated this. Our inventory of theories insert themselves into an analysis only because they indicate the

many different ways in which real firms lack the transparency of the neoclassical theorists' firm. The real firm implies a failure to meet the expectations of total transparency or, put another way, the firm's nature is not universal but contingent on the specifics of a failure.

The failure metaphor is interesting. Real firms exist only because of market failures—perfect markets have no need of firms. Real people are only definable in the ways they fail to meet the expectations of RM—otherwise they would seem to be no more than exemplars of an ideal type, being blandly homogeneous they would vanish from the analysis. Failure is the source of our identity. In both cases, total rationality leads the entity—firm or person—to vanish from the analysis—be that the perfection of rational man, present in neoclassical economics only as an axiom to the analysis, or that of the neoclassical firm, equally present as an axiom to the perfectly rational economy. Thinking about the interplay of failures in individuals and markets persuaded Simon that there could be a science of administration that might bring imperfect people together into an organization whose behavior would approach full rationality. In this sense, he spent much of his career looking for a theory of the firm that would repair the damage his devastating critique of RM had wrought.

The plethora of ToFs arises from the many ways in which we see the expectations of full rationality not being met in real-world economic activity. Thus, bureaucratic theory for instance, leaves choosing the firm's goal up to the Board—pushed outside the bureaucratic apparatus and the analysis—given there is no certainty about which of all possible goals is the one that would maximize profit (presuming that is their objective). Maximization and rationality are perfectly tenable in the abstract but become much more problematic as soon as the firm is embedded or situated in a real economy. In the background is the recognition that (a) if the socio-economy were rationally constructed and operated and all actors, individuals, institutions, firms and so on, were fully rational, then the whole analysis would hang together and evidence the full power of the neoclassical analysis. (b) given such homogeneity there would be problems about determining the boundaries of each entity and thus, around separating the three levels and

the actors at each level. Why would there ever be more than one firm—or more than one market in an economy? Microeconomic analysis starts from the presupposition that there are distinct demand and supply markets to be linked and that the firm is a device for bridging or repairing this disjunction, this “unnaturalness” or more precisely, for producing the perfection of equilibrium. Where does the idea of separate markets (or products) come from, if it is not a description of the real world?

The microeconomic discipline has changed substantially since Coase asked his killer question—why firms? Micro economists on their way to addressing it translated this “existence problem” into a boundary problem—the puzzle that motivated a generation of economists such as Joan Robinson, Triffin, Chamberlin and Penrose. What determines the size of firms? Why was firm size a power law (Ijiri and Simon 1977)? In the 1960s a new generation of micro economists retreated from the boundary question to explore how different kinds of imperfection led to different ToFs, thereby presuming the existence of firms with rationally determined boundaries and focusing their questions on firm structure and performance. With considerable vigor, they seized these questions away from organization theorists, taking the initiative in ways that had a profound effect on BSchools (Amadae 2003; Amadae and De Mesquita 1999; Peck 2010).

What did these micro-economists achieve and how does it bear on our humanizing project? Ironically, given the micro-economists’ attachment to rationality, their principal contribution has been methodological, leading to a pluralism that denies the usefulness of perfect rationality. The theory of the firm must be grounded in real-world failure and we have no coherent theory of the real world as pluralism becomes a key methodological issue in the humanizing project for each ToF stands on a particular failure or imperfection. The micro-economists’ project is re-framed as repairing this heterogeneity of failures. For example, the disjunction between supply and demand markets is simply one category of failure. The firm as a production function is invoked as the apparatus to repair this failure.

The term “theory” has changed over the centuries. To oversimplify the point, prior to the 19th century rise of positivism, “theo-

ricing” meant privileging a disengaged way of looking at a practice or phenomenon. The theorist speculated about things, as opposed to those who did them—the theory-practice distinction. Today we might say this distinguishes two kinds of knowing—explicit or tacit, or know-what and know-how. The Enlightenment philosophers privileged rationality, arguing the “speculator” should engage his/her rational powers in the construction of his/her view. Given the fallibility of our senses, knowledge could not be an objective representation or “photograph” of reality; on the contrary, we actively create or construct our knowledge. The human actor’s part in creating knowledge was excised in the positivist approach to the sciences of Nature. The new “objective” presumption was that relying on rationality alone we could gain access to Nature. Every right-thinking (rational) person would see the phenomenon in the same way as it really was, for we presume one person’s rationality identical to another’s. The identity of the theorist became irrelevant. Theory was about Nature’s nature and process, not about people’s thinking.

This view certainly seemed useful in situations that have little or nothing to do with human choices—the movement of the planets, geology, biology and so on. It seems more problematic when it comes to the social sciences, our political, economic and organizational choices and activities. Debates about whether the social and natural sciences are similar or different continue. Much of the European discussion on this goes back to Vico who argued that since we can have no access to the mind of God, the architect of Nature, we can never have certain knowledge of Nature’s workings (Berlin 2000). However, we may have knowledge of a very different type when it comes to understanding the things we have created. Vico was interested in the evolution of language and legal systems—things that did not occur in Nature but were constructed by us (Vico 1988).

The positivist theorists’ urge to explain and measure that everything in terms of causes located in the situation was intended to cut the human agent out of the analysis in all respects save the instrumental one of computing those causes and their effects—an activity wherein all humans, being rational or otherwise, could be considered identical. It specifically denies human uniqueness,

so clearly offends Kant’s dictum and the Golden rule and is dehumanizing on methodological grounds alone. At the lower level of the model then, the idea of humanizing is quite different from that at the upper level, where the concept is grounded in society-wide or universal norms. Lower-level humanizing spins around the uniqueness of the individual and the entailed notion of virtue—our heterogeneity. Thus, the humanizing project breaks into two very different projects; (a) an upper-level “systemic” project of directing firms towards greater shared social benefit or reduced social cost, the politically shaped production of a more-just or more-moral society and (b) finding a non-instrumental place for the uniqueness of human beings in the ToF adopted.

Thus, each of the ToFs in our inventory is different in the way it frames human beings’ idiosyncratic participation in the firm as a context of human practice. The positivist approach to the theory looks to cut all idiosyncrasies out and explain the participation as rational computation. So against this, we position a humanist or agentic approach (Table 6.1).

**TABLE 6.1: Socio-economic levels for ToFs**

	<b>theory</b>	<b>agency</b>
Society		
Social institutions		
Individuals		

The purpose of this framing is to support the idea of human agents idiosyncratically “repairing” the imperfections on which the ToF itself stands. Going back to the presumption of supply and demand markets, the agentic activity is entrepreneurial and consistent with the upper-level humanizing, is therefore socially progressive and humanizing. Ironically, this comes through into micro economics as the assumption that the enterprise that links separated markets—for instance, having merchantmen ply between Amsterdam and the Spice Islands—leads to an overall increase in economic value. Repairing the “economic damage” or imperfection adds new value not previously present in the economic universe. Capitalist democracy takes this improvement as

axiomatic, the result of some kind of “invisible hand”. I am not here concerned with justifying this view—though I would argue that it is not a theoretical matter at all but a purely empirical one open to historical analysis. In general, if we take ToFs as founded on failure, the presumption is that social and economic value is added by repairing the failure.

The lower-level concept of humanizing is about human heterogeneity and prioritizing it against or as a complement to human homogeneity—another entry of pluralism into the analysis. The positivist project rejects pluralism and theorizes human participation as homogeneous. The humanist project in contrast, is about finding a place within each ToF that admits our identity-defining heterogeneity and thereby engages our moral and ethical responsibilities. Just as difference rather than correspondence defines the meaning of our words, so we are defined by our idiosyncrasies or differences rather than in terms of our imperfect likeness to the ideal (Luhmann 2002). Democracy is about pluralism and heterogeneity—political, racial, gender, skill, imagination, status, etc.—as key to a humanized society’s process. Not only is heterogeneity applauded, contained and harvested, it provides the essential social tension and the driving force behind human progress. Heterogeneity is a source of our dynamism but paradoxical and Janus-like, for it may be both progressive and regressive. The humanizing project is about shaping the on-going dynamism and non-equilibrium that when heterogeneity is made central to society. Obviously human heterogeneity affects more than our economic affairs—so, at least at first sight, the project to humanize the firm seems narrower, but how might it work in practice?

#### **6.4. Some ToFs in practice**

The Diamond-Divbig explanation for the existence of banks is that lenders and borrowers have different liquidity preferences (Diamond 1984, 2007). They defined banks as an intermediating social institution that increases value overall by repairing imperfections in the heterogeneous distribution of capital and uses to which it might be put. Economies depend on intermediating institutions. De Soto, for instance, argued that the world system vastly favors the

already rich and hinders the poor because the poor have less access to the institutions that, *inter alia*, lessen the cost of capital and allow illiquid assets to be used as collateral (De Soto 2000). At the same time “disintermediation”, the elimination of inefficient middlemen and usurious moneylenders, can improve economic efficiency. A conclusion is that, absent a deterministic (positivist) theory of the world indicating how it should “repair” its imperfections, the humanizing project is a contingent empirical and socio-political matter, often obscured when we ignore our history or our dogmatic ideological commitment to, say, “market forces”.

Just as how we use theory is an empirical matter—thinking is not inherently anti-humanist, quite the opposite as we can use our theorizing to “humanize”. The methodological challenge is the conflict between the universality or generality of a theoretical statement or “law” and the uniqueness of the human situation to which we are trying to apply it. If the situation is no more than an instance of the general, its uniqueness is denied. One approach is to find how Nature works and get out of its way—stopping smoking as an instantiation of the general “law” that smoking causes lung cancer. An alternative is to use our theorizing to enhance Nature’s workings—and use an antibiotic to treat a condition—an instance of pursuing theory to increase our control over Nature and thereby, our condition. But a human being is more than a medical condition. This particular person might believe that drugs are unethical, or might have an allergic reaction or might prefer the limited supply be made available to children first or ...and so on, so building up the complex of idiosyncrasies that distinguish us from each other. As we discuss, diagnose, explain and advise, we make use of the theories that might apply to the particular. Thus theorizing gets absorbed into our rhetorical processes as we propose, justify or reject alternative practices. Note the humanizing dimension does not lie in the theorizing itself but in how we deploy it as part of the social and political rhetoric. We can use theory to highlight the nature of our actions, endorsing and exposing our responsibility or we can try to hide behind it by arguing “the facts” dictate our actions.

Each ToF in our inventory offers us a different way of discussing human choice, agency, action and responsibility. A theory of

the firm is focused on the agency of its managers but almost everyone involved makes these choices all the time. Take, for instance, the BCG matrix. Its essence is managing the flow of funds from “cash cows” to “question-marks”—helping them develop into “stars” that ultimately mature into cash cows and repeat the cycle. The matrix requires (a) the firm be a portfolio of comparable investment opportunities; with (b) the relevant financial market internalized and (c) all business opportunities conforming to an assumed life-cycle theory of opportunity nascence, growth, and maturity. In principle it might be possible to quantify many of the probabilities in the cycle—the ability of cash cows to throw off funds, the probability that question-marks evolve into stars, the time taken for stars to mature into cash-cows and so on. As we solidify in this way, the ToF approaches a deterministic model of a particular economic world. Of course, the popularity of the BCG matrix had little to do with using it this way. It was more often a guide to “strategy making” where this is defined as clarifying as far as possible, the situation calling for management’s agentic (strategic) choosing. The matrix offered managers a model of their firm—as a bundle of investment opportunities—that they might find more appropriate than thinking of their firm as a production function defined by its markets or a goal-pursuing mechanical apparatus. The term of art here is “strategic framing”. The BCG matrix invites managers to frame their situation in a particular way and judge it one of internal funds flow—in contrast perhaps to the Ansoff matrix, which calls for them to focus on the differing risks in its product-market portfolio or the Chandler strategy-structure “fit” model.

When they apply the BCG matrix, managers must make a cascade of strategic or agentic choices, repairing the linkages so that value-adding activity can proceed. First comes the choice of the BCG matrix from among the other “tools” available, then comes identifying the portfolio, then comes allocating the opportunities into the matrix’s quadrants, then comes deciding the funds to be brought into the cycle, then comes deciding which items are “dogs”, meaning they cannot be brought into the cycle, and deciding what to do with them and so on. The positivist impulse is to think the cascade externally determined, objective, using well-



proven metrics (such as market share) to eliminate “judgmental” non-rational elements from the discussion. This would be using the BCG matrix to de-humanize the managers’ strategic process. Such instrumentality stands in contrast to the agentic and humanizing aspects of management’s choices as expressions of their personal or collective uniqueness. Ironically, the private sector places managerial uniqueness and entrepreneurship at the center of the analysis and it lies at the core of its culture. Entrepreneurial managers welcome any help with their framing task but remain properly suspicious of any theorizing that denies their agency.

By admitting human agency, the private sector reaches beyond its initiating social duty to police the public sector and begins to serve as the socio-economy’s principal engine of discovery and economic growth. As managements make their strategic choices, they shape the lives of others and so take on moral and ethical responsibilities they would have no need to consider if the numbers “spoke for themselves”. As for the BCG matrix, we know many subordinate managers objected to their operations being classified as “cash-cows”, for the resulting loss of the funds meant they could not re-invest in their own business opportunity and the categorization turned into a “self-fulfilling prophecy”. Others objected the “question-marks” were able to escape the evaluation measures applied to the rest of the firm, then no longer a “level playing field”.

The lack of a coherent theory of the world in which the firm is located is simply one aspect of the uncertainty endemic to our affairs and situation. It separates our thinking from the world being thought about and so makes theorizing relevant. It only makes sense to talk about human agency in the absence of full knowledge and its concomitant determinism—an echo of the free will and determinism debate. There is no point in talking about human agency as making a difference in the world if everything is already determined. Likewise, it only makes sense to talk about human knowledge because we lack certainty. If the world presented itself to us openly and unequivocally there would be nothing to know or talk about. Far from knowing everything, we would know nothing—because we could never contrast what we knew against what we did not. Likewise we would have no need to ob-

jectify, categorize, or differentiate things because we would understand how everything was connected to everything else in the “great scheme of things”. Ultimately, the meaning of humanizing lies in the distinction between a positivist attitude to knowledge—the modernist project to generate certainty—against an older attitude, the humanist need to debate our actions in the world as if it was comprised of others towards whom we have inalienable responsibilities—as if we are social beings rather than RM-like isolates. Again, humanizing turns on our attitude to our knowledge and the actions it shapes.

The BCG matrix is a relatively lightweight example of analyzing a ToF to get a sense of how the humanizing attitude might shape a management’s responsible actions. The list of alternative ToFs is long, so I economize and look at only two well known others. The object is not to develop a “humanized theory of the firm”; that is not the correct project. For in our field, humanizing means finding how and where to admit human uniqueness and heterogeneity into the analysis of the firm—and to address the moral and ethical responsibilities to others and to the Self that comes with that. The object is to develop a methodology for looking at ToFs to discover the points of leverage they offer to agentic managers.

Texts on ethics often open with examples of people caught in tough personal situations (Longtin and Peach 2003). Texts on business ethics typically map similar tough personal choices into the managerial context—without considering the ToF that would make the re-positioning meaningful (Finlay 1995; Stackhouse et al. 1995). We need to know how the BCG matrix works before we can identify the morally and ethically burdened humanizing choices the firm’s managers must make. One of the reasons for the discussion of public-private sector relations in the paper’s opening section is to argue that there is no immediate reason to think the firm’s milieu is morally or ethically burdened—so long as the firm sticks to the law and its charter, who is to say anything further? The firm has its own domain and, as a “legal fiction”, has none of the moral and ethical duties we have as citizens. Thus, the entire “humanizing the firm” project relies on uncovering the specific place/s in the theory of the firm that admit the managers’ agency. Abandoning the search for an overarching morally and

ethically penetrated ToF, the project is restructured into a project to develop a method to uncover management's strategic and thus ethically burdened choices—by confronting the heterogeneity of ToFs and the specifics that differentiate them.

To help illustrate this method I shall deal with two ToFs that have attracted our field's attention for very different reasons—principal-agent theory and Porter's 5-force model. Principal-agent theory (PAT) has been widely lambasted for providing the intellectual legitimization of shareholder capitalism and is considered ethically offensive on that score alone (Gintis and Khurana 2006; Khurana 2007). This is missing the point made above—that humanizing is about our attitude towards, and use of, our theorizing. Clearly principal-agent theory is important in our inventory of ToFs. Instead of focusing on the trading link between supply and demand that, given an efficient market, should be transparent and fair, PAT focuses on the relationship between superior and subordinate. Recall that Coase considered the “master-servant” relationship as best illuminating the “nature of the firm”, and PAT—which has little to do with “agency theory” even though it is commonly mislabeled as such (Gintis and Khurana 2006; Miller and Sardais 2011)—theorizes a microcosm of the real firm.

While the principal-agent relationship has a long history the contemporary PAT discussion takes off from Jensen and Meckling's 1976 paper (Spender 2011a). They address an imperfection, the knowledge asymmetry or lack of transparency between principal and agent that allows the agent to act in ways not fully aligned with the interests of the principal. The principal, for his part, offers the agent incentives to act in his interest and incurs further monitoring costs to check on the agent's activities. In a sense, the principal is looking to shut down or shape the agent's agency. PAT has been drawn into the discussion of the causes and implications of the 2008 financial collapse. Jensen and Meckling's paper proposed a single-period rational solution to the structuring of incentive and monitoring costs, homogenizing or generalizing the “principal-agent problem” and seeming to shut the heterogeneity of managerial agentic practice out of the analysis. Many have suggested that if PAT and, in particular the “perverse incentives” that undoubtedly created conditions of “moral haz-

ard”, had been properly understood and applied in the financial and housing markets, the collapse could have been avoided. Proponents of regulatory reform are looking for structures and measures designed with PAT in mind.

It turns out that Jensen and Meckling’s contribution to the PAT discussion has been extremely damaging, drawing attention away from the heterogeneity of the managerial agency actually needed to deal with the superior-subordinate relations that characterize firms. The specific cause of this damage is the logical error in their paper. Close inspection shows Jensen and Meckling’s rationality-based solution depends on the existence of efficient markets and the signals these markets send to the intendedly rational actors (Spender 2011a). If the world was made up of efficient markets, the only economic actors would be principals—there would be no agents. The principal-agent relationship would never have arisen to be theorized.

The broader PAT literature presumes a very different situation; one that calls for the kinds of managerial strategizing illustrated in the application of the BCG matrix. In particular Fama’s 1980 paper shows the principal-agent relationship as bridging between an imperfect market for capital investments and a quite differently imperfect market for managerial labor. Fama’s conclusion was that (a) there could be no rigorous solution to managers’ balancing of losses, incentives and monitoring, and (b) stability emerges from the actors’ multi-period capacity for mutual adjustment, learning and negotiation. The principal and agent get to know each other and how to work together—very commonsensed and humanized. There can be no learning in a single period model, so while Fama’s analysis turns of learning, it is excluded in the Jensen and Meckling analysis. Learning, in this ToF, is a metaphor for humanizing, for it links the uniqueness of experience to our agentic choosing. The ongoing dynamism of the principal-agent relationship was even better illustrated in White’s historical analysis (White 1991). He noted that the principal-agent relationship is often fluid—even to the extent of reversing roles as the context of the relationship changes. In Fama’s analysis, managers must make strategic choices about which agents to hire, which markets to address while stabilizing the relationships that constitute the firm

and what incentives and monitoring to set up. These choices deal with the actors' and the markets' imperfections and uncertainties. The resulting choices situate and articulate the inevitable ethical and moral dimensions of their agency.

To move to the second model, many think of Porter's 5-force model as a fully determining strategic analysis at the level of the industry. This is unfortunate for it bears little relation to Porter's own explanations. The five forces are descriptions of the different kinds of pressures being brought to bear on the firm's idiosyncratic rent-stream (Spender and Kraaijenbrink 2011). They describe rather than rigorously model the multi-dimensional world in which the firm is situated. There is no coherent model, in the sense of the five forces being reducible, one to another and they certainly do not model "an industry". They describe a particular firm's view of its economic and political situation, with the anti-monopoly regulators hovering in the background. While "rivalry" defines other firms within the industry, the other "forces" point to those outside. Customers are seldom in the same industry as suppliers. Technological changes typically come from outside the industries they impact most. Porter wrote that his work is intended to help managers decide what to focus on as they view their firm's situation and the strategic options open to them—which can be re-expressed as help with "framing" the situation calling for their agentic input. The BCG matrix considers a single strategic choice—funds allocation—framed within the funds dimension mentioned previously; withdrawing funds from "cash cows" and investing them in "question-marks". Porter's model suggests five dimensions. The strategists' first task is to settle on some dimensions that (a) capture their sense of the firm's situation, and (b) offer some action options that might improve the firm's position. The dimensions are empirically generated indications of the limits to the management's strategic options—constraints to the exercise of their agency. When these dimensions are not heuristics or empirically derived "best practices" but are theorized into a rigorous analysis, the analysis collapses into deterministic theorizing. Thus, Porter's analysis is far subtler, turning on the single dimension or "currency" of "power"—measured in terms of others' ability to disturb the firm's rent-stream. While it lacks the BCG

matrix's investment life-cycle, there is actually more depth and multi-dimensionality in the differing timescales Porter engaged. It also opens the analysis to the "signaling" that led him into this line of thinking in the first place (Caves and Porter 1977; Porter 1976a, 1976b).

Jensen and Meckling claimed the PAT situation is fully determined and that all right-thinking people must arrive at the same conclusion; management's agency is denied. Fama (and White) suggested the opposite, that a PAT situation is an evolving and ethically penetrated multi-period social relationship between principal and agent. Likewise the analyses of Porter's five forces are not linked analytically but point to a multi-period, dynamic and under-determined complex of relationships. There is no zero-sum game relating supplier and customer power. There is no rigorous relationship between rivalry and the probability of new technology. The situation is deliberately framed as under-determined for the various ways in which the actors' choices are limited cannot be condensed into a coherent one-dimensioned analysis. As ever, agency is about the human process of dealing with or resolving heterogeneity as a situated socio-economic and ethical practice. The point where (and when) management's agency is called into the ToF tells us where the humanizing project intersects with the managerial task. Porter framed the strategic task as resolving the empirically grounded heterogeneity between five dimensions or characteristic constraints on the management's agency. As managers resolve these heuristics into reasoned action they invest their choices with moral and ethical content.

### **6.5. A methodology of/for agency**

The previous sections show that the humanizing project stands on a switch of method from generalities to particularities. Instead of imagining a more humane totalizing theory substituting, perhaps, moral maximization or "virtue" in lieu of economic maximization, we see theory itself, in the current positivistic sense, as potentially dehumanizing as it (a) denies what could be, as a result of being chosen by actors who act agentially and bring a specific future about, and (b) admits only what "must be" for reasons forever

beyond us. The switch is away from standing apart and analyzing, and into engagement and the practicalities of agentic choosing in an under-determined world. Humanizing is not only about an attitude to human knowing, engagement rather than observations, it is about appreciating the morally and ethically implications of using knowledge where it cannot but affect others. Knowing has no humane dimensions—neither does thinking. Humanizing is about action. The guilt we might feel about thinking “bad thoughts” is not part of our project—that is about the construction of the Self. Humanizing is about how we act while socially embedded, situated in the lived world beyond the privacy of our thinking in social space and time. That place is neither abstract nor time-free, so our project is not usefully informed by neoclassical theorizing.

As we switch method from prioritizing theory to prioritizing agentic practice, we transform the way we do and use analysis. The philosophy of science orients us towards the extraction of the general from the multiple specifics of experience because theory-production is our objective. If we are focused on the humane aspects of our practice, we move in the opposite direction, from the general to the specific. The agentic aspect of our practice is what of ourselves we put into the situation as we resolve the discovered absence of external causes. Our agency becomes the final cause that has no cause; it becomes who we are. In our agentic practice we reveal our humanity; its presence or absence, its moral and ethical dimensions. As we act in under-determined situations, we reveal our uniqueness and heterogeneity—rather than hiding it behind the claim that we act rationally, objectively and like all other right-thinking people. Our humanizing project is about “showing up”, revealing the uniqueness of the firm’s managers as they act; the very opposite of showing how they must act if they are rational.

The idiosyncrasy of our identity might be thought of as what remains after all generalities have been stripped away. We ignore the stereotypes of gender, age, nationality, education and so on—and eventually see the uniqueness that we add to life. Analyzing this means discovering and setting aside as many of the external or non-personal causes as we can, where these can be seen as constraints to the strategist’s agency, the “what could not be otherwise”. Just as freedom makes no sense if there are no constraints,

agency can only be understood in terms of the situation's constraints—the limits to how we are able to project ourselves into the situation. We frame the agentic “opportunity space” as we discover the constraints on the choosing actor, defining those aspects of the situation that are not otherwise determined by what we might regard as the facts of the situation. Theorizing is about laying out the full set of determining “independent variables” that make strategic choice irrelevant and so, shutting the choosing actor out of the analysis. Framing leaves open an “opportunity space”, the absence that human agency ultimately resolves. The opposition of generalities and specifics recalls the *Methodenstreit* and the debate over historical method, exemplified by the difference between “covering laws” of historical development such as the idea that wealth disparity leads to social unrest and for instance, Collingwood's idea of history as getting inside the head of the historical actor in question (Collingwood 1994, 1999; Vaughn 1994).

In the sections above, we looked at some ToFs to show how to surface those points at which management's agency is essential if reasoned practice is to result. The first section's exploration of the differences between the public and private sectors showed further, that firms operate within the legal constraints that define their charter and secondly, within the set of other constraints that show the other non-legal aspects of the firm's context that identify what it may not or should not do. This is what the organization “knows” about its environment, as Porter's analysis illustrates. More precisely, the management's knowledge encompasses both explicit and tacit types of knowledge, synthesizing the constraints to its agentic practice with the practice of projecting its agency into the space left unresolved. There is an allusion here to the constructivist concept of knowledge as the distillation of our experience of how we cannot change our situation—which is all we actually know about it. The constructivist assumption is Humean—that we reason from our experience rather than from some principles or covering laws that capture the essence of reality.

Given the firm is embedded in a specific socio-economy, its strategists have certain possibilities eliminated before they enter into their task. They do not seek the theory that determines the way things must be. They work instead, to frame the options that



arise precisely because the situation's uncertainties eliminate the determinism of theory. While many regard the practice desired as the selection and application of an optimal determining theory, agentic practice stands opposed—dealing with the uncertainties that theory cannot deal with. The inquiry method for agency focuses on the discovery of the constraints that either did or should enter into a strategist's process—and those upper-level constraints considered in the paper's first section are but one step in this method.

There are other steps at the lower level where the actor is an individual rather than a firm or the society. Traitist theory has so much resilience in entrepreneurial analysis because we presume different people approach agentic situations differently—differing in risk-propensity, ability to focus, experience and background, intellectual capability and so on. We presume heterogeneity, yet still want to capture it with some general categorization of the factors determining individuals' agentic practice. This may be a methodological error, reinforced by a century of empirical evidence that we have failed to identify the successful entrepreneur's traits. Instead of investigating the causes behind the entrepreneur's choosing this rather than that, a more profitable line of research may follow Collingwood's into establishing the constraints that defined a particular entrepreneurial situation. It is not clear that the traitist approach can be usefully expanded to consider faith, emotion, memory and the other concepts we use to capture our human uniqueness. If we could develop a richer model of the individual, it might well support a different part of the humanizing project. In its absence, the key to our project's method is its focus on the uniqueness of the situation and on its under-determination rather than on generalities about the characteristics of the person choosing.

Below the upper level societal and legal constraints are others that capture the idiosyncrasies of what managers have learnt about their situation from their own experiences and from those of others. Even BSchool education might come into play and shape manager's strategic choices. Since these choices are agentic and not merely enacting theorized prescriptions, they are morally and ethically burdened. The method here is that of inventorying

every possible constraint, but the idea of doing this is clearly arbitrary so long as we lack an overarching concept of agentic human action. The theory of rhetoric offers an entirely different universe of possibilities. The task of analyzing human practice to discover its moral and ethical content is, of course, similar to the task of justifying the choice to others. To say “I acted this way because...” is an appeal to determining constraints about which I suggest I had no choice. Most of us have discovered the naked expression of our agency—I acted this way because “it seemed like a good idea at the time”—is unpersuasive.

The Aristotelian trinity of *logos*, *ethos* and *pathos* suggests ways to examine human agentic practice and its justification. The contrasting dimensions match Barnard’s analysis of the “function of the executive” as bringing together the “incommensurate” physical, social and psychological sub-systems, so creating the firm (Barnard 1938). Justification becomes explanation and *vice versa*. While this might be helpful, rhetorical theory has a great deal more to offer, having benefited from millennia of thinking about how rhetors successfully shape the agentic practice of others (their audience). Entrepreneurs, as creators of agentic collaboration, are the rhetors of note in today’s socio-economy, in contrast to the political and judicial rhetors that dominated in Aristotle’s time. Redefining entrepreneurs as rhetors shifts the focus from opportunity creation or discovery—given that “ideas are ten-a-penny”—and onto the practice of realizing the opportunity as real-world social practice that adds value (Sarasvathy 2008). The entrepreneur searches for some unoccupied socio-economic “space” that his or her agency and rhetorical skills can resolve and possess as the private firm’s legitimate value-adding domain—and actualizes this by persuading others into like views.

Rhetorical theory also addresses the constraints to the rhetor’s choices in the analysis of “stases”, ways in which the overall task is deconstructed and associated with different stages of the argument. The questions noted previously that ToFs address—existence, boundaries, structure and performance—are modern versions of the classical conjectural, definitional, translativ and qualitative stases, a typology attributed to Hermogenes and Quintilian (Lauer 2004). Stasis theory also presumes a distinction be-

tween superior and inferior stases (Prelli 1989, 146)—essentially that between method (superior) and content (inferior). The four superior stases of rhetorical argument are methodological, evidential, interpretive and evaluative. The methodological switch from positivism to the method of agency shows how methodology moves from the background to become a superior stasis. Problematizing the nature of the firm and comparing and contrasting ToFs shows the superior evidential and interpretive stases. The claim that agentic activity is morally and ethically burdened shows the evaluative stasis.

What of the inferior stases? Coleman's three-level model suggests a cascade of content as the inferior stases come into the analysis. There is a cascade of evidence and interpretation between the constraints at the upper level and the eventual display of the agentic Self at the lowest level. Again, the analysis is being harnessed to the rhetorical tasks of explanation and justification; there may be no corresponding ontology. Indeed, Giddens's notion of structuration suggests the value of the three-level model is to set up the endless mutually constructing dynamic as upper-level structures narrow the options of lower-level actors, as they themselves emerge from the lower-level activities.

The practical question is about where to locate the agency that is the ultimate source of change. Systems theory, especially as Boulding, saw it was an attempt to lift the analysis above the level of the individual (Boulding 1956). That would be workable if the system being analyzed was an equilibrium-seeking one. Assuming social systems have no agentic capability, it follows that the great weakness of systems theorizing is that it draws the analysis away from human agency and the non-equilibrium thinking it enables—so it is dehumanizing in this additional sense. Note especially, how the micro-foundational agenda pushes the analysis back to the individual level, the place where we can find agentic capacity (Felin and Spender 2009; Foss and Mahnke 2000; Foss and Mahoney 2010; Foss and Michailova 2009). But when we are not looking for agency but for the constraints to agency, many of these will be at other levels. The upper socio-legal level was considered earlier. Within the middle level of social institutions—and of the firm—there are obviously sub-levels. There is institution-

al theory, suggesting a sub-level of collectivities of firms. Within the organization there is heterogeneity—divisions, departments, teams and so on.

### 6.6. The agentic individual

Finally, lower at the level of the individual, there are notions of shaping the Self, training, professionalization or, as Simon labeled it, engaging human beings' "docility". Rhetoric theory takes off from Isocrates's argument that the principal characteristic of human beings is that "they can persuade and be persuaded"—i. e. they are "docile", even though there is no reference to rhetoric in any of Simon's writings (Spender, forthcoming). The reader probably shares the view that teaching ethics should go beyond merely informing students about the ethical and moral issues of managing, to engage their processes of learning and self-management to help them become different more-ethical people. The scary bit is that if people are docile and changeable, they might equally well be changed for the worse. No question a viable theory of the firm is also a theory of personal change. But once Knightian uncertainty is made central to the analysis as the characteristic of our lives that draws in our human agency, the specter of radical relativism appears, as troublesome today as it was to Aristotle. Again we see the contrast of the general and the particular. Rather than proposing some ends as "naturally" superior to others, we turn again to our research methodology itself as the dominating superior stasis. Is our humanizing project about outlining a more-just theory of society, the firm, or the individual—as if any or all are simply objects? Or, is it about encouraging a particular thought-through method of being a society, a firm or an individual, a particular way of living?

Capitalist democracy is presumed in the first section of my paper. Aside from denying a Leviathan, it also denies the priority of the social-collective, as sometimes reflected, for instance, in Confucian, Communist, or Islamic thought (Boylan 2011). We presume individualism and property owning are foundational. Society is process—interaction between individuals and between individuals and property. The uncertainties around our part in the interaction

open the world to our human agency and thereby our flourishing. Laws shape the process as one dimension of constraint. It is also shaped by norms emerging from the interaction rather than from any “fiat” or edict. The individual is likewise redefined as the process of agentic being rather than being defined as an object, rational, political, emotional or otherwise. We place interaction such as learning, at the core of what it means to be individual. “To be is to act”—not merely to think, “believe or be of physical substance”. Our learning is about interaction with other individuals—all the social institutions that interested Vico such as language, law, and norms—and with property. The modern age is marked by an overwhelming interest in property and its place in the social process. Natural science is the process of learning from our interactions with property—the constructivist view mentioned earlier that stands against the positivist view that the interactions teach us something about “reality”. If we move in this direction, the locus of humanizing lies in our intervening in our society-shaping processes in the pursuit of change, growth, betterment, development, innovation, progress, flourishing; all terms we use to capture the dynamism of the ongoing process of being in an uncertain world—wherein “going where none have gone before” is always a possibility and all our agentic interventions are thereby morally and ethically burdened.

If tenable, the lower-level relationship between social and legally enfranchised individuals and the firm spins around these interaction processes. Do they allow, enable, or provoke individuals to progress and flourish? The goods and services firms produce are likewise to be judged on the basis of whether they encourage dynamism and progress. The notion of meeting basic needs is inherently static, achieving no more than treading water, a failure to lead consumers forward from initial products to better ones—say from the portable gramophone our parents took to the beach, through the Sony Walkman to the Apple iPod, or from simple texts to others deeper and richer, from simple exercises to Pilates (Cavanaugh 2008). Likewise humanizing production urges producers forward from primitive products to better ones, perhaps more complex, like software, perhaps simpler—as the Bauhaus sought—showing our ability to make progress and produce more efficiently, more ecologically, more responsibly where this is judged against others’

present and our past, not against some timeless ideal. Behind this, given our uncertain and non-equilibrium world and having no knowledge of final causes or conditions is the contested debate about what progress and betterment actually mean. A society that makes property foundational necessarily brings production and consumption to its center to stand opposed to human thought, agency and flourishing. Innovation of production and consumption is made the thing, and the focus moves onto humanizing our interaction with property—sharing, eliminating the wealth gap, safety nets and so on. The humanizing dimension of our interactions with each other gets pushed into the background.

How does the middle layer of Coleman's model fit with this process notion of individual being? Humanizing the individual-firm relationship means measuring work against the participating individuals' progress. Imagining work as no more than the enactment of an economic contract between principals, is a moral failure for it wipes the progress dimension from the analysis. Ironically we see that the ideal individual-firm relationship is not the freely made employment contract for this is actually dehumanizing as it dismisses the personal progress dimension. At least in a coercive situation—the company town, for instance or even the prison—we might try to justify employment as ethical when it makes possible other forms of flourishing otherwise denied, including sheer survival but employment in the private firm raises ethical questions precisely because of the “legal fiction” or artifice of separation between the firm and the societal process. Behind the firm's transformation of input property into output property lies the employees' artificial way of individual being, the cog in the machine deliberately constructed towards private non-societal interests. Its processes may be opportunistic, exploiting the freedoms granted to private firms in order to attract their enterprise into supporting the socio-economy's flourishing, to construct a process that is anything but supportive to the society or to the individuals engaged with the firm.

Practice, especially agentic practice, changes us precisely because we are docile, just as others' rhetoric changes us. We become what we do. Thus the private firm is a domain of rhetoric and practice that creates individuals anew in support of the process of bringing the firm into existence and sustaining it. Boot

camp is an extreme example as individuals are forced to shed their previous persona and adopt another, be that of the “organization man”, the “cloth” or the “uniform” (Simon 1973; Whyte 1956). If humanizing is to be measured in terms of the resulting individual flourishing and progress, this transformation by and subjugation to the organizational milieu cannot be offensive by definition for, not knowing its final cause or state, the change can be regressive or progressive. We go back to our method and appreciate the humanizing project is about exposing the process of personal transformation to societal rules and norms. Transparency is crucial but so is the developmental “tension” suggested by structuration, as individuals are both docile, accepting change, and agents of change.

Herein lies the deepest paradox or tension about the private firm, explored, for instance, by Veblen or Chamberlin, the institutional economists (such as Commons or Mason)—re-expressed in Porter’s ToF (Spender and Kraaijenbrink 2011). If uncertainty is the principal characteristic of the lived situation, bringing human agency to the center of the discourse, then notions such as perfect markets and perfect competition, while interesting enough as intellectual artifacts are irrelevant to illuminating the process of being and acting in the real world. If there are transaction costs, non-zero frictions in the socio-economic process, then existence and survival precede all forms of agency. For the firm, this depends on a degree of non-competitive or monopolistic profit—and this, in turn, depends on a lack of transparency. Veblen argued that the survival of the firm hinged on its investors and customers and suppliers being partially ignorant of what its managers knew—a knowledge asymmetry that reaffirms the separation of the firm as a milieu or process from the context in which it is embedded. Here the key to the humanizing project is balancing the secrecy that ensures the continued existence of the firm against its impact on those who, being transformed by engaging in the institution’s processes, become separated from their social context—a separation memorialized for sociologists between *Gemeinschaft* and *Gesellschaft* (Toennies 1971). The separation, and its impacts, is the ethical cost a capitalist democracy pays for its embrace of property and its thinking that the transformation into goods and services are legitimate means of

driving and measuring societal and personal progress. The cost extends and becomes more complicated as our flourishing comes to depend on goods and services that can only be produced and consumed collaboratively by harnessing the agency of the many, one of the most obvious marks of our age that leads us to lose connection to the human identity of those who create what we consume. The rhetorical and physical apparatus that extends and coordinates the division of labor reflects precisely the complexity of the products and services produced. The notion of consumers entering into human relationships with producers gets left far behind (Cavanaugh 2008). The village it takes to “raise a child” or “make a life” has a humanized economy; the baker knows the candle-maker and the saddler and priest too. The progress that is technological change, and globalization become the process of excising all human traces from the goods and services we consume, so detaching them from the social fabric. From this point of view, the humanizing project is less about the ethics of employment and its attendant subjugation than about paying attention to ways in which the products and services we consume lead to reconstructing society into a property producing and consuming system, and thereby the eventual reconstruction of our Selves and our desires.

### **6.7. Conclusions and comments on business education**

The Conference’s call to humanize the theory of the firm concerns all in our capitalist democracy, not just micro-economic theorists. Our politics and life-style depends on firms, yet none of us really understand them. A useful ToF must address fundamental questions about firms’ place in and contribution to society as well as narrower questions about their existence, definition, structure and process. In the background are poorly articulated questions around whether and how firms add social and economic value, justifying our academic interest in them.

The first part of the conclusion summarizes my paper’s argument. Humanizing, at bottom, is about a switch in attitude towards our knowledge. We change our methodology from positivist objectification, rationality, causal modeling and the notion of deter-



ministic theory that dominates our discourse, and move towards the humanly contingent agentic processes of confronting and resolving the Knightian uncertainties of being in the lived world. The positivist method shuts agentic human inputs out of the analysis; the second brings them to its center. The first is theorizing and the second is framing. The second sees the firm as a process; it does not seek or require objectification of society, firm or the individual. Firms are re-conceptualized as dynamic on-going social artifacts, continually regenerated by the business leader's process of harnessing the agency of many towards socially legitimated purposes under conditions of ever changing uncertainty. This puts us at some distance from the view on which most BSchool curricula stand, so the second part of the conclusion touches on how business education might be re-shaped to engage the issues raised.

The starting point is Coleman's three-tier model of modern society, with the private-sector firm as a major component at its middle social-institution level. Firms arose in a historical-political process that legitimated the separation between their processes and those of society at large. Our society is constituted with democracy as its socio-politics while the private firm is allowed a different process, legitimated as an a-social milieu. Leveraging from Coase's comments, the firm not only supersedes or suspends the price mechanism—the economists' definition of the social—it also supersedes or suspends the democratic processes that citizens and politicians use to define the social. These comments help define the firm in terms of what it is not—but say little about what it is. The initial political justification for legitimating this separation was the social duty of private firms to pressure the public sector and second, their increasingly important duty to be the engines of society's economic innovation and progress. The business history of the 19th century showed a radical restructuring of the socio-economy along with the increasing power of the private firm—often overly so. The private sector's duties were the “higher aims” considered in Khurana's analysis (Khurana 2007). Firms were able to meet these duties not simply because they were paragons or exemplars of rational design, rationally constructed or administered machines or production functions—the Weberian story. It was because they were socio-economic innovations that demonstrated a

remarkable ability to overcome the uncertainties of being by harnessing the agency of others into collaborative agentic activity—what Barnard saw as the magic of “cooperation”, the product of effective leadership.

The American private firm was more successful than most because of the vigor of the interplay of freedoms and constraints it articulated. Note the separateness or privacy of the private firm does not itself ensure efficiency; on the contrary, private firms can be very inefficient. There is no argument for privatizing everything. Nor are non-U.S. forms of governance, such as German codetermination or cooperatives necessarily less or more efficient. The key is always the opportunity spaces the socio-economy allows and the way entrepreneurs and managers exploit them. From the economic historian’s point of view managerial agency may seem to compete against technology and resource availability as an explanatory variable. Yet, as Penrose pointed out so pithily, neither technology nor resources are of strategic importance if management does not treat them thus. Management’s agency shapes every aspect of the firm—its existence, nature and persistence. Given Knightian uncertainty, whether or not the firm is more efficient than a publicly chartered organization or open market operations is an empirical question, not a theoretical one, for management’s agentic contributions make up for the absence of determining theory.

The next sections of the paper unpack my view of the firm as the politically legitimated process of harnessing others’ agency towards private ends. While my focus is on management’s agentic contribution, human agency is applied throughout the firm as employees successfully confront and resolve their specific “local” uncertainties with “work arounds” as the organization’s explicit rules, structures and controls fail. Adam Smith’s explanation of the causality of the division of labor as “abridging labor and enabling one man to do the work of many” resonates. Several ToFs were examined to see precisely where the process of selecting and addressing the strategic uncertainties that defined the ToF’s “opportunity space”—the strategic questions the “business model” must address agentially. The business model comes to life as an ongoing socio-economic process as its participants’ human agency is drawn or projected into this multi-dimensional space, resolving

and mobilizing it. The result is new economic value, the miracle we treat as basic to democratic capitalism.

Management might improve the firm’s value-generating processes, thereby humanizing them by managing the division of labor towards more social goals. They may also leverage its participants’ functional and agentic contributions with better tools and “technology”, another dimension of progressing or humanizing the firm. Doing this may call for further subordination of the employees, denied ownership of the means of production, a consequence of the firm’s need to concentrate funds in order to acquire the most effective technologies and engage the most extensive and complex opportunity spaces. The issue is not the humanizing consequences of concentration or ownership *per se*, it is whether management shuts out the employees’ agency, through “deskilling” for instance, or enhances, up-skills or empowers it by providing the employees with more powerful tools, such as CAD-CAM, supply-chain management tools, etc. that leverage their agency. Management may also engage the agency of others towards social purposes through uncertainty managing choices such as mergers, acquisitions and alliances, as well as by downsizing, outsourcing and getting “back to basics”. Likewise moving to a more flexible labor force and deeper involvement in the Precariat is not de-humanizing *per se*. In each issue the key is the management of others’ agency.

TABLE 6.2: Detailed socio-economic levels

	Theory	Agency
Political process		
Public agencies		
Professional associations / institutions / unions		
FIRMS		
Departments / teams		
Professionals		
Citizens		

Clearly, it makes sense to speak of humanizing the firm at all three levels but in the absence of a coherent theory of capitalist democracy that would link all three levels in a rigorous way, humanizing's practical meaning is always specific to the legitimate practices at the level being considered. At the upper level there are external controls to direct the firm towards more societal objectives, the problematic of those interested in governance, regulation, legal reform and so on. At the middle level, managers are left free to choose but, being embedded in the social, they remain open to persuasive measure to (a) progress the goods and services their firm produces, and (b) to advance the impact the firm has on those it engages. Other social institutions, professional societies and unions, for instance, can also pressure management to humanize the firm's processes. At the lower level are individual's attitudes towards the private sector, whether their lives revolve around preparing to enter them, working within them, or about a life quite different.

In this paper, I stand against a "natural rights" view and am thereby exposed to the charge of relativism. This is less a philosophical choice than a practical one. I see humanizing as about changing the way human agency is managed in firms—into the processes of interaction that constitute our socio-economic situation both between individuals and between people and property. These processes constitute our world as a practical observable process. Humanizing must be gauged against historically contingent attitudes and aspirations. Natural rights, in contrast, go back to what people intend or think gauged against universal virtues. I see this evaluation as a private matter, ultimately inaccessible to others and so beyond our humanizing project. I am proposing a kind of pragmatism. Denying the transcendentalism implicit in the natural rights view, I am focused on humanizing as extending the social benefits of collaborative activity—its cash value. I am also some distance from Deweyian or Jamesian pragmatism. Their analyses suffered because their truth or value criterion was social progress. When the uncertainties of (a) inter-individual heterogeneity and (b) multiple time periods in a non-equilibrium framework are admitted, the concept of the social is destabilized. By subordinating the notion of social progress to the democratic

political process rather than some externally defined system of virtue, and by bounding the firm in terms of its constraints, the idea of measuring humanizing against its goals can be sustained. Given Knightian uncertainty, those goals can never be fully identified and the humanism of a methodology that admits human agency becomes the touchstone. All three levels of analysis support and co-define each other.

The humanizing attitude—reflected at the upper level in the adoption of democracy—at the lower level stands on our being able to project our human uniqueness and heterogeneity into the world. I do not proceed from any uniformity in the model of the individual beyond the Enlightenment view that we humans are defined, *inter alia*, by our immeasurable powers of reason and agency. My argument is grounded on human agency, its application and its interplay with our rationality. To think of humanizing as replacing the rationality axiomatic to economic analysis with some other “more ethical” system or metric completely is to displace one form of dehumanizing with another—missing the point that humanizing is about engaging our uniqueness and heterogeneity, equally crushed by any overarching principle other than the absence of principles. Knightian uncertainty or, more precisely, humility, is my founding axiom, to be framed in the practical interplay of reason and imagination. Agency is our imagination brought into our world in ways that reflect the many-dimensioned contingencies that set out what we know of its nature—historical, physical, social, political, technological, psychological, normative, spiritual and so on.

Positivist science, both natural and social, has led to many vast and often positive changes in our society—improved health, services, agriculture, transportation, information and so on. Humanizing is not about rejecting positivism but the very opposite. It is about embracing it in the service of human progress rather than as a methodological dogma. Our project is more a matter of complementing our positivism and saving it from itself whenever it threatens to become mere dogma. For the most part, the various anti-positivisms are an engaging philosophical pastime but they have an important function. To critique positivism, help us see its limitations along with its strengths—and thereby move beyond

them to a better grasp of our condition. The positivist approach to firms and managing them is hugely important. Where would we be without logical planning and accounting? The problems we have are not with planning *per se* but with our attitude and expectations of it. Denying uncertainty, we often convince ourselves that planning can determine the outcome of real projects. The fact that every plan fails at some level as it meets the situation's uncertainties is too often swept under the carpet. So my paper is about bringing human responses to uncertainty to the center of the analysis—with the intention of complementing the rationality that led to the plan. Absent the plan and there is no breakdown. Humanizing is about applauding our agentic capacity to deal with breakdowns.

The normal BSchool curriculum has few opportunities to address this, though some think this is what casework is about. Perhaps—though it is more often about illustrating “real world” examples of the theories that mainly make up the curriculum's content. Others see open-ended brainstorming and collaborative project work this way. No question these practices can enlighten students. But the underlying question is always methodological, what I earlier labeled our attitude to our knowing; whether, in the pursuit of the “one right way”, we shut out human agency or whether we focus on our ability to change the world and treat our agency as what shapes it. In other words whether we fetishize positivist theorizing or look to the human condition as one of purposive practice under Knightian uncertainty. Knight had no doubt, and in a paper titled “Business Management: Science or Art?” chose art (Knight 1923). Elsewhere, I have suggested BSchools might learn something useful from the many centuries of debate about art education, which is less about correctly determining the art object and more about encouraging agentic input and progressive (humanizing) art (Spender 2005). While art schools can get along without too much of an agreed “theory of art”, BSchools cannot simply turn their back on theorizing in the pursuit of agency—whether in their entrepreneurship, leadership or their strategy courses.

BSchools might benefit from greater sensitivity to the dynamic complementarity of human rationality and human agency. One

place to find this treated systematically is the work of von Clausewitz (Sumida 2008; von Ghyczy, von Oetinger and Bassford 2001). His thinking was directed against the deterministic orthodoxy of French military analysis and Jomini's Comtean pursuit of rational "covering laws" for the successful conduct of war. Clausewitz saw successful generalship as emerging from a moment of creative insight—a *coup d'oeil*—that led the general to see the situation in a strategically advantageous way. There could be no universal rules about this because every military situation and every strategic possibility is unique and therein lay the possibility of strategic advantage. Generals can never fight the same battle twice, especially when their action is socially and historically embedded as an extension of politics. Nonetheless, strategists could learn a great deal from close study of previous military heuristics, theories, and intelligence, all of which fed the military mind and prepared it for that moment of insight. There could be no insight without thorough preparation. This would include immersion in the practical details, especially the terrain of the engagement, extensive study of military history and considerable discussion with aides and others. Theory had a special further place in shaping language that facilitated rigorous discourse with other experts. The key to the method was the strategist's expectation, in seeing theorizing and "the facts" as informing and constraining but never determining. Clausewitz also stressed the multi-dimensionality of the analysis so that the strategist's insight was both crystallizing and synthesizing—separating the vast amount of information gathered into what mattered and what did not. His definition of "human intelligence" was the ability to hold two or more contrary ideas in mind, so as to have many available for the moment of insight.

BSchools could adopt the Clausewitzian methodology with the intent of having students discover and exercise their natural agentic capabilities in the business milieu—reinforcing the notion that agency is about situated innovative practice rather than arms-length analysis whose practical relevance has to be established later. Doing this would leave two issues unconsidered; first, one of the obvious drivers of our humanizing project, discussion of the management's morality and ethics, and second, the practicalities of harnessing the agency of others. While Clausewitz did

not deal specifically with either, his work is permeated by the general's need to be wise about the real world, to study its history and politics, and peoples' behavior and to reflect. He presumed the strategist was a man of considerable education and interest in people—which raises questions about whether we intend BSchool to be this kind of educational experience or merely a vocational or professional one (Spender 2007).

Education is in a state of upheaval everywhere, its role, process and cost increasingly debated. Business education has worked its way into the center of this, given that one in five U.S. students is studying business, even as business education's contribution has somehow remained relatively outside the debate. Those questioning it seem more focused on debating its value and impact than the philosophy or methodology behind it. Nonetheless, we can distinguish some alternative strategies such as preparing students for (a) full-time private-sector employment, or (b) life in our capitalist democracy. Most BSchools seem focused on (a), especially when the MBA is seen as the school's flagship product. Yet the need for (b) seems increasingly urgent. The humanizing project has a voice here, especially when it takes up a position against the positivist view that education is about rote-learning deterministic theory. Universities in general are turning to doubt courses constructed with (a) in mind. While higher education has achieved high levels of social penetration, its value is increasingly questioned; students find themselves caught in a trap—massive student debt and poor job prospects. Some speak of higher education, BSchool especially, as yet another bubble waiting to burst.

Perhaps the world is telling us what to do. The developed nations' economies seem to be changing rapidly, work is less and less structured by the social certainties of corporate continuity, professional and technological stability and steady career progression. The impact of the 2008 financial collapses was huge and remains ongoing, leading us into unfamiliar circumstances; problems with housing, mortgages, unemployment and the Euro. Everywhere we see insider trading, untrustworthy drug firms, ill-monitored nuclear plants, falsified accounts etc. Some engaged in our humanizing project may see it as one of getting back to a more stable and trustworthy world but there is no going back and perhaps the deeper



impact of the recent changes is on our expectations of work itself as a citizen's mode of engaging our capitalist democracy. The business literature overflows with millennial trumpeting, from the "end is nigh" to "new dawn", seldom marked by deep analysis or understanding of the firm, work, or the economy (e. g. Gratton 2010). We are in the age of the Precariat and Barcelona's 2003 street event has a special place in its history. It is not just about youth unemployment, outsourcing, or graduate's job prospects or illegal migrant workers from Mexico or Africa. The concept of work is changing. Silicon Valley's software engineers have lived the precarious life for decades. Likewise film crews have formed and dissolved for decades. Mergers and acquisitions have long been instruments for destabilizing labor contracts as in the airline business but cold winds are blowing into places long insulated. Senior U.S. law partners are being pressured to increase their billable hours or go architects too. Even universities are moving against granting tenure, hiring adjuncts instead, or, as in engineering departments, insisting professors "earn their keep" or leave.

The humanizing project has to address this as a fact of the BSchool situation. For those who fetishize competition and market forces—often from the security of a tenured position—the change from yesterday's institutionalized world to today's precarious world sounds welcome the harbinger of more efficiency and rationality. That may be—history will tell but humanizing is not about retreating into the past in search of golden ages that probably never existed anyway. It is about thinking what to do about today. If we propose the private firm, the quintessentially American engine of economic progress as the way to harness the agency of others to the entrepreneur's purposes, then it is clear that old-style work—the expectation that others (managers and entrepreneurs) manage one's agency—is disappearing. The Precariat scene demands one manages one's own agency, live by one's wits; I am reminded of Defoe and Hogarth<sup>1</sup>. Levi's depiction of life in the death camps is relevant too—to be "organized" was to have found a way of being that promised life (Levi 1986).

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<sup>1</sup> Ioannes Paulus PP. II *Laborem Exercens* (1981) is especially interesting on this.

Given the a-social nature of the private firms that dominate our socio-economy, living by one's wits, as a consultant, part-time employee, freelancer, health-benefits seeking contractor, temporarily employed full-timer, and so on, is becoming a specialized business. There is much BSchools could do different that would help prepare people for that life rather than for life as an enfranchised, salaried, and pensioned senior manager. Ironically, of course, the senior management life is increasingly turbulent, one evident impetus behind the growth of "managerialism" and the impulse for these "officers" to line their pockets at the expense of any and all, be they shareholders, customers, employees or future generations (Locke and Spender 2011). Given the rise of the Precariat, we see the growing number of BSchools preparing ever more graduates for high corporate office as more shooting at a shrinking target. So we might do well to complement the standard education oriented towards "getting that top firm interview" with a very different one about living on one's wits—agenticallly.

We know from von Clausewitz that strategic success hinges on extensive preparation and study—as well as from those qualities of persistence, ambition, focus and the other traits we find endlessly repeated in the entrepreneurship literature. Von Clausewitz also explained the importance of careful management of the strategist's expectations that, on the one hand, saw theory as supporting strategizing rather than dictating it, and second, helping one attach meaning to the intelligence gathered. But von Clausewitz also argued that meaning was never available as an objective truth, it was ultimately defined by the strategy chosen; a precursor to Penrose's insight that resources have no value in and of themselves, only in how they support the firm's strategy. BSchools educating their students for the time of the Precariat could follow von Clausewitz's and Penrose's line, having them immerse themselves in the practical realities of specific business situations to explore and surface the constraints to the strategist's' agency and so outline the opportunity spaces presented to the ambitious mind. This kind of process trains the agentic mind to focus on what is absent, to avoid the passive mind's over-focus on what is present (Kim and Mauborgne 2004).

My final point goes back to educating students about harnessing the agency of others. The private firm stands apart from its social milieu. The “decision to participate” is not simply a matter of redirecting one’s capabilities in order to self-maximize. Given the impossibility of calculating the outcome of agentic activity under Knightian uncertainty, participation is ultimately a matter of subjugation and docility, of becoming a different person—in micro-economic language, of accepting an incomplete contract. Why would people do this? How are they persuaded? This is what rhetoric is about, the oldest academic discipline and for millennia the core of Western education, for education was not simply about scholarship, it was also about preparing young men for military, ecclesiastical and political leadership, i. e., for persuading others in different socio-economic contexts. Politics especially, is about debating contrasting ways of seeing the world, alternative ways of socio-economic being, with the intent of spurring others to the actions that would bring that way of being about; it is not about debating contrasting rational plans for reaching objectively defined goals or persuading others to an opinion. The distinction between the firm as a process of harnessed agentic activity and the personal process of citizenship is a political one that is generated by effective rhetoric.

All this suggests BSchools interested in preparing students for the time of the Precariat might consider replacing the courses in rhetoric to the central place they held for thousands of years—only displaced in the 19th century as a result of the adoption of positivism and what we now see as our fetishizing rationality, believing human affairs can be theorized as a deterministic science.

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## 7. The “Management Case” for Corporate Social Responsibility

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### 7.1. Introduction

There is no agreed definition of corporate social responsibility (CSR) that is accepted by all, or even most experts and managers and it is unlikely that there ever will be (Argandoña and Hoivik 2009, Dahlsrud 2008). This has not prevented a growing number of academics and practitioners from promoting CSR as a means of shifting the paradigm of the firm, away from a purely economic model oriented to maximizing shareholder value, toward a much deeper model that takes ethical, social and humanistic variables into account and is oriented to a broad spectrum of stakeholders.

This is certainly a step forward in the theory of the firm, but an unsteady step—at least as regards the reasons why companies are supposed to be socially responsible. In this paper I put forward some “new” reasons why companies should be socially responsible, explaining how ethical and socially responsible behavior can foster good management and organizational success: the “management case”. My main contention is that companies must be socially responsible not only because it is demanded by society or because it makes companies more profitable or because it is expected under a certain conception of business ethics, but, above all, because CSR is part of good management. That is to say, an ethical and socially responsible company is a good company and

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a manager who manages in accordance with social responsibility criteria is an excellent manager, or at least is in a good position to become one.

In what follows, we look, first, at the traditional arguments in favor of social responsibility in companies, namely: the legal, social, moral and business case. After that, we examine what do we mean, when we say that a company is socially responsible. Finally, we present the management case and the conclusions.

## **7.2. Arguments for corporate social responsibility**

Why must companies be socially responsible?<sup>1</sup> The arguments put forward in the literature can be summed up as follows (Argandoña 2008a, 2008b):

### **7.2.1. The legal or government case**

The term responsibility is used in legal language. The law defines the responsibilities that directly or indirectly attach to certain acts and omissions and their effects (as when we say that a person is responsible for the injuries her dog caused to another person, perhaps because she failed to take the necessary precautions to prevent the attack). Legal responsibility allows us to determine some of the effects of an action.<sup>2</sup> However, it is widely agreed that CSR goes beyond the law, which means that the legal case is not a good explanation of why companies must act in a socially responsible way (although there is a broad movement calling for making CSR legally binding).

### **7.2.2. The social case**

The social case is probably the one most often cited. According to many accounts of CSR, companies must act responsibly because society, represented by its main stakeholder groups, expects, demands or requests that they do so (Carroll 1979; Wood 1991).

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<sup>1</sup> Naturally enough, there are also authors who reject CSR, e. g., Friedman (1970), Henderson (2001), Sternberg (1994).

<sup>2</sup> Not all and perhaps, not even the most important ones, e. g., those relating to moral learning.

Certainly, society expects or demands certain behavior from individuals and organizations, whether as simple citizens or as bearers of a particular status or role in society (politicians, managers, property owners, etc.) or as organizations (firms, trade unions, political parties, etc.). The important thing however, is not that these expectations or demands exist but why they create an obligation that companies must fulfill. If they do, it is probably for one of the following three reasons:

1. Because these responsibilities presuppose that those demands of society create a moral duty (e. g., because acting responsibly is part of companies' contribution to the common good (Argandoña 1998) or because they define that moral duty in specific situations (e. g., they specify what constitutes employment discrimination in a given society at a given time).<sup>3</sup>
2. Because meeting those expectations or demands is a civic responsibility, similar to the rules of behavior among individuals, backed not by the coercive power of the State but by the pressure of society itself.<sup>4</sup>
3. Because CSR prevents costs or brings benefits, economic or otherwise to the company in the form of lower costs, stronger customer and employee loyalty, higher productivity, enhanced reputation, etc.,<sup>5</sup> which leads into the business case, discussed further below.

### **7.2.3. The moral case**

The term responsibility can have an ethical meaning as well as a legal one. "To say that a person is responsible (...) for a given ac-

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<sup>3</sup> There are many situations in which people or organizations feel obliged to act in accordance with "social norms" within the framework of a "social contract" (Donaldson 1982, Donaldson and Dunfee 1994, 1999).

<sup>4</sup> Corporate responsibility is sometimes said to be "social" on the grounds that companies are "agents" that operate in society and so need a "social license" to operate or that they have an obligation to contribute as good "corporate citizens" to society (McIntosh et al. 1998).

<sup>5</sup> For example, the argument that consumers are willing to reward socially responsible companies with greater loyalty or the willingness to pay higher prices (Devinney et al. 2006) or the argument that investors demand higher risk premiums of the companies that are not socially responsible (Geczy et al. 2005).

tion is only to say that it is appropriate to take it as a basis of moral appraisal of that person” (Scanlon 1998, 248).

From the ethical point of view, responsibility can be understood in two ways:

1. It appears when an action (or omission) and its effects are attributed to a person not only as the cause of the action, but as a “moral” agent (responsibility as attribution).<sup>6</sup> It is retrospective or a posteriori: an agent acted (or failed to act) in the past and the resulting moral responsibility for the action and its consequences is attributed to her. Moral responsibility as an attribution implies the existence of a prior duty (Jonas 1984).
2. Responsibility implies that the agent must be accountable for her actions or omissions and their consequences, not only to herself but above all to others<sup>7</sup> and not only for what she does, but also for the moral reasons for which she does it (responsibility as accountability). It presupposes responsibility as an attribution; but it adds something else, because it is social, open to others, owed to the community, and it is subject to the normative standards required of interpersonal behavior—external scrutiny, evaluation and sanction—and implies duties of disclosure and transparency (Eshleman 2004).

#### **7.2.4. The business case**

The business case shows a positive correlation between CSR and profits: being socially responsible is profitable, the argument goes. Numerous empirical studies have been carried out relating corporate social performance to financial performance. Many of them come to the conclusion that the relationship is positive; a few find a negative relationship; and, above all, many find no statistically significant relationship at all.<sup>8</sup>

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<sup>6</sup> The classic reference is Watson (1996); cf. Weber (1921), on a person’s availability to answer for the foreseeable consequences of his actions. See also Fischer (1999) and Williams (2008).

<sup>7</sup> See Oshana (1997) for a classic discussion of responsibility as accountability.

<sup>8</sup> Up to 88% according to the meta-analysis of Margolis et al. (2007).

The most likely conclusion from these studies is that there appears to be a positive relationship between CSR and profitability, but this conclusion is not definitive, as the relationship depends on variables like the country and the environment, the period studied and how the variables are defined (Allouche and Laroche 2005, Goll and Rasheed 2004, Margolis and Walsh 2003, Margolis et al. 2007, Orlitzky et al. 2003, Vogel 2005, Wu 2006).<sup>9</sup> On the other hand, the fact that social performance and financial performance are correlated does not necessarily mean that the causality goes from CSR to profits: it may be that CSR actions consist of distributing corporate profits among stakeholder (Devinney 2009). Furthermore, much published research displays major theoretical and empirical limitations (McWilliams and Siegel 2000).<sup>10</sup>

In any case, a company is unlikely to decide to implement CSR policies simply because empirical studies show that such policies have a positive impact on financial performance. More direct arguments, addressing the details of the relationship between the two variables for a particular sector, location and company, will be needed. For example, if it can be shown that a commitment to CSR attracts the best employees, makes their work more attractive to them and makes them more efficient and more loyal, then the case for the profitability of CSR will be more effective and more credible.

Especially where the focus is on the business case, the CSR literature usually mentions a series of advantages enjoyed by responsible companies. First, there are what we might call external advantages (i. e., external to the organization). Socially responsible companies are believed to have a more favorable legal and political environment for their activity, smoother relations with regulatory agencies, even the possibility of new and better regulations or a say in the drafting of new regulations; less risk of complaints

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<sup>9</sup> Confirming the usual scientific biases, the studies that reach negative or uncertain conclusions tend to appear in economics journals and the positive ones in business ethics or strategy journals. It is also likely that many studies that find no clear relationship are never published, as journal editors are less likely to accept them.

<sup>10</sup> For example, social performance measures are based merely on manifestations of potentially responsible behavior such as publication of sustainability reports, adoption of codes of conduct, investment in pollution reduction equipment or establishment of minority employment policies, social action programs, or philanthropy.

and fines; better relations with governments (e. g., preferential access to contracts, concessions and subsidies); and an active role in spreading their good practices. They may also have advantages in relations with customers and suppliers, including a better image, brand and reputation, and more loyal customers, who may even be willing to pay more for the companies' goods and services because it is respectful of the environment or human rights. They may have better relations with society, that is to say, agreement with society's expectations and demands, fewer disputes, less risk of negative advertising and boycotts, better relations with the media, opinion makers and the social agents, and so on.

Socially responsible companies are also likely to have internal advantages. For instance, they may well have an edge when it comes to attracting, retaining and motivating the best employees; greater transparency, morale and trust in relations with their internal stakeholders, more satisfactory employment relationships, a better working atmosphere, better supervision of the supply chain, etc.

All these internal and external outcomes may translate into better financial and economic performance. For instance, they may give a company a strategic advantage over its competitors in the form of higher or more stable sales, product differentiation, a higher price, and so on (Porter and Kramer 2006). They may also reduce costs, perhaps because the company runs fewer risks (with employees, customers, processes, litigation, boycotts, etc.), which will reduce finance and operating or management costs (e. g., those arising from wastage of resources). A policy of honesty is likely to reduce litigation, complaints and fraud costs, enhance employee productivity (through higher motivation and commitment or self-selection of the best workers) or reduce the risk premium for financing (attracting socially responsible investors who value the company's CSR policies), etc.

As we already pointed out, however, all this is not enough to guarantee higher accounting profits or a higher share price. CSR can generate greater social value for society as a whole in the form of better products and services, lower production and transaction costs, lower risk premiums, higher productivity and innovation, etc. That value, however, is just as likely to be captured by employees (in

the form of higher wages or other benefits), customers (in the form of lower prices or of better products at the same prices) or other stakeholders as it is by the owners of the company. The problem is comparable to that of a company that has a privileged location or holds a patent: if CSR creates economic rents, they may be captured by other stakeholders, rather than by the owners (Argandoña 2011b), in which case the private profit will be no greater than before.

The business case has acquired a new dimension in recent years as CSR is winning legitimacy: academics make efforts to show that CSR is profitable, while managers claim to believe in it and try to justify this belief in the hoped financial results of CSR. This has led to the development of a formidable “industry”, ranging from consultants and professors to communication and PR experts, auditors, certification authorities, social rating agencies, socially responsible investment companies and CSR professional associations. To sell their products and services, all of these participants need to prove that CSR “pays”. Ultimately, the attitudes of academics, shareholders, managers and CSR players are mutually reinforcing.

Nevertheless, the soundness of the business case has not been proved—and probably cannot be proved once and for all, because if socially responsible companies achieve better financial results, the non-responsible companies can always reproduce these practices, making those better results to vanish. But this conclusion will not hold if CSR is not just a list of external, easy to imitate practices, but has an impact in the principles and practices of management as we will show below.

### **7.3. What does it mean that a manager acts in a socially responsible way?**

In the previous pages we have looked at various arguments as to why organizations need or want to be socially responsible. The legal, social and business cases have an impact on profitability, legitimacy and other external aspects of the organization, but the CSR actions taken by moral reasons have consequences not only on the firm but also on the manager. Indeed, when the manager



makes a decision, he is seeking one or more of the following outcomes (Argandoña 2008c, 2008d, Pérez López 1991a, 1993b):

1. Extrinsic, i. e., a response to be delivered to him by the “environment” (customers, suppliers, owners, employees, etc.). This response may be tangible (in terms of salary, for example) or intangible (reputation, prestige, etc.). Extrinsic effects are a driving force for managers in the business and the social cases.
2. Intrinsic, i. e., an outcome that occurs in the agent himself as a consequence of his decision. This outcome may be psychological (the satisfaction of fulfilling a duty or of making a good decision, for example), operational (the acquisition of knowledge, capabilities or skills as a result of the decision) or evaluative (learning to resist the attraction of an immediate reward, developing in himself capabilities that will enable him to make better decisions in the future, mainly as regards understanding the needs and interests of other people, and as regards his contribution to the company).<sup>11</sup> This argument may be a part of the social and moral cases.

Whether he likes it or not, the agent’s action will give rise to all these outcomes and each one of them “can be a powerful source of motivation; that is, each one can be directly intended by the person who acts and can therefore be a reason for performing the action” (Pérez López 1993b, 52). Whatever the goals of the organization may be, managers want to achieve all of these outcomes; and to do so, they must secure the cooperation of the members of the organization (shareholders, managers, employees, suppliers, customers, etc.), because they own the material resources as well as the knowledge, capacities and values the company needs.

Lastly, managers must take into account the time dimension. Decisions are not isolated and independent but are all related to one another, at least insofar as they are all made by, or affect, the same people (Andreu and Rosanas 2010). Managers must there-

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<sup>11</sup> This classification of the results of human actions is based on Pérez López (1991a, 1993b); cf. also Argandoña (2008c, 2008d). It also mirrors other ways of classifying the goods that people seek, e. g., Finnis (1983).

fore bear in mind that the decisions they make today will affect how other agents respond today and in the future (if the decisions are capable of developing the capabilities the company needs, mainly the evaluative capabilities, which will lead the stakeholders to cooperate in achieving the objectives of the company) and above all, the ability of the managers themselves to make the right decisions in the future, including their ability to satisfy their needs through extrinsic outcomes, but also what we have called intrinsic outcomes.

Decisions in companies, especially CSR decisions therefore, cannot be justified by any one argument, be it social, ethical or economic. Indeed, overemphasizing any one case may well have undesirable consequences. The social case, for example, may turn the company into a provider of funds for all sorts of social initiatives, even if remote from the company's goals,<sup>12</sup> and the business case may prompt opportunistic behavior, aimed at obtaining short-term profits at the expense of other objectives.

In short, in every decision they make, managers must monitor three "state variables" in the organization (Pérez López 1991a, 1993b):

1. Effectiveness: in order to get the collaboration of its stakeholders, a company must generate (economic) value for them (Argandoña 2011b, Freeman et al. 2010). The business case is always relevant, not necessarily because CSR generates higher profits but, if nothing else, as a minimum condition for the economic feasibility of the firm.
2. Attractiveness: a company must provide its members with the opportunity of satisfactory jobs and generate learning which will allow the organization to learn how to resolve problems more effectively or how to resolve more complex problems, since its members have a better knowledge of the needs to be addressed and are more capable of addressing them. The social and moral cases also are important.

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<sup>12</sup> This is probably the main argument against CSR. Cf. Friedman (1970), HENDERSON (2001), STERNBERG (1994).

3. Consistency, which is achieved when the members identify with the organization and trust develops between them and the company. In fact, in making decisions about CSR, the managers will be learning to take the consequences of their actions for other agents to take into account and to internalize those consequences. Here, the moral case predominates.

Every decision within the organization, including CSR decisions, “must necessarily respect certain minimum levels of effectiveness and attractiveness” and, above all, consistency (Pérez López 1981, 14). These three dimensions may act in different directions. However, a CSR plan, for example, may be effective (e. g., it may increase customer loyalty and sales), yet not attractive (e. g., the persons implementing the plan may feel that they are not doing their duties, perhaps because they think that it is a PR exercise and not genuine CSR) or inconsistent (e. g., because the employees have noticed a gap between what the company promises to do and what it actually does and so are reluctant to collaborate).<sup>13</sup>

### **7.3.1. Back to the moral case**

The important issue in the decision process we have just described is the changes that take place in the agent when he takes into account (or ignores) the effects that the action he is about to perform will have on himself and on other people (consistency), because those are the changes that explain how the agent actually improves. So, ethics enters into the decision-making process, since “evaluating human acts according to how much they improve the person who performs them is the very substance of ethics” (Pérez López 1977a, 5).

Ethics bears on the inner transformation of human beings through their actions and that is the object of the moral virtues. Virtues are operational habits that are acquired and developed through deliberate, effortful repetition of acts aimed at develop-

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<sup>13</sup> This, of course, applies fairly broadly. A particular decision may be ineffective, not attractive, or inconsistent; none of this will yet be serious if the decision is inconsequential and is embedded in a pattern of actions that, overall, are sufficiently effective, attractive and consistent.

ing them (Argandoña 2011a). This process of acquiring and developing moral virtues takes place when the agent makes an effort to achieve what is good for him and for others. "Every time a person freely chooses something that he knows is better, even though it is less attractive, he is training and building up the strength that will free him of any pressure that might deflect him" (Pérez López 1977b, 10).

In other words, acting in accordance with ethics allows a manager: 1) To develop his ability "to perceive reality—the whole of the reality that affects him, not just the small part of reality that attracts him or which he observes at a particular point in time" (Pérez López 1993a, 6). That reality includes the external consequences of his actions as well as what he himself learns and how he becomes aware of the consequences of his actions for others. 2) To be capable of always choosing the best option, to enable him to resist the temptation to act in accordance with what he prefers or what appeals to him in the short run and do what is best for himself, for the organization and for the other people involved (Pérez López 1991a).

From our point of view, ethics in organizations does not consist (only or fundamentally) of applying rules, codes or principles, nor of calculating the costs and benefits of every decision in order to get a positive balance. Making ethical decisions is a dynamic process that will depend on the agents' evaluative learning. The ethical nature of a decision will depend on how it develops the agent's moral capacity, that is, his capacity to know on every occasion what is good, and his ability to do it, overcoming the (primarily internal) resistances that make it difficult for him to do so.<sup>14</sup>

This means that the idea that managers have moral responsibilities must play a central role in decision making and especially in CSR. However, this view is not shared by many authors, maybe, because they have an instrumental view of CSR as a set of tools for achieving certain given goals—and this makes way only for opera-

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<sup>14</sup> Managerial ethics does not coincide with corporate ethics insofar as the latter must also include culture, rules, routines, structure and organization that allow a company to foster, or at least not undermine, the ability of the various stakeholders to make ethically correct decisions.

tional learning: the moral case is irrelevant,<sup>15</sup> because of the “separation thesis” (Freeman 2008) that excludes any role for ethics in economic decisions since they are technical, not moral (Miller 2009), or, perhaps, because those authors have another way of understanding ethics (an utilitarian view, for example).

There is still another reason why the moral case for CSR does not appeal to some authors: As it is voluntary. Managers will have no incentives to put it into practice unlike the legal case (imposed by the coercive power of the State), the social case (society demands is either by quasi-coercive means or through economic incentives such as those relating to corporate reputation or legitimacy) or the business case (through the positive incentives arising from the goal of profit maximization). If, however, as we stated earlier, ethical behavior is a requirement for carrying out effective, attractive and consistent actions, it can autonomously generate self-enforceable norms which do not depend on a pattern of rewards and punishments. A good manager must take into account not only the effectiveness and attractiveness of his decisions but also their consistency, that is, how they affect his own ability to make good decisions in the future and how they affect the ability of other people in their future decision making insofar as these people’s decisions also affect the company (e. g., as they are a response to the manager’s decisions).<sup>16</sup> Ethics is as self-enforceable as the call to excellence is.<sup>17</sup>

Is being an ethical manager the same as being a socially responsible manager? No, although the two are closely related, since the practice of CSR is part of his ethical duties. Yet the practice of

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<sup>15</sup> The strategic approach to CSR (Porter and Kramer 2006) may fit with this view, but not necessarily, because there are many reasons why moral responsibilities are present in strategic actions (Andrews 1971) and why it can create competitive advantages for the company.

<sup>16</sup> Ethics is not confined to the practice of the virtues, it also includes rules and goods (Abbà 1992, Aranzadi 2011, Polo 1996). The rules the manager must observe include both negative rules (prohibiting actions that damage his capacity to make good decisions) and positive ones: and these positive rules essentially show the manager his duty to always seek what is good for the company, for other people and for himself.

<sup>17</sup> An good manager is not only the one who makes good decisions but one who has developed the ability to always make consistently better decisions. The also the fact that the manager makes mistakes does not contradict this, so long as he is capable of recognizing and correcting them.

CSR is not a manager’s only moral duty.<sup>18</sup> As CSR, management has other dimensions (economic, strategic, social, communicative, etc.) that are not subsumed under the ethical one, although they should not contradict it either. In other words, an excellent manager needs to be excellent in both the ethical and other dimensions.

#### 7.4. The “management case”

All the above suggests that there is another reason why managers should be socially responsible, namely: what we might call the “management case”. Being socially responsible is a good way to manage a company, as it is the only way to run a company well. An ethical and socially responsible company is a well managed company, and a well managed company must be an ethical and socially responsible company (Argandoña 2008b). But how does this come about? How does ethics come into good management?

As we have already explained, an ethical manager tries to achieve the best results in the three dimensions mentioned earlier: effectiveness (financial performance), attractiveness (personal satisfaction and development of people’s operational capabilities) and consistency (improvement of people’s ability to make the right decisions). His excellence as a manager will therefore depend on how well he takes into account the impact of his decisions, in all three dimensions, will have on himself and others without confining himself to profitability but without neglecting it either;<sup>19</sup> rather, on how well he is learning to take all these dimensions into account. He will achieve this by living these virtues.<sup>20</sup>

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<sup>18</sup> Elsewhere I have suggested that CSR is the range of responsibilities a manager assumes in relation to society, in dialogue with stakeholders, giving account of those responsibilities (Argandoña 2008a, Argandoña and Hoivik 2009).

<sup>19</sup> “The manager’s task is largely projective, that is, targeted to action and its outcome calculating the consequences and thinking his project step by step (how each step leads to the next). Normal this should be the case but (...) it is important to realize that the manager himself is involved in all this and to notice what happens to the manager precisely when he acts or how he must prepared for action” (Polo and Llano 1997, 103).

<sup>20</sup> He will naturally also need knowledge, capabilities and skills, and an appropriate organization and structure, a favorable environment and many other things

The virtues are the fruit of purposeful and effortful actions aimed at knowing what is best, evaluating it and acting accordingly. The acquisition of the virtues has a rational dimension (seeking what is best in each case and finding the means to do it) and a dimension rooted in the will, which moves the agent to make an effort to achieve what he sees fit, resisting the temptation to give in to short-term extrinsic satisfactions. "Every time a person freely chooses something that he knows is better, even though it is less attractive than another thing that is worse, he is training and building up the strength that will free him of any pressure that might deflect him" (Pérez López 1977b, 10).

What we have called the rational dimension will enable a manager to perceive reality in all its facets, including the effects his actions have on others and on himself. For example, ordering a subordinate to tell a lie for the benefit of the company, he will be able to appreciate all the consequences of that action for the employee (the manager is effectively teaching the employee to lie, thus undermining her self-esteem, and possibly causing indignation, giving a bad example to other employees, etc.). As for himself (he is learning to lie and to treat his employees unjustly). Similarly, his approach to the alternatives of the action will be different; he will value them differently and will have more initiative to look for solutions that do not require the employee to lie.

He will be able to choose the best option in each case, because he will have learnt not to give in to short-term satisfactions, so that his natural tendencies will be increasingly stable and firm. This ability to renounce short-term outcomes in order to achieve better ones implies that a good manager acts with a view to the long term, not only in the sense of desirable future outcomes but also in the sense of the foreseeable consequences of present decisions.

Now, reason and will reinforce one another. A person who is never concerned with the good of others is unlikely to understand why he should be respectful to others, but if he begins to think about the good of then others he will be in a position to under-

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we shall not discuss here (although we may consider that taking care of these other requirements is also part of a manager's responsibilities).

stand and show interest. In other words, knowing what constitutes an excellent action, finding it attractive and having an interest in it requires an "education" which the virtues make possible.<sup>21</sup> A person who does not have this "education" will develop other attractions and interests and, to some extent, will become closed to the possibility of acting in accordance with the virtues.<sup>22</sup>

An ethical manager can "see" or "know" other realities (based on the possible effects of his actions on others and, above all, himself, i. e., evaluative learning)<sup>23</sup> and value them differently; discover other alternatives and also judge them differently (not only by their effectiveness or attractiveness but by their consistency) and self-control, so that he can make the decisions he considers appropriate, since he would have learnt to resist the temptation of immediate results.<sup>24</sup>

A person's capacity to "see" and act expands over time as virtues are acquired and developed, since "growing as a human being implies an increase in the capacity to act" (Polo and Llano 1997, 109).<sup>25</sup> For instance, a manager who has never done anything for his employees may consider it uthopic to imagine that

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<sup>21</sup> Including the necessary judgment, based on first or second-hand experience, as to whether what the manager wants to achieve is feasible.

<sup>22</sup> "It is relatively easy to make a decision of principles. Problems start when a subject as complex and fragile as the human subject, seeks a path of self-realization in the complexity and variety of specific situations. There are problems for reason, which must seek out, anticipate, remember, invent and take account of so many relevant circumstances and, even before that, discern those circumstances, judge them and prepare a precise plan. There are problems for the will, which must issue desires and interests, overcoming impediments, pre-existing inclinations and indifference and there are problems for the passional appetites, which have great influence in this context: docility to respond to incentives and deterrents to amend his own objectives and to defer to the demands of higher criteria" (Abbà 1992, 127–128). Virtues make this process easy.

<sup>23</sup> "Virtues themselves influence the way the manager 'sees' the world": Abbà (1992, 242), with references to Hauerwas (1984) and Murdoch (1970).

<sup>24</sup> "He perceives as relevant circumstances that he would otherwise have overlooked; he chooses opportunities for action that others fail to notice; he considers relevant rules that others ignore; he sets himself goals that others fail to see" (Abbà 1992, 260).

<sup>25</sup> "From situation A, objective D may be utopian because in that situation one lacks the capacity to get to D but if the person practices certain actions, then A becomes A', i. e., it changes intrinsically. If from A one can reach B, from A' he can reach C; and as a result, A' changes again intrinsically, becoming A". A person from A" can reach D (...), which is a realistic objective from A" but not from A (...) These changes on the initial conditions is a strictly human characteristic" (Polo and Llano 1997, 109).



they would ever put any initiative or enthusiasm into a new project unless they were offered a financial reward; yet if he changes his attitude towards them and starts taking interest in them, giving them responsibility for their tasks and showing them trust, that outcome may be possible (Polo and Llano 1997, 109).<sup>26</sup>

All the above leads us to the conclusion that ethics, understood as the practice of the virtues, becomes a possibility of excellence. Applied to CSR, the possibilities multiply. For example, that virtues are in the service of relations between people; so when we talk about virtues, we are talking about communication and dialogue. A good manager will be open to dialogue and he should be aware of his limitations, the capabilities of others and the opportunities for personal development that arise from dialogue. Through the practice of stakeholder dialogue the manager, he will know the kind of interest each stakeholder has in the company, how each can contribute to the company's goals, what each expects from the company and why each collaborates with the company and how to build on that collaboration. The manager will no longer see them as stakeholder "groups" but as people with "names and faces" (McVea and Freeman 2005), thus building trust.

Furthermore, participation will flourish because everybody has a common task to carry out. CSR will be a shared responsibility (Argandoña 2008a) which implies giving not only responsibility to the different stakeholders but the means to exercise it (Bhattacharya et al. 2008), so that stakeholders feel responsible for developing and applying their own capabilities to achieve their own objectives or motivations within the framework of the common goals of the company.<sup>27</sup>

This implies that CSR must focus more on relationships than on outcomes (Bowles and Gintis 1998, Donati 2008, Zamagni 2008) because the transforming potential of the management case for CSR lies, above all, in interpersonal relations and the development of non strictly economic motivations (Andreu and Rosanas 2010).

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<sup>26</sup> "With habits [the virtues], the active power becomes capable of what is beyond it" (Polo 2007, 104).

<sup>27</sup> The development of spontaneous forms of cooperation can turn potential conflict situations into cooperation situations.

## 7.5. Conclusions

The literature on the ethical behavior of socially responsible companies points to a set of duties of managers who wish to act ethically with respect to their stakeholders. Where the aim is, for example, to define companies' duties to customers for example, truthfulness in information, advertising, product safety, the matching of product, or service, quality to customer, expectations, suitable packaging, fair price and so on (Kujala 2001). This way of addressing issues is attractive since it specifies companies' responsibility to their stakeholders. However, it confines itself to CSR defined as a responsibility or obligation.

What we have tried to do here is present CSR as an opportunity. We shifted our focus from the responsibility of the company to the responsibility of the manager, because the subject of ethics is the person not the organization. Then we discovered that found out managers, acting in a socially responsible way makes it possible to capture aspects of reality without which this ethical view would remain undetected. It introduces an interest in people, starting with the manager himself, facilitating his involvement in the company's goals and allowing him to develop his operational and evaluative capabilities, which, in turn, allows him to establish and to improve the organization's core competencies and so contribute to long-term results, including economic results. Then, the expected outcomes of the business and the social cases are possible, but they are more of the achievements of the ethical managers than the extrinsic responses of other persons to the socially responsible actions of the company.<sup>28</sup>

By understanding CSR as an ethical responsibility, we can propose a "management case" for CSR, namely that being ethical and socially responsible is a way—the only way—of being an excellent manager. I believe that the business case, the social case or the moral case, is the best case that can be followed to persuade man-

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<sup>28</sup> But motivations are very important in ethics. A manager must be socially responsible not because it makes the company more profitable but because it is what is best for the company, for the manager himself, and for his stakeholders. Otherwise, when he has the opportunity to obtain an extraordinary financial return at the cost of acting in a socially irresponsible way, the manager will not have the capacity, based on reason and will, to do the right thing.

agers to be ethical and socially responsible. Unfortunately, the expected extension of the capacity of managers for “seeing” new issues, opening new alternatives and strengthening their will to put them into practice cannot be foretold, i. e. they may expect these consequences, but they cannot predict which ones they will be.

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## 8. Caring About Firm Stakeholders: Towards a Theory of Proactive Stakeholder Engagement

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A new theory of the firm should look at stakeholders. Moreover, Stakeholder Management (SM) is increasingly at the forefront of the corporate agenda. At its core is the notion that the firm has multiple goals in addition to the singular end of maximizing shareholder's value or, saying it differently, that firm success should be defined not only in terms of financial results or shareholder welfare but also by the extent to which it satisfies the needs of multiple constituents affected by the firm's actions (Donaldson and Preston 1995; Freeman 1984). This requires that the firm sees beyond its own financial goals to consider, identify and meet the desires of diverse parties such as employees, suppliers, customers, environmentalists and the community at large.

During the last two decades organizational scholars have produced an impressive volume of research trying to understand the factors that influence social strategies in a firm. The literature has outlined three main drivers to the adoption of such strategies. A major research stream in the field argues that firms adopt social agendas because they are economically beneficial to the firm. From this instrumental perspective, management's concern for maximizing shareholder welfare is what drives their agenda to care for other



stakeholders. Even if economic gains can be ambiguous, long term and difficult to assess (McWilliams and Siegel 2001; Surroca, Tribó and Waddock 2010), caring for stakeholders may generate intangible benefits that improve the firm's ability to attract resources, enhance reputational trust and eventually build competitive advantage. Another stream of research explains the adoption of social practices for normative reasons, that is, firms engage and are responsive to stakeholders' demands "because it is the right thing to do" (Harrison et al. 2010). At the core of this perspective, is the idea that social actions are deeply grounded in moral values and are a reflection of the principal's ethical stance and a genuine attitude towards social ills. Finally, a third stream has emphasized the role of exogenous drivers as the main influence to embark in social initiatives. The drivers include institutional forces (e. g., Campbell 2007; Hoffman 1999; Jennings and Zandbergen 1995) and stakeholder pressures (e. g., Buysse and Verbeke 2003; Sharma and Henriques 2005) to which firms respond in order to gain social legitimacy (Deephouse 1999; Scott 2005). Under this view, firms react to unavoidable societal influences inducing the organization to positively contribute to the community. However, some firms may strive to give the appearance of acquiescence rather than adopting substantive actions in order to balance the tension between these external pressures for social initiatives and the rational, instrumental objectives of principals (Oliver 1991).

The starkly different positions noted above rarely consider the role of the individual manager in unleashing or inhibiting corporate social endeavors and when considered, the manager tends to be portrayed as a passive actor who plays a secondary role reacting to competitive or societal pressures. This omission is notable considering that managers, particularly the senior executives, make social decisions on behalf of principals in light of internal and external constraints as well as personal inducements. This omission can be explicatory of why similar firms vary widely in substantive actions to meet the needs of stakeholders. These actions can seldom be justified on pure financial considerations for the firm's principal. Thus, for instance, some firms in the same polluting industry and subject to the same regulatory regime may invest much more than others in pollution prevention and pollution control equipment

(Berrone and Gómez-Mejía 2009a; Berrone et al. 2010). Likewise firms facing similar financial conditions vary greatly in their willingness to lay off employees (Cascio 2006) or in providing work at home opportunities for employees who otherwise would be terminated (due to sickness, care of family members, spousal move and the like; Mayo et al. 2009). The fact that many of these managerial decisions are not taken for instrumental reasons to further shareholders' welfare may account for the fact that the link between social actions and firm performance has been equivocal (Choi and Wang 2009; Margolis and Walsh 2003; Orlitzky, Schmidt and Rynes 2003; Laplume, Sonpar and Litz 2008).

A related issue is that principals can afford to be more normative in their social outlook than managers who bear the employment and compensation risk of pursuing a social agenda. As noted by agency theorists, managers depend on a single firm for their livelihood unlike principals who typically enjoy more wealth diversification (Eisenhart 1989; Fama 1980; Fama and Jensen 1983a). For agents, lower returns as a result of diverting resources and attention to social causes could mean less pay, termination and a negative reputation in the managerial labor market which could impair their future earnings stream. Managers are unlikely to adopt a strong social and stakeholders orientation posture that is loosely coupled or detached from financial returns unless two conditions are present. The first is that dominant principals actively support such orientation and that this is clearly reflected in the monitoring and incentive alignment system for agents. The second is that managers enjoy sufficient discretion to pursue a stakeholder agenda. This means that depending on the level of analysis (owners versus managers), a normative or an instrumental view of stakeholder caring may be more salient. Managers are more likely to pursue a stakeholder agenda if they believe that this is instrumental to their career success by appealing to the principal's normative expectations and that this is something that they can actually implement.

As a whole the literature on care and compassion has tended to be internally focused, looking at people as either moral, amoral or immoral agents and runs parallel to the literature on stakeholder management that concentrates on the firm and its relation to those affected by the firm's actions. Perhaps part of the reason for these

separate streams is that the former generally treats the value of care and compassion as an indirect or intrinsic benefit for the players involved (Dutton and Quinn 2003) while the latter literature has a stronger instrumental flavor (namely that stakeholder management can provide the firm with a competitive advantage; Hillman and Keim 2001; Surroca et al. 2010). Consistent with these different orientations, the literature on care and compassion generally falls under the rubric of organizational behavior while the literature on stakeholder management largely falls under the purview of strategic management. We believe that as a result of this split, there is little theoretical guidance to examine why some organizations more than others purposefully take collective actions to meet the needs of stakeholders (see Dutton et al. 2006 and Brickson (2005, 2007) for an important exception). Organizations are frequently faced with choices that may cause physical and/or emotional harm to others, such as for example mass layoffs, plant closings, and polluting the environment. Studies on caring and compassion have mainly examined processes at the individual or subunit level (Lind et al. 2000; Seo, Barrett and Bartunek 2004) even though most critical aggregate decisions involving care and compassion for the needs of others which affect a great number of people take place at the top of the organization. That is, in a public corporation, senior executives make these decisions in light of what they think dominant owners value. Unfortunately, use of the term “firm”, which is an abstract concept used for analytical convenience, often means neglecting the proactive role of managers in making the strategic choice to pursue a social agenda.

We set out to develop a model that, focusing on the primary role of executives as decision-makers, sketch the conditions that facilitate or inhibit the intensity of what we call *proactive stakeholder engagement* (PSE). By this we mean, concerted organizational initiatives to identify and address the needs of others who have not financially invested in the firm, yet, who might benefit by the firm’s actions. This is important because, to date, there is no integrated analytical framework that helps explain differences among firms in these endeavors and what role managers, who are subject to varying constraints and governance systems, play in such heterogeneous responses.

Central to our model is the notion that PSE is ultimately a function of the latitude of action and incentives top executives have towards meeting the needs of stakeholders. Our theoretical logic starts from the premise that “to explain firm behavior is to explain how firms distribute and regulate the attention of their decision-makers” (Ocasio 1997, 188). In particular, we argue that managers’ ability to explore different practices in an attempt to learn about and meet stakeholders’ needs depends on the level of a) *explorative capacity*—the extent to which a firm’s stakeholder environment provides diverse opportunities and options for stakeholder-oriented activities; b) *managerial empowerment*—the boundary width of the feasible set of options managers can explore, as defined by the influence and control of a firm’s shareholders and board’s directors; and c) *salience of PSE* in the *monitoring and incentive system*. We contend that when all of these three dimensions are high, firms have a higher propensity towards PSE; henceforth, they are more likely to care for stakeholders’ concerns and attempt to meet their needs. When these dimensions are weak or misaligned (showing contrasting directions), tensions will arise in the decision-making process, which will lead to discontinuous, uncoordinated or limited investments into PSE. We further postulate the presence of factors within the firm (resource slack), competitive environment (environment dynamism), and manager level (individual values) that moderate these dynamics.

Our paper contributes to our understanding of caring and compassion for stakeholders at the organizational level in several different ways. First, we specify those factors that induce managers to proactively identify and consider the needs of others without a financial investment in the firm and attempt to meet those needs without a clear expectation of economic gains for shareholders. This allows us to develop a predictive model that explains why some firms more than others express a high degree of concern for stakeholders. Second, we highlight the central role top executives play in the design and implementation of stakeholder-oriented practices. This is an overlooked area in the stakeholder management literature which have tended to be very abstract in nature, focusing on stakeholder attributes (e. g., Frooman 1999; Mitchell et al. 1997), stakeholder-oriented strategies (e. g., Bermann et al. 1999; Hillman

and Keim 2001), or firm/industry characteristics (e. g., Jones 1995; King and Lenox 2000), treating the top executives who make PSE decisions as a black box. Third, we posit a set of moderators that have not been considered before that influence the extent to which enabling PSE factors (explorative capacity, managerial empowerment, and incentive alignment system) result in stronger organizational attempts to meet stakeholder needs. We conclude by sketching different scenarios that consider the combined or interactive effect of the three predictors noted above on the firm's PSE and discuss the implications of the model.

### 8.1. Theoretical background

Stakeholder theorists conceive the firm as part of a wider, open system where it is interdependently linked to stakeholders who can influence organizational objectives or be affected by its achievement (Freeman 1984). According to this view, the firm represents a multilateral set of relationships among stakeholders (Aguilera and Jackson 2003). One of the premises of the stakeholder model is that organizations should integrate relevant stakeholders into their strategic plans and decision-making process (e. g., Donaldson and Preston 1995; Jones 1995). Efforts aimed at improving stakeholders' welfare, firm-stakeholder relations and blending of diverse stakeholder needs into company strategies is usually referred to in the literature as *stakeholder management* (SM).

For our purposes, stakeholders are any internal or external individual or entity that can affect or may be affected by the firm's activities even if these parties have not financially invested in the firm or may not contribute to the wealth creating capacity of the firm. As such, they are potential beneficiaries of what we call proactive stakeholder engagement (PSE). As noted earlier, some scholars argue that the firm should engage its stakeholders and aim for a social impact because of its moral obligations and duty as corporate citizen (e. g., Donaldson and Preston 1995; Margolis and Walsh 2003). Yet, the vast majority of studies in the field have adopted the instrumental perspective, according to which firms that systematically consider all stakeholders' interests would also benefit financially (e. g., Bermann et al. 1999; Surroca et al. 2010).

Stakeholder-oriented firms might build long-term relational contracts, which can help save on transaction and governance costs (Jones 1995), increase operation efficiency and corporate overall reputation (Berrone and Gómez-Mejía 2009a), and develop intangible assets and dynamic capabilities (Aragón-Correa and Sharma 2003; Sharma and Vredenburg 1998). To the extent that these resources are valuable and difficult to imitate, their acquisition via SM may ultimately lead to better performance and be a driver of competitive advantage (Bermann et al. 1999; Hillman and Keim 2001). Institutional theorists have also argued that stakeholder management can enhance organizational legitimacy and that this, in turn, can help ensure firm survival (Scott 2008). Paradoxically, empirical support for the economic value of stakeholder management is weak at best (Margolis and Walsh 2003; Orlitzky, Schmidt and Rynes 2003), suggesting that other reasons play a large role, if not the most important role, in why some firms care more about the needs of stakeholders than others.

Surprisingly, most of the SM literature has sidestepped the manager as a locus of proactive stakeholder engagement (PSE). Yet the extent to which companies are able to build and integrate social initiatives into their strategic decisions depends on managers' capacity to identify and select stakeholders' issues that can impact or be impacted by organizational activities (Mitchell et al. 1997; Porter and Kramer 2006). It also depends on their actual ability to deploy resources for the implementation of those initiatives (Phillips et al. 2010). Mitchell et al. (1997) recognize that stakeholders' concerns do not manifest automatically as relevant; their claims are rather brought to management's attention by their relative legitimacy, pressure and influence. Only then managers become aware of the issue and might respond to it. According to their model, managers' response choices towards stakeholders are a function of a firm's dependence over salient stakeholders, so that only claims from stakeholders that are (perceived as) powerful, legitimate and urgent are addressed. Despite the emergence of this logic as to why some parties exert more influence than others on management, it still retains a distinctive instrumental flavor—executives react more quickly to satisfy those entities capable of withdrawing resources, inflicting harm and/or possibly jeopard-

izing their jobs (e. g., Frooman 1999). This leaves open the question of why some managers are more likely to engage stakeholders proactively apart from an explicit instrumental motive, to further shareholders' welfare. Next, we elaborate on the factors enabling managers to devote greater attention to identifying and meeting the needs of stakeholders.

### **8.1.1. Proactive stakeholder engagement**

The literature has provided a wide range of concepts and definitions including but not limited to corporate social performance, stakeholder management, social responsiveness, corporate ethics, and social policies (see Carroll 1999 for a review). In spite of differences in nomenclature, there is a general agreement among SM scholars that typologies of corporate social strategies can be placed broadly along a continuum that ranges from reactive to proactive. Reactive social strategies focus on meeting social and legal minimum requirements and oftentimes they are cosmetic rather than substantive (Berrone, Gelabert and Fosfuri 2009). They are used to manage impressions and "provide cover" by appearing to take steps in the right direction to fulfill the firm obligations to external constituencies. Firms pursuing such strategies are driven by instrumental factors such as avoiding legal sanctions or penalties and negative impacts on a firm's image or reputation (Russo and Fouts 1997; Sharma 2000). Examples of this strategy may include pollution control actions when dealing with environmental issues (Russo and Fouts 1997; Sharma 2000) or charitable contributions to non-governmental organizations and other civil entities without any further involvement.

Conversely, proactive social strategies, what we call proactive stakeholder engagement (PSE), focus on strategic substantive actions intended to solve a given social ill even if financial benefits to shareholders are distant or perhaps non-existent. Unlike reactive strategies, PSE implies meeting or fulfilling the needs of others when there is no clear reciprocity or direct exchange benefits provided by those stakeholders who are the recipient of the firm's PSE. In other words, PSE provides no direct gratification apart from the intrinsic satisfaction of creating social value for others. Another relevant difference with reactive strategies, which normally focus on

social aspects generated by the own firm such as firm's carbon footprint or direct unemployment, is that PSE relates to complex social problems that have an indirect link, if any, with the specific firm's actions like poverty, global hunger, child abuse, illiteracy, human rights, among many other social ills with the aim of promoting social values and greater social and civil integration. Therefore, a firm's PSE is more holistic and thus addresses stakeholders in the broadest sense: those affected directly or indirectly by firms actions as well as those who do not interface with the firm but suffer any form of pain (such as starving children in Africa or people left homeless in Haiti after a major hurricane). Put simply, PSE implies a genuine concern for the well being of humans, taking concrete actions to alleviate social problems. Given the depth and breadth of PSE and the fact that it does not happen by happenstance, PSE can generate major changes in operating processes and entail investments in new organizational resources and capabilities and, thus, it requires the inclusion of social criteria into the decision-making at the helm of the organization (Kanter 2009). Therefore, we focus on factors that influence managers' intentions and abilities to pursue PSE.

Our model advances three distinct factors—*explorative capacity*, *managerial empowerment*, and *incentive alignment system*—affecting decision-makers' attention and their propensity to engage stakeholders more broadly and actively. Once again we refer to this propensity as PSE to stress managerial desire to uncover and satisfy the concerns of stakeholders, even though the beneficiaries may not be able to reciprocate in a *quid pro quo* manner for this effort. With the PSE construct, we intend to capture all of those purposeful, organized actions implemented by the firm to (a) be alert and search for opportunities to meet the needs of all stakeholders; (b) scan the environment to uncover issues of importance to all stakeholders; (c) assess whether these issues are rising, peaking or declining, and their impact on firm's activities; and (d) experimenting through trial and error to see what may or may not work, before consolidating the practice into a new firm's stakeholder routine.

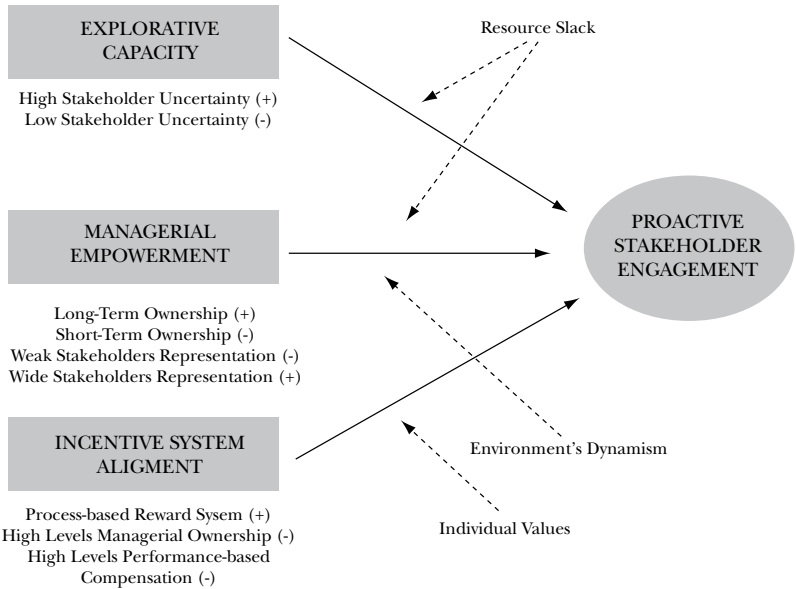
The stakeholder literature implicitly assumes that top executives face a broad array of options to manage diverse stakeholders and that they implement practices to engage them with the best interests of the firm in mind (e. g., Aragón-Correa, Matias-Reche



and Senise-Barrio 2004; Sharma 2000). However, in many situations, top executives have very limited “wobble room” to manage important stakeholders or have very limited information to detect and address stakeholders’ issues. For instance, Majumdar and Marcus (2001) found choices of environmental strategies contingent upon the degree of discretion allowed by environmental regulations of electric utilities in the United States. Moreover, having the opportunity or ability to act towards stakeholders may not automatically imply that managers will in fact take actions and implement new stakeholder-oriented practices. Managers might, for instance, lack the power and/or incentives to commit resources to the continuous engagement of stakeholders. In this regard, Dutton et al. (2006) found that the given set and type of routines within the organization may enable or limit the level and diffusion of attention to pain, and the coordination of responses.

In what follows, we delineate the contingencies broadening firm’s opportunities for proactive stakeholder engagement (PSE) and develop propositions on the enabling factors. Figure 8.1 offers an overview of the proposed model.

**FIGURE 8.1: The proactive stakeholder engagement framework**



### 8.1.2. Explorative capacity

*Explorative capacity* captures the extent to which a firm's stakeholder environment allows for a variegated set of opportunities to engage and manage stakeholders (Phillips et al. 2010). It accounts for the latitude of action top executives have towards a firm's stakeholders. The higher this latitude, the greater the number of options executives are required to scan and assess while implementing new practices for addressing stakeholders (Harrison et al. 2010). This wider latitude is generally associated with the necessity for the firm to continuously update its SM strategy in order to match the evolving preferences of its stakeholders. A major factor affecting explorative capacity is the level of uncertainty around the identification of stakeholders' issues and understanding of their relevance. High uncertainty increases the demand to continuously scan the environment to uncover what issues are of importance to stakeholders and for searching and implementing new initiatives that meet stakeholders' needs. Thus, it enlarges the field of options executives must consider when attempting to identify and satisfy these needs.

One effect of uncertainty is rendering ambiguous means-ends linkages, so that there are no well defined approaches for managing firm-stakeholders relationships (Li and Simerly 1998). Some stakeholders' issues and claims are context-dependent; may differ across different groups of stakeholders and may also change over time in the degree of their importance (Buyse and Verbeke 2003; Mitchell et al. 1997). This implies that the ambiguity or clarity with which stakeholders reveal their preferences and claims can vary greatly (Harrison et al. 2010). Accordingly, managers' capacity to aim at stakeholders is influenced by the degree of uncertainty that is involved with the process of scanning for and assessing stakeholders' issues. Existing stakeholder models fail to explicitly account for this critical dimension. In contexts where uncertainty about stakeholders' issues is pronounced, though, top managers must sort through a great deal of "noise" when trying to identify and prioritize among stakeholders' issues and assess trends in stakeholder relationships that may have implications on company's activities and/or performance.

Hall and Vredenburg (2003) introduced the concept of stakeholder ambiguity to refer to the uncertainty surrounding the

identification and accommodation of emerging and continuously changing stakeholders' preferences. Some stakeholders' positions, though not clearly articulated, can surge, in a particular moment, to relevant centrality for a firm's operations and competitive standing. Examples of stakeholder ambiguity extend to every context where conflicting and disparate goals create uncertainty about stakeholders' expectations and claims, information-processing complexity and high uncertainty about the options to reconcile those differences (Hall and Vredenburg 2003, 2005). For instance, stakeholder ambiguity is exacerbated by the lack of industry recipes (Cennamo, Berrone and Gómez-Mejía 2009; Spender 1989) in contexts where competitive dynamics spawn numerous competitive initiatives, which constantly affect the competitive environment and relative position of the participants. These environments show heterogeneity in firms' stakeholder practices, volatility in demand and performance and uncertainty about means-ends linkages (Aragón-Correa and Sharma 2003; Hambrick and Finkelstein 1987; Miles and Snow 1978). Instability and uncertainty define how risky the environment is; one where managers have, though, many opportunities of contributing to a company's value (Finkelstein 1992; Hambrick 2007). Those managers able to explore and implement the broad array of options these environments offer may be more willing to attend the needs of both close and fringe stakeholders (Hart and Sharma 2004) by experimenting and developing firm-stakeholders specific capabilities (Aragón-Correa and Sharma 2003; Sharma 2000; Sharma and Vredenburg 1998).

The ambiguity surrounding stakeholders (Hall and Vredenburg 2005) makes management's task hardly definable *ex-ante* (Jensen 2002). This also implies that managers are not bound to standard practices when implementing PSE: Different beliefs exist about the appropriate actions that meet stakeholders' preferences (Brickson 2007; Cennamo et al. 2009). In fact, Mitchell et al. (1997) notice that stakeholders' claims are not stable over time and across groups. As the authors maintain, "managers should never forget that stakeholders change in salience, requiring different degrees and types of attention" (Mitchell et al. 1997, 879). Since this interpretation is subject to the managers' vision and the company's strategy and

culture, it is likely to be idiosyncratic to each company (Agle et al. 1999), leading to differentials in firms' strategic postures towards stakeholders and in the intensity of PSE.

Stakeholder ambiguity would be high in environments of rapid market growth, where information about stakeholders may be contradictory because of the rapid evolution and because consensus about accepted PSE practices is lacking or harder to form (Hall and Vredenburg 2003, 2005). High-growth industries tend to have high demand instability (Amit and Schoemaker 1993; Barney 1986), usually associated with disruptive changes in technologies or production processes, that might in turn lead to changes in consumers' tastes and preferences, and/or changes in market or antitrust regulation (Hambrick and Finkelstein 1987; Finkelstein 1992). These contexts require and grant executives ample flexibility to consider multiple courses of action for managing firm-stakeholder relationships. Established practices might no longer be valid: what was an attractive alternative in the past might no longer be appreciated in the market or satisfy stakeholders (e. g., Amit and Schoemaker 1993; Buysse and Verbeke 2003; Mitchell et al. 1997). Accordingly, "demand instability creates uncertainty about means-ends linkages, which, in turn, creates discretion [as] the range of options is significantly expanded, inertial tendencies are reduced and the executive role is increased" (Hambrick and Finkelstein 1987, 382).

In summary, when uncertainty about stakeholders' issues is high, we expect upper echelons to have a broad terrain to explore and define stakeholder needs, expanding the set of options a firm can and must consider for addressing these needs.

*Proposition 1a: States of high uncertainty around firm stakeholders' issues and relevance*

- i) *Widen managers' capacity to exercise discretion towards stakeholders by enlarging the set of strategic options they can explore to manage firm-stakeholder relationships*
- ii) *Provide more opportunities for proactive stakeholder engagement activities.*

Conversely, in contexts where stakeholders' issues are more explicit and stable, they can be more easily and unambiguously detected (Campbell 2007). Such contexts are characterized by low stakeholder uncertainty. Herein, there is an implicit understanding of "who really counts" and of how much a weight and voice each stakeholder has in the decision-making process of the firm (Goll and Rasheed 2004; Mitchell et al. 1997; Phillips et al. 2010). Accepted practices to manage stakeholders usually emerge as legitimate at the industry level and restrict top managers' options (e. g., Frooman 1999; Marquis et al. 2007). Indeed, in such contexts, legitimacy may be the primary concern and scope of social actions (e. g., Campbell 2007; Deephouse 1996). When this is the case, firms might more likely tend to adopt homogeneous stakeholder-oriented practices by force of institutional pressure (Deephouse 1996; DiMaggio and Powell 1983; Marquis et al. 2007); and it may be more difficult for managers to justify broad social actions to peripheral stakeholders if sectorial social standards were not first met. In the oil and gas industry, for instance, local communities, environmental and governmental agencies are commonly perceived as powerful and legitimate stakeholders (Sharma and Vredenburg 1998), and efforts in the industry are concentrated in showing compliance with legal requirements rather than trying to solve "remote" social issues like world hunger. Environmental standards exist and are usually fixed by law; and processes to comply with them and "off-the-shelf" solutions are widely available as common knowledge to every company operating in the industry. Though companies can go beyond these requirements by devising innovative practices, this option is more risky and less likely: institutional convergence exercises a stronger pressure on firms (Berrone and Gómez-Mejía 2009a; Campbell 2007; King and Lenox 2000). For instance, in regulated industries, governmental agencies receive a great deal of attention from top managers, who are accordingly influenced in their choices by these agencies' vision, activity and recommendations (Marquis et al. 2007).

Quasi-legal constraints have a similar effect on managerial discretion, as regulations are important guides for how and where to focus corporate stakeholder-caring and social action (Campbell 2007; Marquis et al. 2007). King and Lenox (2000) find that,

under governmental intervention, companies tend to adopt required and often well-accepted environmental standards. Indeed, in cases of heavily regulated industries, the set of options available to managers is highly defined by explicit legal norms. Stakeholder-oriented activities may then be limited to practices that are prescribed by law or emerged as industry's standards, such that managers' capacity to exercise discretion towards stakeholders would be bounded by those practices (Campbell 2007). Given the strong convergence pressure of these contexts and the more limited opportunities for firms to develop unique firm-stakeholders competencies, firm's propensity towards PSE is expected to be relatively low.

*Proposition 1b: States of low uncertainty around firm stakeholders' issues and relevance*

- i) Limit managers' capacity to exercise discretion towards stakeholders by restricting the set of strategic options they can use to manage firm-stakeholder relationships to accepted, institutional practices*
- ii) Provide limited opportunities for proactive stakeholder engagement activities.*

### **8.1.3. Managerial empowerment**

Explorative capacity is not the same as having the discretion to actually choose different initiatives aiming at satisfying stakeholders. While the first indicates the existence of and *potential* ability for pursuing different options, empowerment to exercise such discretion specifies the *actual* actions that managers can undertake. Explorative capacity refers to the set of available options, whereas managerial empowerment relates to the firm's governance forces that shape the directions top executives can navigate. These ultimately, depend on where the control of company's interests resides and who has the ability to set the goals of the firm. Depending on the goals and interests of the company and of those who define them, managers' attention and consideration will be directed to some specific options rather than others (e. g., Gottschalg and Zollo 2007; Ocasio 1997). We examine here the effects of a firm's ownership and board composition, since share-

holder preferences and the directors who represent them have been shown to affect firm's goals and managers' behavior.

In the modern corporation, shareholders are usually those who set and redefine over time firm's objectives (Fama and Jensen 1983a). By prioritizing some goals over others and by exercising more or less stringent control over management's choices, they pave the direction for managers' initiatives, defining the boundaries of executives' power over firm's activities and strategic operations. The corporate governance literature has consistently looked at ownership concentration and composition as relevant predictors of managerial behavior (see Tosi et al. 1999, for a broad review). However, such distinction between concentrated and atomistic ownership says little about shareholders' preferences over stakeholder-caring activities and managers' capacity to explore practices towards stakeholders.

Though shareholders with large stakes may be uniform in their monitoring incentive, they may vary in their profile and interests, and hence, in their monitoring emphasis. That is, some large shareholders may be prominently focused on the return of their financial investment while others may favor investments meant to enhance the firm's long-term value and continuity. The implicit assumption that large shareholders are *all* long-term oriented is, in fact, an assumption that may find important exceptions (Kochhar and David 1996; Hoskisson et al. 2002); particularly when referring to stakeholder-caring practices (e. g., Johnson and Greening 1999; Walls, Phan and Berrone 2007). It is, then, more informative to directly analyze the identity and preferences of such shareholders rather than simply looking at the aggregate effect (Thomsen and Pedersen 2000). To that end, it is useful to classify ownership into long-term versus short-term oriented shareholders. The first comprises individuals or entities (e. g., families or pension funds) that have a long-term interest in the activities and value of the company, whereas the second refers mainly to investment funds and other financial investors whose main interest resides in more immediate financial returns of the company. While the former usually exercise voice, the latter rarely do so and rather prefer to exit the relationship with the firm and invest in other targets, should the firm disappoint

their financial expectations (Hoskisson et al. 2002; Johnson and Greening 1999; Ryan and Schneider 2002).

When firms invest in actions that may be questionable from an economic perspective, such as addressing the needs of fringe stakeholders, top managers may require the assurance of continuity in order to commit firm's resources to practices that are uncertain and whose value can be appraised only in the long-term. For PSE to be fully accepted, stakeholders might also need some sort of pledge that the firm is truly committed to a stakeholder approach. Long-term ownership like the one characterizing family firms may well signal such a commitment to both managers and stakeholders at large. First, and most importantly for our discussion, the family does not have a primary or exclusive interest in short-term financial performance (Casson 1999); rather, it tends to value multiple performance dimensions, including some that are non-economic in nature, such as the prestige, image and reputation of the firm in the local environment wherein the firm is socially rooted (Berrone et al. 2010). Second, since one of the main concerns of family owners is to provide the family with wealth and jobs for its members (Schulze et al. 2001), long-term prospects and continuity of the firm is an important, if not central, objective of those shareholders. Accordingly, they are likely to be interested in building a network of long-term relationships with the firm's stakeholders that can support the desired firm identity and provide the sort of high longevity ties that these family owners value. Therefore, family firms consider to a greater extent the welfare of their stakeholders and are more inclined to continuously engage their stakeholders, as research in the family business literature shows (Gómez-Mejía et al. 2007; Schulze et al. 2001). Berrone et al. (2010) find that family firms have better environmental performance and this effect is stronger the higher the roots of the firm in the local stakeholder environment. Moreover, these firms are more likely to go beyond accepted standards and explore different and more innovative ways of addressing stakeholders.

Other types of long-term oriented shareholders may have similar effects on the propensity of a firm towards stakeholders. As a case in point, in Japanese corporations—usually conceived as stakeholder-oriented—banks and insurance companies hold a large propor-



tion of shares which are rarely sold, since these owners are more interested in long-term business relationships with the firm (e. g., provision of financial services) rather than mere financial return (Sheard 1994). Indeed, existing research examining the effects of different categories of institutional ownership on corporate social performance has documented that long-term oriented shareholders play a more activist monitoring role, exercise less pressure over quarterly earnings and emphasize a firm's non-economic goals as a key organizational objective (e. g., Johnson and Greening 1999). On the other hand, shareholders oriented to short-term figures, such as investment banks and mutual funds, emphasize quarterly performance and may have a clear "preference for strategies and projects with a high profitability of a short-term payoff" (Johnson and Greening 1999, 566). Managers pressured by a short-term financial focus may have limited power to invest in stakeholder-caring activities that appear very uncertain and of dubious economic generation capacity. The dominant presence of these shareholders may also signal to stakeholders that managerial attention is limited to activities and strategies with clear focus on firm's profitability. Accordingly, managers of firms where ownership is concentrated in the hands of financially focused (short-term oriented) investors may eschew investments and commitment of firm's resources in PSE in favor of strictly financial operations.

In summary, especially in contexts where uncertainty and volatility about stakeholder preferences may induce risk-averse managers to desist from exploring different PSE options, long-term ownership concentration may properly alter this disincentive and *empower* managers to continuously explore activities to identify and meet stakeholders' demands even if doing so does not report any evident, direct economic gains. We claim, here, that long-term ownership concentration provides top managers with the empowerment and guidance towards continuous social activities. Formally stated,

*Proposition 2a: Long-term ownership concentration*

- i) Empowers top executives to take initiative towards stakeholders by offering commitment to firm-stakeholder relationships and assurance of continuity for investments in PSE strategies*

- ii) *Increases the likelihood for proactive stakeholder engagement activities.*

On the contrary, short-term owners (normally composed of financially focused investors) may constrain managers' capacity to act towards stakeholders by opposing and refusing firm's strategies that are not directly related with financial operations and not oriented to short-term financial results.

*Proposition 2b: Short-term ownership concentration*

- i) *Restricts top executives' empowerment to take initiative towards stakeholders by channeling managerial focus and commitment to firm financial objectives*
- ii) *Decreases the likelihood for proactive stakeholder engagement activities*

Relatedly, one would expect that firms whose dominant shareholders enjoy a high non-economic utility from social actions are more likely to empower managers to implement such actions. For instance, as noted above, family principals (who own a substantial portion of the shares in most privately and publicly controlled firms in developed economies, including one third of "Fortune 500" firms; Sirmon and Hitt (2003) tend to place a high priority on what Gómez-Mejía et al. (2007) refer to as socioemotional endowment or the stock of affect-related value a family derives from its controlling position in a particular firm. The preservation and growth of that endowment is not driven by an economic logic and often represents a pivotal utility to family principals. To be known as a caring and compassionate, firm should enhance that socioemotional endowment, similar to the arguments used by Berrone et al. (2010) to explain why family controlled chemical firms pollute less. Thus,

*Proposition 2c: Presence of dominant principals who place a high priority on socioemotional utilities*

- i) *Empowers top executives to take initiative towards stakeholders in order to enhance the principal's socioemotional endowment*
- ii) *Increases the likelihood for proactive stakeholder engagement activities.*

The capacity of managers to engage in PSE may also be influenced by knowledge of stakeholders' utility function, which in turn depends on the amount and quality of information executives have about stakeholders' issues and relevance (Harrison et al. 2010). Existing research has pointed to the board of directors as an important body of the company that can influence the degree of stakeholder orientation by acting as information channel. Directors assist the company's management on strategic and other important organizational decisions, propose strategies, monitor internal accounts and activities, ratify management's initiatives and appraise its performance (Fama and Jensen 1983a,b; Johnson, Daily and Ellstrand 1996). Of particular interest here is the composition of the board, since stakeholder representation and a firm's orientation towards stakeholders, may well vary contingent upon different directors (Luoma and Goodstein 1999; Wang and Dewhirst 1992). While stakeholder representation in the board can facilitate specific needs of the stakeholders that board members represent, it is likely they will also consider the needs of those who are underrepresented as they share unfavorable conditions. Instead of broadly considering the inside-outside dichotomy, we analyze differences between directors (both insiders and outsiders) representing a large set of stakeholders, and independent directors mainly focused on the financial objectives representing shareholders' interests (Byrd and Hickman 1992; Johnson et al. 1993).

If managers experience stakeholder uncertainty, directors are also likely to face it. This may be more pronounced for independent members who, restricted by their limited relationship with the company's stakeholders may lack knowledge about their needs and relevance. Some scholars have found that independent directors are less informed than insiders and can contribute less to board discussions (e. g., Baysinger and Hoskisson 1990; Boyd 1994). Because of this, and given their fiduciary obligation to shareholders, they might misperceive some of the PSE activities as "waste of resources" or self-interested spending. They could, thus, forego these practices as presumably conceived as detrimental to profitability and therefore against shareholders' financial interests. Westphal (1999) argues and provides evi-

dence for the notion that, while independence might increase the intensity of monitoring, it diminishes the value of a director's advice and counsel role.

In addition, counseling and monitoring from independent directors could heavily rely on peers' benchmarking activity, which inevitably restricts managerial behavior toward the adoption of industry's "best practices". Judgment takes the form of acceptable behavior on a yardstick basis; that is, the appropriateness of a CEO's action is evaluated in terms of what other CEOs generally do under similar circumstances, irrespective of their impact on performance (Staw and Epstein 2000). Since directors' reputation greatly depends on their monitoring capacity (Fama 1980), benchmarking appears as a less risky, straight and more reliable assessment procedure (Baysinger and Hoskisson 1990). When facing uncertainty about stakeholders, independent directors, we suspect, may simply support practices that are commonly employed by competitors. These monitoring preferences of independent members will limit the capacity of managers to take initiative towards (i. e., engage pro-actively) stakeholders by reducing the set of options they can adopt. The firm may accordingly fail to design and implement practices for integrating and meeting new stakeholders' issues and expectations that could arise in the specific firm-competitive context. Along this line, existing empirical evidence suggests that independent directors do not spur innovative solutions to improve environmental performance (Berrone and Gómez-Mejía 2009a; McKendall et al. 1999; Walls, Phan and Berrone 2007).

*Proposition 3a: A board of directors with weak representation of stakeholders*

- i) *Reduces top executives' empowerment to take initiative towards stakeholders by restricting to best practices the set of strategic options they can use to manage firm-stakeholder relationships*
- ii) *Decreases the likelihood for proactive stakeholder engagement activities.*

At the other end, directors representing broader stakeholder interests may be in a better position to evaluate the po-

tential benefits of social strategies and serve as support to the stakeholder orientation of the firm. They can provide precious advisory knowledge that they derive from their close relationship with the represented stakeholders. By spanning the boundaries of the stakeholder network, they can function as gate access to and channel of superior information (e. g., Hillman 2005; Hillman and Dalziel 2003) about stakeholders' utility function. Also, stakeholder representatives may be more sensitive about other issues of those who are not represented in the board and yet have a social valid claim. Moreover, stakeholder directors can prove an invaluable resource for top managers while solving the uncertainty underlying the identification of relevant stakeholders' issues. Knowledge of stakeholders' needs and their impact on firm's activities is indeed critical for a firm's ability to continuously form updated value propositions for stakeholders (Harrison et al. 2010; Porter and Kramer 2006). For instance, firms with boards in which stakeholders are largely represented tend to promote new environmentally friendly products and innovative social practices (Johnson and Greening 1999). Luoma and Goodstein (1999, 554) also suggest that stakeholder representation on board committees is a way for corporations to "enhance their legitimacy by signaling external and internal constituents that their boards have a stakeholder orientation". To the extent that these directors provide better stakeholder information to top executives, and that better information improves the odds of a successful social strategy design and implementation; managers of firms with a wider representation of stakeholders in their governing boards can have, all else equal, greater ability and empowerment to identify and address emerging stakeholder issues through PSE.

*Proposition 3b: A board of directors with wide representation of stakeholders*

- i) Empowers top executives to take initiative towards stakeholders by providing them with superior information about stakeholder's utility function*
- ii) Increases the likelihood for proactive stakeholder engagement activities.*

#### **8.1.4. Incentive alignment system and managerial risk bearing**

Even when endowed with the capacity and empowerment to engage stakeholders pro-actively, managers may still refrain from exploring different stakeholder-oriented practices because of limited incentives for it. As noted earlier, the agency literature has repeatedly warned us that top executives depend on one firm for their job security and their livelihood unlike diversified shareholders (Fama 1980; Fama and Jensen 1983a, b; Makadok and Coff 2009). For managers to engage in actions without instrumental value for shareholders, this might mean incurring greater employment and compensation risk, which for them could be personally catastrophic. Hence, the corporate governance system needs to provide managers with personal inducements to overcome an understandable reluctance to push a substantive PSE agenda. PSE activities entail complexity and require continuous investments of resources that rarely will prove to be economically beneficial. Because of the higher effort and attention they require on the side of managers and the limited economic results they offer, managers may refrain from such investments. Furthermore, pursuit of these activities with unclear financial value, which some shareholders may see as wasted altruistic efforts, may entail employment risk for managers whose contracts are usually renewed on an annual basis. Executives are likely to avoid these initiatives unless they are counterbalanced by strong incentives linked to process rather than outcomes, what Wiseman and Gómez-Mejía (1998) referred to as compensated risk. In our context, this captures the extent to which top executives are appraised and rewarded for evidence that they actively engage stakeholders even if the (financial) beneficial outcomes of this engagement cannot be quantified. This will involve a subjective judgment on the part of shareholders as represented by the board of directors.

Managers can have intrinsic motivations for addressing stakeholders that might derive from personal values and beliefs. And this certainly influences their propensity towards social initiatives (Agle et al. 1999; Goll and Rasheed 2004; Hemingway and MacLagan 2004). Nonetheless, managers usually rationalize their effort and motivation according to how much employment risk they face

(Godfrey et al. 2009) and the evaluation criteria used by the firm to assess their performance (Tosi et al. 1999). There is empirical evidence indicating that managers will pursue more proactive environmental practices if their compensation packages include environmental criteria to economically compensate the associated risks these practices entail (Berrone and Gómez-Mejía 2009). As Gottschalg and Zollo (2007, 420) put it, “the impact of extrinsic motivation depends jointly on the reward system in place, which determines the extrinsic work rewards (or sanctions) that the individual obtains as a function of any given behavior, and the importance of these rewards to the individual”. Due to the ambiguous link between PSE and performance, however, pursuit of PSE strategies requires the inclusion measurement and monitoring of social criteria as a part of the managerial assessment that is detached from measuring and reporting economic performance. Thus,

*Proposition 4a: Top executives are more likely to engage in proactive stakeholder engagement if these activities are evaluated and rewarded based on process rather than actual or imputed financial returns.*

Managerial equity ownership is one of the mechanisms often employed to align executives’ interests with firm’s objectives (Fama and Jensen 1983b). Equity holding should help CEOs adopt the long-term and flexible perspective, which is generally characteristic of equity ownership (e. g., Morck, Shleifer and Vishny 1988) and required for continuous investment in PSE. Johnson and Greening (1999, 574) found that managerial equity holdings increase managerial attention to stakeholders’ issues, since a commitment to social strategies may be viewed as “long-term commitment to sustainability”. When equity holding provides the right incentive for top managers to make long-term investments, and insurance against potential delayed results and failed experimentation, managers may feel more comfortable and motivated for experimenting broader stakeholder practices. By doing so, they are also more likely to contribute to the building of an enduring firm’s intangible strategic asset—firm-stakeholder relationships. To the extent that managers believe that this translates into a greater market financial value of the company, managers’ equity portfolio, hence wealth, should

perceptually improve, providing clear monetary incentives for investing in PSE.

However, as managerial equity holding grows large, a curvilinear effect may be in place. Different studies in the financial literature have documented a potential entrenchment problem associated with high managerial ownership (e. g., McConnell and Servaes 1990). One of the major problems associated with entrenchment is excessive inertia. Top managers, having their decisions barely questioned, may fail to explore different strategic options and conform to the first they consider valuable or that proved successful in the past. This may be particularly likely in contexts where means-ends linkages are so ambiguous that they may lead to inertia as a result of managerial overconfidence and self-attribution for success (Powell et al. 2006). Additionally, since a large stake of their wealth is at risk, top managers may eschew riskier social activities in favor of more conservative practices, as predicted by recent behavioral models on managers' risk-taking (Wiseman and Gómez-Mejía 1998). When large managerial stock holding induces excessive risk-aversion, top executives may avoid additional proactive social practices and conform to generalized policies, eventually failing to build the intangible assets derived from the consolidation of firm's idiosyncratic relationships with stakeholders. In summary, increasing levels of managerial ownership may stimulate managers toward PSE, but at a decreasing rate: high ownership levels may lead to PSE inertia due to excessive risk-aversion and/or overconfidence.

*Proposition 4b: Increasing levels of managerial ownership will increase managers' motivation to consider stakeholder needs and to take initiatives to meet them, but at a decreasing rate. In particular, high levels of managerial ownership*

- i) Reduce top executives' incentives to take initiative towards stakeholders by increasing the risk of the underlying asset at stake, hence strategic inertia*
- ii) Decrease the likelihood for proactive stakeholder engagement activities*

By tying the management's wealth to the company's financial value, stock-options are meant to motivate managers to act in the service of the company's long-term value: when company's value



increases, their remuneration and wealth also increases. It is further argued that this form of compensation stimulates strategic exploration by encouraging managers towards risk-taking activities, as stock options provide managers with infinite potential gains but limited losses (Dee et al. 2005). However, these benefits have been recently questioned (Gillan 2006), in particular with respect to stakeholder-oriented activities. For instance, Mahoney and Thorne (2005) and McGuire et al. (2003) both document a negative relationship between high levels of stock options and corporate social performance, and this has been mostly attributed to the missing association of strong corporate social performance with the firm's market value (Bird et al. 2007; McGuire et al. 2003). Berrone and Gómez-Mejía (2009b) also argues that stock options and other monetary incentives can crowd out natural intrinsic incentives common in social endeavors and promote opportunistic behaviors. Along this line, Cennamo (2008) advances that managers may take more than optimal risk when forecasting sure "losses" in their options (i. e., market price lower than grant option price), and that such perverse incentive (Deyà-Tortella et al. 2005) can "jeopardize the firm's relations with its risk-averse stakeholders, and reduce the potential benefits that could have been derived from a SM [stakeholder management] strategy" (2008, 107).

This potential inconsistency has been empirically documented in numerous studies. O'Connor et al. (2006) and Denis et al. (2006) find a positive association between large option-based managerial pay and the likelihood of fraud allegations, with the latter concluding that there exists a dark side to incentive compensation. Zangh et al. (2008) also find a higher likelihood of CEO earnings manipulation for firms with a larger number of out-of-the-money options (options with no positive value). As the authors state, "stock option incentives may not always be effective in aligning the interests of CEOs and stakeholders. Rather, they may actually encourage the pursuit of self-interest under some conditions, resulting in incentive misalignment" (Zangh et al. 2008, 242). From a stakeholder theory perspective, Jones (1995) also contends that excessive executive compensation can be perceived as an abuse of trust. Firms with high levels of performance-based compensation may accordingly distract managers' attention from

stakeholder-caring activities, convey contradictory signals to stakeholders and negatively affect the stakeholder orientation of the firm. Managers may avoid investments in PSE activities and rather privilege self-interested, short-term financial activities (Cennamo et al. 2009) over long-term strategies that are in the interest of the company and its stakeholders at large.

*Proposition 4c: Increasing levels of stock options will augment managers' motivation to take initiatives towards identifying and meeting stakeholders' needs, but at a decreasing rate. In particular, high levels of stock options*

- i) Reduce top executives' incentives to take initiative towards stakeholders by diverting their attention to market-based financial objectives and self-interested activities*
- ii) Decrease the likelihood for proactive stakeholder engagement activities*

In short, the above propositions suggest that an appropriate monitoring and incentive alignment system is needed to induce managers to undertake substantive PSE actions, which, *ex ante*, offer doubtful, ambiguous benefits to shareholders.

### **8.1.5. Moderating effects**

#### *8.1.5.1. Resource Slack*

The degree of explorative capacity, as argued above, varies according to the degree of uncertainty around firm stakeholders' issues and relevance. It is a function of the contextual stakeholder environment a firm faces. Nonetheless, firm-level factors, such as availability of slack resources, can magnify (when high) or reduce (when low) the effect of explorative capacity on PSE. Available slack can be conceived as a "resource cushion" (Bourgeois 1981) that firms can use to create new capabilities or alter the existing ones in response to environmental changes (Sirmon et al. 2007); lessen organization internal conflicts and facilitate innovative initiatives (Cheng and Kesner 1997); and exploit opportunities (Daniel et al. 2005). Bowen and Sharma (2005, A2) contend that, "available slack in the forms of retained earnings, discretionary budgets or excess managerial time, [Ö] in the short term [Ö] is

not absorbed into the firm, and is available for discretionary use. Uncommitted, available slack that they maintain can improve a social and environmental posture of a firm by better supporting firm's environmental practices. Such practices, as any other strategies for managing firm-stakeholders relationships, entail some degrees of ambiguity since the firm cannot fully assess the ultimate value and performance effects of the underlying intangible assets stakeholder-caring practices aim to build. An abundance of resources can be then necessary for exploring different practices also because slack creates funds that can be redirected toward projects with uncertain outcomes, fostering an environment for innovation" (George 2005: 661). Other studies have also found a positive relationship between availability of firm's resources and stakeholder-oriented practices (e. g., Buchholtz et al. 1999; Goll and Rasheed 2004; Surroca et al. 2010).

All else equal, greater slack has the ultimate effect of enlarging managerial explorative capacity and managerial empowerment since it provides CEOs with abundant resources they can pool from to support their strategic initiatives (Bowen and Sharma 2005; Cheng and Kesner 1997; George 2005). Higher slack expands the set of strategic choices that managers can pursue and promote higher exploration and experimentation (George 2005). On the contrary, when little slack exists, managers' ability to navigate different course of actions will be limited, reducing organization's flexibility (Cheng and Kesner 1997). We expect resource slack to affect and moderate the influence of explorative capacity and managerial power on PSE.

*Proposition 5a: A firm's resource slack will affect a firm's propensity towards proactive stakeholder engagement by moderating positively the explorative capacity–PSE relationship*

*Proposition 5b: A firm's resource slack will affect a firm's propensity towards proactive stakeholder engagement by moderating positively the managerial empowerment–PSE relationship*

#### 8.1.5.2. Environment's Dynamism

We have argued that even when they face contexts of higher explorative capacity managers could fail to exercise such discretion because of the boundaries imposed on resource allocation

activities by other powerful actors; namely, firm's owners and board directors. These constraining effects could be greater in more dynamic competitive environments. These environments are characterized by a higher rate of change in customers' demand, products' utility and stakeholders' preferences (Garg et al. 2003; Li and Simerly 1998).

Dynamism entails varying degrees of innovation and munificence, which affect the value of a firm's existing capabilities (Sirmon et al. 2007), including firm's ability to engage proactively stakeholders (Goll and Rasheed 2004), and the effectiveness of monitoring systems (Li and Simerly 1998). Existing studies have shown that firms operating in dynamic environments need greater information and strategic flexibility, exert greater efforts in their environment scanning activities, and must continuously explore new innovative options for better matching evolving preferences of customers and stakeholders at large (e. g., Garg et al. 2003; Goll and Rasheed 2004; Li and Simerly 1998). Since experimentation and flexibility are more important in dynamic environments, the negative effects of the mechanisms and forces that limit discretionary activities can be stronger therein. Goll and Rasheed (2004) find that in dynamic environments a firm that engages more broadly its stakeholders is in a better position to gain support from its stakeholder groups. Stakeholder support, in turn, helps the firm to reduce part of the unpredictability implied by the environmental change.

Firms with a low PSE propensity cannot fully benefit, though, from such support and might further reduce their stakeholder engagement activity. Under rapid change in stakeholders' preferences, owners with short-term investment horizons, as well as boards with weak stakeholder representation, will have very limited and ambiguous information about stakeholders' utility and might be even more inclined to perceive PSE as a resource distracting activity. In line with this logic, Li and Simerly (1998) argue that, under greater environmental dynamism, monitoring activities of top managers and their performance might be inadequate when conducted by external constituents (outside owners). These owners will find it difficult to assess the validity and potential impact of given strategies because of their lack of engagement in the strategy-making process. Thus, we expect the following.

*Proposition 5c: The degree of environment's dynamism will affect a firm's propensity towards proactive stakeholder engagement by moderating positively the managerial empowerment–PSE relationship*

#### 8.1.5.3. *Managers' Individual Values*

The positive effects of the appraisal and reward systems on managerial motivation to identify, to care for and satisfy stakeholder needs can be reinforced or mitigated by managers' individual values. Besides extrinsic motivation that top managers derive from objective (mainly monetary) incentives, intrinsic motivation—the relevance of each goal to the individual motivational preferences and the congruence of the behavior with his/her norms and values—does affect managerial inclination for acting in a certain way and the intensity of such actions (Gottschalg and Zollo 2007). Especially with respect to stakeholder orientation and social initiatives there is extensive evidence for the notion that intrinsic values influence, and some times are key determinants of managers' desire to meet the needs of stakeholders (e. g., Agle et al. 1999; Goll and Rasheed 2004; Dutton et al. 2006). In this regard, Hemingway and MacLagan (2004, 36) argue that the degree of stakeholder engagement can be “the result of championing by a few managers, due to their personal values and beliefs, despite the risks associated with this”. Similarly, Mitchell and colleagues (1997) suggest that the beliefs and values of top executives will likely influence managerial perception of stakeholder salience, hence the propensity to act towards stakeholders, and are expected to moderate, therefore, the relationship between stakeholder salience and corporate social performance. Both Goll and Rasheed (2004) and Agle et al. (1999) have tested and found evidence for this moderating effect. Disentangling extrinsic versus intrinsic motivation, Agle and colleagues make, for instance, a distinction on the value dimension of a top executive between self-interest and “other-regarding” interest; the latter signifying the propensity of managers to act in ways that benefit others. Values, then, “shape levels of selectivity and intensity [towards stakeholder-oriented practices] through their influence on what dominates an individual's perceptual field and demands mental focus” (Agle et al. 1999: 511). Other scholars have found that for family-controlled companies

these effects can be particularly strong since owners' and managers' beliefs and value systems can highly influence firm's values, vision and mission, and foster higher integration of stakeholder practices into a firm's strategy (e. g., Berrone et al. 2010; Perrini and Minoja 2008). Thus, we expect managerial extrinsic motivation for PSE to be influenced in its intensity by managers' individual values, and propose the following last proposition.

*Proposition 5d: Managers' individual values will affect a firm's propensity towards proactive stakeholder engagement, by moderating positively the incentive alignment system–PSE relationship.*

## 8.2. Discussion and conclusion

Taking a step back from the stakeholder management (SM)-performance debate, we have developed a model outlining the antecedents that explain why some firms devote more time, effort and financial resources to identify and meet the needs of a broad set of stakeholders. While the care and compassion literature has been primarily focused on intraorganizational activities, we extend the horizon of that literature to consider a firm's relationship with multiple stakeholders including those, may be at the fringe of the organization. Our model predicts that firms are more likely to engage stakeholders, even when economic benefits of this activity to principals are doubtful, when managers operate in environments of high uncertainty about stakeholders' issues and concerns, when managers are empowered by dominant owners to pursue a social agenda, and organizational control mechanisms encourage managers toward PSE. Intervening factors (such as slack, environmental dynamism and congruent managerial values) may then reinforce these effects.

The proposed theoretical framework is not intended to be comprehensive in explaining the whole set of factors that influence the allocation of resources for the development and deployment of organizational capabilities for generating PSE. Rather, it highlights some organizational characteristics that will make them more likely to develop and deploy capabilities for such a strategy, explaining, at least partially, why some firms are more

sensitive than others to the needs of stakeholders, especially when responses to those needs do not report a clear, direct economic value. Other frameworks, such as those deeply rooted in ethical principles, can complement our rationale for corporate actions intended to solve social ills, particularly when doing good implies sacrificing profits.

One challenging issue in our formulation is to accommodate the fact that different combinations of exploratory capacity, managerial empowerment, and incentive alignment system may lead to varying levels of PSE. Some of these dimensions may substitute or neutralize the impact of others, and the joint effect of some combinations may have a higher influence on PSE than singular additive effects. We speculate that the following combined scenarios are likely, although other possibilities may be present.

*SM reactive orientation.* A scenario where top executives are in a strong position to take actions towards stakeholders (high explorative capacity and managerial empowerment), yet have limited incentives to invest time, resources and capabilities in PSE (low PSE salience in the incentive system). Managers might undertake actions towards stakeholders only when pressured by their claims and issues, or by influential shareholders/directors.

*SM frustrated orientation.* In contexts where top executives are motivated to engage stakeholders more actively and broadly, yet are limited in the set of resources they can deploy to attend to stakeholders (low empowerment), they have a higher propensity towards PSE but limited means and discretion for implementing explorative practices. This is a “wish-but-can’t” scenario.

*Social laggard.* In the case where both empowerment and motivation (from the incentive system) are low, but explorative capacity high, the firm may lag behind competitors in its social stance. Explorative capacity is high, providing different opportunities for attending to stakeholders; yet, the firm fails to explore and give course to them. When rivals do explore different social practices to attend to and anticipate stakeholders’ needs, the focal firm may rank low compared to those firms in terms of social performance. It could be perceived by stakeholders as “socially irresponsible” or that it does not do enough relatively to competitors and be accordingly penalized.

*SM disruptive orientation.* High explorative capacity, high empowerment, and high motivation represent cases where environmental and organizational conditions push managers to continually explore different options for managing and satisfying stakeholders. Stakeholder-oriented practices are designed and explored with an eye on the future, rather than as response to current pressure from salient stakeholders. Eventually, innovative practices will disrupt and substitute current, standard practices (Christensen and Bower 1996).

The foregoing taxonomy sets the bases for future research aiming at the understanding of caring corporations. Empirical tests of our framework should isolate the impact of environmental conditions, organizational structures, and individual motivations on corporate social engagement. Results can not only be useful to describing how organizational controls and incentives define each of the above categories but eventually evolve to a set of normative expressions which will indicate what organizational elements can be modified in order to make organizations genuinely more socially conscious. This is particularly encouraging for the social management field, which is largely accused of being irrelevant and ineffective at creating social welfare (Karnani 2010).

Our paper highlights the importance of how normative expectations by principals translate into social endeavors by managers who by virtue of their vulnerable position are more likely to view PSE in an instrumental manner (that is, considering the effect of PSE on performance appraisals, job security, compensation and the like). As social initiatives follow under the PSE approach, which emphasizes their social rather than economic value, reliance on financial measures seem to be less appropriate. Yet, social actions require to be assessed by some means in order to evaluate their effectiveness in addressing social demands and do not deviate from their intended aims. This is also important when designing explicit incentives, as they should account for the process of implementing social actions rather than for their economic value. This represents an opportunity and a challenge for organizations and scholars in the area.

An ongoing debate in the stakeholder management literature revolves around the controversial question of whether firms simply respond to stakeholders' issues when they arise by adopting



institutional practices, or take a more active stance towards stakeholders by trying to anticipate their needs and developing firm-specific, care-oriented practices (e. g., Hillman and Keim 2001; Sharma 2000). An additional, less explored issue is the management's role in identifying who are relevant stakeholders, determining their relative importance, and assessing the magnitude of their claims (Mitchell et al. 1997). Our position is that these two issues are in fact interdependent. That is, whether the firm engages more or less proactively its stakeholders depends on whether its executives have wider (or restricted) capacity and inducements to invest resources in exploration activities aimed at identifying and integrating stakeholders' issues within the firm's strategies.

We have avoided the issue of PSE-firm performance relations in large measure because an organization's initiatives to meet stakeholders' needs may not be primarily driven by an instrumental "tit for tat" exchange logic that benefits shareholders. And as noted earlier, empirical attempts to establish a SM-performance linkage have generally led to conflicting and difficult to interpret results, no doubt because it is extraordinarily difficult to isolate the unique influence of SM activities on firm performance. Firm's desire to identify and meet the needs of stakeholders depends on the decision framing of the top management team. The choice to do so may be influenced by instrumental concerns (such as coopting parties that may harm the interests of managers or the creation of intangible resources) yet this perspective is overly narrow. Whether or not top executives decide to proactively engage stakeholders is likely to be influenced by factors that are not directly coupled with firm performance such as discretion, preferences of dominant shareholders, personal incentives and values. Enhanced firm performance may only be a loose byproduct of this complex set of factors. And while there is a tension between caring and compassionate actions by firms with the rational, instrumental objectives of organizations, it is ultimately the manager who bears most of the burden of risk for making these decisions, which might or might not benefit the firm's principals.

As the world cries out for repair, the society looks at corporations as major social players, expecting from them to actively participate in addressing social problems. While the traditional economic ra-

tionale indicates that the market will ultimately sort out what is the best use of a firm's resources, mounting evidence of human pain and suffering is an indication that market itself is handicapped to create social welfare. One of the major constraints resides in the causally ambiguous link between social activities and firm's financial performance. If the motivation to take on social issues should rely uniquely on its instrumental value for financial performance, the promotion of social welfare would be hardly advanced. Instead, a more proactive approach might be needed; one that involves all individuals in the corporate world (managers, directors, scholars, and regulators) to help create organizations more caring and compassionate.

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## PART THREE

### ON MICRO-FOUNDATIONS



## 9. Corporate Governance and Stakeholder Relations

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TRADITIONAL economic theorizing on corporate governance has often relied on the assumption that contracts between an organization and its stakeholders are complete. Such contracts address all possible disputes that may arise during the relationship between the contracting parties. The assumption of complete contracting has been challenged within the property rights literature, which can be differentiated in a classical and a modern property rights approach (Asher, Mahoney and Mahoney 2005; Mahoney, Chapter 5). The classical approach (e. g., Alchian and Demsetz 1972; Coase 1960) is concerned with aligning residual claims to mitigate *ex ante* contractual problems, whereas the modern approach (e. g., Grossman and Hart 1986; Hart and Moore 1990) examines the allocation of residual control rights to mitigate *ex post* contractual problems. The incomplete contracting perspective of the modern property rights approach, as used in Chapter 5, is particularly useful to examine stakeholder relations in a corporate governance context.

Using the lens of incomplete contracting, organizations create value by governing the joint production of multiple stakeholders in ways that would not be possible in pure market relationships (Zingales 2000). In this view, corporate governance has an important function in resolving conflicts among stakeholders. Based on these ideas, we conceptualize corporate governance from an incomplete contracting perspective and distinguish different types

of stakeholder relations. We draw on the theoretical and empirical literature, in particular in the area of law and economics, to analyze the diversity of governance arrangements that deal with incomplete contracts. Thereby, we focus on three categories of governance institutions that influence this diversity, namely corporate law, organizational arrangements, and social norms. Our analysis reveals that there exists a large potential for diversity in corporate governance arrangements. We suggest that an explicit consideration of such diversity deepens our understanding of the governance characteristics as well as their possible determinants that shape a firm's stakeholder relations in order to create organizational value.

### **9.1. Defining corporate governance from an incomplete contracting perspective**

Corporate governance at the first glance, may appear to be an alien element in a free-market economy (Zingales 1998). This is true only in a world of complete contracts. In such a world, the market would allocate resources efficiently. There would be no apparent need for the exercise of authority and control, as in the case of corporate governance. Instead of exercising authority, the different parties involved in a transaction would just agree on the terms of a contract. The decision to enter into a contract would be based on the anticipation by the contracting parties that the contract will make them all better off. This decision would be completely voluntary and the only authority needed would be the courts enforcing the contracts. Therefore, an important question is why we often observe authority relationships even among contracting parties.

In contrast to this view, the modern property rights literature derives the importance of corporate governance from the shortcomings of formal contracts. This literature states that contracts are especially useful when different parties intend to arrange an exchange that involves promises to do something in the future (Stout 2011b). For example, suppliers may receive a part of their payment before they deliver their goods and services. Or employees may receive wages during their training period before they are able to

contribute to joint production in the firm. Such contracts typically are incomplete in the sense that they do not address all possible disputes that may arise during the relationship between contracting parties. The bounded rationality of contracting parties, the complexity of exchanges between them and the difficulty of proving contract breaches, often make it costly or impossible for contracting parties to write complete contracts (Williamson 1985).

Although most contracts are incomplete (Scott 2003), there is a great variety in the extent of incompleteness. This variety ranges from relatively “discrete” contracts, which are easily written and are able to address most relevant aspects of the exchanges between parties, to “relational” contracts, which leave many aspects of the exchanges open to future resolution (Macneil 2000). Due to their paucity of formalization, relational contracts<sup>1</sup> can be defined as “informal agreements and unwritten codes of conduct that powerfully affect the behaviors of individuals” (Baker, Gibbons and Murphy 2002, 39). Relational contracts typically involve complex, long-term exchanges and are widely used between organizations and their stakeholders to circumvent the problems associated with formal contracting.

Relational contracts are difficult to enforce in courts because the unwritten terms of contract are difficult to verify by judges. Indeed, Posner suggests that courts may be “*radically incompetent* given the demands that are placed on them by relational contracts” (2000, 754 emphasis in the original). Moreover, Stout (2011b) submits that the way courts resolve disputes over relational contracts is similar to resolving disputes by flipping a coin because the contracting parties can hardly anticipate the court’s decision. Judges might decide based on their beliefs about what the contracting parties would have written into their contracts if these contracts were complete. However, such a decision is complicated by the judges’ bounded rationality and by the complexity of exchanges in relational contracts. Thus, the same factors that prevented contracting parties from writing complete contracts *ex ante* also make it difficult for courts to settle disputes *ex post*.

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<sup>1</sup> Relational contracts are also known as implicit contracts (e. g., Bull 1987) or self-enforcing agreements (e. g., Telser 1980). We use these terms interchangeably.

The difficulties of enforcing relational contracts explain why different parties may not enter into a contract, even though both parties would benefit from potential economic exchanges. Because the reliance on courts is often insufficient, the parties can resort to other institutions for conflict resolution. If these other institutions provide a satisfactory solution to the enforcement problem, they can facilitate beneficial economic exchanges that would otherwise not occur.

In the organizational context, corporate governance represents such an institution that can support the enforcement of relational contracts. Organizations typically have incomplete contracts with various stakeholders, such as shareholders, employees, customers, and suppliers. These stakeholders often contribute essential resources to the joint creation of value (Blair and Stout 1999). The created value, called a quasi-rent, is defined as the difference between the value generated by the stakeholders in joint production and the value they can obtain in the marketplace (Zingales 1998). Because incomplete contracts do not perfectly specify the distribution of value among stakeholders *ex ante*, quasi-rents need to be divided among stakeholders after they enter into relationships with the organization (Williamson 1985). The bargaining over quasi-rents creates the potential for conflicts among the stakeholders. Corporate governance can serve as an institution for solving these conflicts and assuring the stakeholders that their contributions to joint production will be properly rewarded.

In this spirit, we follow Zingales' (1998: 498, emphasis in the original) definition of corporate governance as:

*the complex set of constraints that shape the ex post bargaining over the quasi-rents generated by a firm.*

In sum, corporate governance can contribute to organizational value creation by facilitating economic exchanges that would otherwise be prevented by the problems of enforcing relational contracts. But what are the types of exchanges that need to be fostered in this way? The economic theory of incomplete contracts particularly emphasizes the exchanges involving firm-specific investments.

## 9.2. Stakeholders' firm-specific investments and organizational value creation

The corporate governance definition derived from the incomplete contracting perspective is based on the view of the firm as a *nexus of firm-specific investments* (Rajan and Zingales 1998; Zingales 2000). This view of the firm is consistent with the resource-based approach in the management literature because it acknowledges the importance of stakeholders' firm-specific investments for organizational value creation (Mahoney, Chapter 5; Wang and Barney 2006).

Firm-specific investments often are essential sources of an organization's sustained competitive advantage because they are likely to contribute to the creation of intangible and non-imitable assets (Barney 1991; Grant 1991; Hall 1993). An important asset of this type is firm-specific human capital, which needs to be generated, accumulated, transferred, and protected (Foss and Foss 2000; Grandori and Kogut 2002; Grant 1996; Kogut and Zander 1996; Mahoney and Pandian 1992; Penrose 1959; Rumelt 1984; Teece, Pisano and Shuen 1997).

Although firm-specific investments may enhance organizational value creation, this does not necessarily imply that the organization will have a superior performance in terms of shareholder value (Lepak, Smith and Taylor 2007). The reason is that stakeholders other than shareholders may appropriate a large share of the rents. As Coff (1999) maintains, the resource-based approach was originally formulated to examine the total rents generated by an organization, rather than the part of the rents appropriated by shareholders. In some cases, it may well be that shareholders receive only average returns on their investment, whereas other stakeholders appropriate large surpluses generated by the organization.

From a standard economic perspective, one might ask why researchers should bother about the rents appropriated by non-shareholder constituencies. After all, shareholders are commonly known to be the residual claimants to the firm's earnings. Therefore, maximizing share value should equate to maximizing the total value of the firm (Easterbrook and Fischel 1983). However, Blair (1995) posits that there may be other residual claimants be-



sides shareholders, namely stakeholders that make firm-specific investments and cannot fully protect their investments through formal contracts. These stakeholders bear a firm-specific risk and therefore have a legitimate claim to part of the firm's residual earnings. Accordingly, the total value generated by a firm equates to the total value captured by all stakeholders (Asher et al. 2005; Mahoney 2005).

Coff provides a formal definition of rent generation and posits that “a firm generates rent when *all stakeholders receive sufficient compensation to hold them in place* ( $\text{pay} \geq \text{opportunity cost}$ ) and *some stakeholders get more than would be required to hold them in place* (rent)” (1999: 121, emphasis in the original). For example, employees may appropriate rents in terms of high wages and suppliers may earn above-market returns. However, these rents are not reflected in the firm's profits because profits are calculated as the residual after these other stakeholders have been paid. Consequently, the total value generated by an organization is difficult to observe in traditional measures of organizational performance such as profits and stock prices. Even if traditional performance measures were positively correlated with resource-based advantages, Coff (1999) suggests that these performance measures would only reflect the “tip of the iceberg”, with much of the generated rents being “below the water line.”

Researchers recognize the importance of value appropriation by multiple stakeholders not only within the resource-based approach but also within the corporate finance literature. Zingales suggests that, “in assessing the value generated by a firm we have to consider the surplus captured by other stakeholders. A more reasonable approach to valuation, thus, would be to discount the total value added generated by the firm” (2000, 1645). Such an approach to the valuation of firms would indeed be a paradigm shift compared to traditional approaches in corporate finance. Zingales (2000) posits that this paradigm shift is necessary because of the changing nature of firms, with firms becoming more decentralized, more dependent on human capital and less characterized by clear-cut stable boundaries.

Of course, measuring the total rent generation by the firm is a major challenge. If the total value added is already difficult to

observe by the organization's stakeholders and competitors (Coff 1999), it may be even more difficult to observe by researchers. From a theoretical point of view, a direct measurement of quasi-rents would require researchers to collect data on stakeholders' opportunity costs and on the payments they actually receive. Moreover, researchers would need to estimate stakeholders' future surpluses and to calculate their net present value. However, such a direct measurement is rarely feasible due to data constraints. Thus, it is understandable that most empirical studies still rely on traditional performance measures to assess organizational value creation.

To circumvent the problems of data constraints, researchers have developed other (more indirect) approaches to estimating the total rent generated by a firm. One possible solution is to find indicators for the value captured by salient stakeholders such as employees. For example, Yoshikawa, Phan, and David (2005) used wage intensity, defined as the ratio of expenditure on employee wages to sales, as an indicator for employees' value capture. Another solution is to estimate changes in total factor productivity as an approximation for changes in value creation by the firm. Lieberman and Balasubramanian (2007) applied this approach to quantify the value created by Toyota and GM over 20 years and they assessed how this value was distributed among shareholders, employees, customers, and the government.

Although these approaches provide promising avenues for future empirical research, they are still in their infancy and are not widely used. The inclusion of additional stakeholders in empirical analysis is likely to be (partly) driven by data availability. Further, the included stakeholders may not always be those that make substantial firm-specific investments. For example, Lieberman and Balasubramanian (2007) included the customers in their empirical analysis but had to drop the suppliers due to data constraints. However, the suppliers are likely to make substantial firm-specific investments to adjust their production processes to those of Toyota and GM, whereas the customers typically have more arm's-length relationships with these auto manufacturing firms.

As a complement to examining organizational value creation, researchers may also investigate non-monetary dependent variables such as stakeholders' happiness. In economics, happiness has

increasingly been used as an indicator of individual utility (e. g., Blanchflower and Oswald 2011; Frey and Stutzer 2002; Oswald 1997). Judge and Kammeyer-Mueller (2011) have recently suggested to consider happiness as an important end in itself in management. Although the management literature has shown some interest in related constructs such as job satisfaction, the analyses have often focused on the connection between these constructs and other outcome variables, such as profits, costs, or productivity (Pfeffer 2010). Viewing stakeholders' happiness in a non-instrumental way would lead to a more varied assessment of firm performance, beyond traditional measures of shareholder value.

As noted above, organizational value creation and value distribution are closely intertwined. When stakeholders anticipate that proper rewards will be forthcoming for their contributions, they are more likely to make firm-specific investments thus contributing to organizational value creation. The anticipation of proper rewards typically relies on the maintenance of relational contracts. Now we turn to the questions on how relational contracts can be breached and how corporate governance mechanisms can prevent such breaches.

### **9.3. How to support relational contracts**

Because relational contracts are difficult to enforce in courts, they need to be self-enforcing (Telser 1980). That is, the contracting parties need to have faith that they are better off by continuing the contract instead of ending it. The faith of the organization's stakeholders in relational contracts can be threatened by managerial opportunism (Williamson 2002), which may lead to breaches of relational contracts. Managers can breach relational contracts, first, by ceasing to cooperate with a stakeholder unexpectedly and cooperating with another stakeholder instead (Bull 1987). This type of breach is less likely to happen when the organization faces prohibitive transaction costs of replacing stakeholders (Williamson 1975). For example, organizations might incur high costs when dismissing employees and then recruiting and training new ones until they reach the same level of productivity. Second, managers may breach relational contracts by unilaterally changing the terms of coopera-

tion with stakeholders and thereby exposing them to “holdup” risks (Klein, Crawford and Alchian 1978). For example, after employees have made firm-specific investments, managers may unilaterally cut their wages and thus undermine the value of their firm-specific human capital (Yoshikawa et al. 2005). As employees cannot easily re-deploy their firm-specific human capital to another firm, they are vulnerable to this type of renegeing on relational contracts.

Corporate governance mechanisms can serve as safeguards for relational contracts. When these governance mechanisms are designed to protect the stakeholders’ bargaining position, they can induce the stakeholders to make firm-specific investments (Hart 1989; Wang and Barney 2006; Wang, He and Mahoney 2009). In cases where shareholders are the only stakeholders that need protection, the economic literature provides extensive discussions of the appropriate design of corporate governance. To align the interests of managers and shareholders, internal mechanisms, such as board monitoring and incentive compensation for managers, as well as the external mechanism of capital market pressure are employed. But how can corporate governance protect the interests of multiple stakeholders?

We distinguish two generic governance mechanisms that can protect relational contracts between the organization and its *multiple* stakeholders. These governance mechanisms are, first, shared decision making, referring to stakeholder participation in managerial decision making; and second, arbitration, referring to an implicit understanding that the organization’s management takes into account stakeholders’ interests. Whereas shared decision making provides stakeholders with formal or informal control rights, arbitration entrusts managers with a mandate to act in the joint interests of multiple stakeholders.

These two generic governance mechanisms enable us to distinguish different types of stakeholder relations. Organizations may use shared decision making and/or arbitration to a small or to a large extent. Although organizations can vary substantially in their usage of the two governance mechanisms, they may still achieve the same outcome such as high performance. This phenomenon is called equifinality and is a well-known phenomenon in the organizational literature (e. g., Doty, Glick and Huber

1993; Meyer, Tsui and Hinings 1993). It has been researched extensively within the configurational approach to organizational analysis (Bierly and Chakrabarti 1996; Dess, Lumpkin and Covin 1997; Galbraith and Schendel 1983; Merz and Sauber 1995; Miller and Friesen 1978, 1980; Mintzberg and McHugh 1985). Configurations are defined as “any multidimensional constellation of conceptually distinct characteristics that commonly occur together” (Meyer et al. 1993, 1175). The configurational approach implies that the common occurrence often indicates an internal consistency or “fit” among these characteristics. Therefore, some organizational phenomena may be better understood by identifying internally consistent configurations than by searching for simple, universal findings (Ketchen, Thomas and Snow 1993).

From an economic perspective, the concept of “complementarities” is closely related to that of “fit” within the configurational approach. Although the analysis of complementarities is more widely known in the context of complementary goods. Economic researchers have extended the concept to analyze complementarities among institutions. Following Milgrom and Roberts (1990, 1995) and Aoki (1994), a group of institutions is complementary when raising the levels of a subset of institutions in the group increases the returns, to raising the levels of other institutions. Complementarities can result in a variety of different corporate governance arrangements achieving high performance.

A transplant of extrinsic practices into the organization can hamper complementarities among an organization’s institutions. Such a transplant can happen when regulations and practices are designed for a subset of organizations and then spill over to other organizations regardless of their size and ownership structure (Cheffins 2003; Hertig 2005). For example, the strong emphasis on pay-for-performance in large, widely held corporations may spill over to family-owned or foundation-owned businesses. Similarly, firms with controlling shareholders may adopt board regulations that were initially designed for widely held firms. As Hertig (2005) maintains, such spillovers may lead to unintended inefficiencies as a result of *de facto* one-size-fits-all effects.

The above considerations suggest why it is important to examine the potential variety of corporate governance arrangements

as well as the complementarities within these arrangements. In the next sections, we will discuss the institutions that determine the variety of organizations within the presented framework. That is, we will investigate the institutions that influence the extent to which shared decision making and/or arbitration are used. This discussion intends to deepen our understanding of the governance characteristics that shape a firm's stakeholder relations.

#### **9.4. The variety of corporate governance arrangements**

Corporate governance arrangements can vary with regard to shared decision making and arbitration both across and within countries. A stream of literature has developed to investigate national corporate governance systems (e. g., Dietl 1998; Hall and Soskice 2001; Hertig 2006; Hoskisson, Yiu and Kim 2004). This literature has resulted in various typologies of different countries. For example, Hall and Soskice (2001) differentiate between liberal market economies (e. g., United States) and coordinated market economies (e. g., Germany). They suggest that institutional complementarities reinforce the differences between both types of economies. In liberal market economies, firms depend primarily on hierarchies and competitive market arrangements to coordinate their activities, whereas in coordinated market economies, firms rely more heavily on non-market relationships. Other typologies have shown that some countries may represent hybrids that exhibit elements of several different systems simultaneously (Pendleton 2005; Rajan and Zingales 2001).

Although such typologies are a useful approach to analyzing national systems, they tend to neglect the large variety of corporate governance arrangements within countries. The construction of typologies often focuses on some salient characteristics of large, publicly traded corporations. These typologies typically omit differences among publicly traded corporations within a country as well as other types of organizations, such as privately held companies, cooperatives, and partnerships.

The variety of governance arrangements within the presented framework is likely to depend on state regulations (i. e., corporate

law), organizational arrangements and social norms (Hill 1995; Williamson 1975). In following sections, we will focus in particular on corporate law to set the frame. Then we will briefly touch on the role of organizational arrangements and social norms.

#### **9.4.1. Influence of corporate law**

Hambrick and Wowak (chapter 1) suggest that an institutional shift over the last 30 years in the United States, following the election of President Ronald Reagan in 1980, has caused many publicly traded firms to move toward shareholder primacy. This institutional shift represents a widespread implementation of the precepts of agency theory, which focuses in particular on the potential conflicts of interest between shareholders as principals and managers as their agents (Jensen and Meckling 1976). Hambrick and Wowak (chapter 1) further submit that other countries are following the development in the United States to varying degrees and with a certain time lag (e. g., Sanders and Tuschke 2007).

An obvious conjecture could be that corporate law forces companies to prioritize shareholders' interests over other stakeholders' interests. Surprisingly, this is not the case. As Hansmann (2006) outlines, corporate law in the United States today provides corporations with an extraordinary amount of freedom to draft charters that deviate from the default terms but the vast majority of publicly traded corporations do not make use of this freedom. Hansmann (2006) examines various explanations for this phenomenon. The transaction costs of drafting and negotiating deviations from default terms might be prohibitively high; companies might shy away from drafting deviations from default terms because innovations in charter terms are a public good; sticking to default terms might yield standardization benefits, such as the greater certainty concerning judicial interpretation and the lower costs of finding lawyers who are familiar with the default terms; investors might not reward innovative charter terms with a stock price premium and the incentives to deviate from default terms might be modest because such deviations may direct investors' attention toward charter terms that are unfavorable to dispersed shareholders. He concludes that these conventionally offered reasons may have some explanatory power but fall short of explaining the whole phenomenon.

To better explain why publicly traded corporations closely follow the default charter terms, Hansmann (2006) offers a different explanation that touches upon the relational contracts between shareholders and managers. By sticking to default terms, publicly traded corporations make use of the government as a delegated third-party contracting agent, which means that the government is responsible for adapting the default terms over time (Williamson 1976). Why can it be efficient to delegate the adaptation of charter terms to the government?

In the presence of long-term relational contracts between shareholders and managers, Hansmann (2006) submits that both parties face important challenges when trying to adapt the corporation's charters to changing circumstances. On the one hand, charters that are easy to amend leave room for opportunistic amendments by either shareholders or managers. On the other hand, charters that are hard to amend leave little flexibility for adaptation. To circumvent these problems, shareholders and managers can defer to default terms, thereby delegating the adaptation of charter terms to the government. For example, in 1963 the state of Delaware decided to reduce the (default) shareholder vote required to approve a merger from two-thirds of the outstanding shares to a simple majority. This decision was taken to accommodate changes in ownership structures as well as new production technologies that increased the need to recombine corporate assets through mergers. By changing the default terms, the state of Delaware was able to adapt the charters of numerous corporations to the new environment. Because most publicly traded corporations in the United States hold on to the default terms, these terms can be almost as powerful as mandatory terms in shaping corporate charters.

As a preliminary conclusion, corporate law can have a strong influence on the governance mechanisms of a corporation both through default and mandatory features (Hertig and McCahery 2006). What are the features of corporate law that may support relational contracts between the organization and its multiple stakeholders?

*Shared decision making* with stakeholders can be induced by co-determination rules. These rules oblige corporations to allocate



some of the seats on the board of directors to employee representatives (Hertig 2006), and they are common in many parts of Europe (Kluge and Stollt 2006). Beyond board representation of employees, co-determination rules may also include the installation of works councils at the plant level (Freeman and Lazear 1995). When European states introduced co-determination regulations as early as in the 1970s, these regulations were mainly justified on moral and political grounds instead of efficiency considerations. After the adoption of democratic mechanisms at the political level, many people considered the enhancement of democratic mechanisms within the economic system as the natural next step. Today, co-determination regulations are under pressure because there are loopholes to circumvent them and because some practitioners criticize them as inefficient. Although the German Chancellor Angela Merkel praised co-determination as a “big achievement” (Bundesregierung 2006), Michael Rogowski (a former president of the Federation of German Industries) described it in a much noticed comment as a historical mistake. The press covered these controversial discussions on the occasion of the thirtieth anniversary of German co-determination law with headlines such as “No Reason to Celebrate?” and “30 Years of Dispute.”

Although co-determination rules may generate disputes (or costs of collective decision making, using an economic terminology), may also support relational contracts with employees and thereby improve corporate efficiency. Because theoretical considerations alone cannot determine the net effect, the economic efficiency of co-determination rules is an empirical question. Empirical studies on the performance effects of co-determination have shown mixed and inconclusive results (Osterloh, Frey and Zeitoun 2011). While these studies are burdened with various methodological challenges, they do not represent a clear case for or against the use of shared decision making in corporate governance.

Of course, corporations may also adopt co-determination rules voluntarily in the absence of mandatory co-determination laws (Gerum and Wagner 1998). Osterloh and Frey (2006) suggest that it may even be in the shareholders’ own interests to invite knowledge workers as board directors. In contrast, Jensen and Meckling maintain that “if codetermination is beneficial to both

stockholders and labor, why do we need laws which force firms to engage in it? Surely, they would do so voluntarily” (1979, 474). They posit that the lack of voluntary adoption of co-determination rules represents the strongest evidence that these rules negatively affect shareholders’ wealth. However, there is no unanimity on this argument. Levine and Tyson (1990) and Freeman and Lazear (1995) submit that individual firms are likely to be reluctant to introduce co-determination rules even though mandatory co-determination laws may enhance corporate efficiency. Some of the offered reasons are that firms with voluntary co-determination may suffer from an adverse selection of employees and that shareholders may find it difficult to anticipate how the distribution of earnings will change once co-determination is introduced.

The introduction of co-determination in Germany represents an interesting example for the difficulties to anticipate the costs and the benefits of shared decision making. *Ex ante*, it is entirely plausible to suspect that employees might use their gained control rights only for rent seeking but not for productivity improvements. Indeed, Höpner (2004) highlights that the discrepancies between managers’ *ex ante* suspicions and their *ex-post* assessments were enormous. Although the co-determination law of 1976 encountered fierce resistance by managers and employers’ associations, sometimes with dramatic predictions of economic deterioration, twenty years later several surveys revealed that a majority of managers either were indifferent or had a positive attitude toward co-determination (Glaum 1998; Martens and Michailow 2003). The survey results were similar for both large and medium-sized corporations. This managerial attitude change may have various reasons, such as the installation of effective conflict-resolution mechanisms; the selection of managers who are better able to negotiate with shareholders and employees; and the update of managers’ beliefs about employees’ willingness to cooperate and to make firm-specific investments (Fehr and Fischbacher 2003; Frey and Meier 2004).

It might be argued that managers are satisfied with co-determination because they may benefit from shared decision making at the expense of shareholders. For example, Jensen (2010) argues that it is difficult to hold managers accountable when they have

to serve multiple constituencies. When firm performance is poor, managers may try to eschew their accountability by pointing to the need to protect employees' interests. Hence, Jensen suggests that "Multiple Objectives is No Objective" (2010, 34). However, there are also reasons to believe that co-determination can run contrary to managers' self-interest. Smith (1991, 2006) submits that co-determination may constrain different forms of managerial opportunism, namely managers' credit taking for innovative ideas that are not their own; managers' actions that increase short-term profits at the expense of the company's long-term viability; managers' exploitation of their informational advantage over shareholders to increase their own bargaining power (Hertig 2006); and managers' proclivity to stick to their authority even in cases where the organization would benefit from shared decision making (Klein 1984). Therefore, it is not clear that managers' positive attitude toward co-determination arises from their self-interest exclusively.

Another argument for the modesty of managers' resistance against co-determination rules is that these rules may not have achieved true shared decision making. Hansmann holds that "codetermination does not generally seem to have resulted in effective worker participation in control of the corporation at the board level; rather, control essentially remains in the hands of investors" (1990, 1803). Even in the large German corporations, which are obliged to allocate half of the board seats to employee representatives, shareholders have the right to select the chairperson of the board. This chairperson can cast a double vote in the case of a stand-off. However, various press reports suggest that chairpersons rarely make use of the double vote and that employee representatives typically do influence decisions, instead of having just an informational role on the board of directors (e. g., *Die Zeit* 2007).

In sum, much of the literature on shared decision making in corporate governance has focused co-determination rules and their consequences for shareholders. Researchers have recognized that co-determination has advantages in fostering firm-specific investments but also has disadvantages in terms of high governance costs (Hertig 2006). Co-determination between

only shareholders and employees is the most common form of shared decision making because adding additional stakeholders may lead to prohibitively high governance costs, especially when the stakeholders have highly heterogeneous interests. According to Hansmann (1990), these governance costs include both the costs of collective decision making and the costs of inefficient decisions. For example, inefficient decisions may arise with majority voting. If the median voter’s preferences differ substantially from those of the average voter, a majority may adopt measures under which it gains less than what the minority loses (Shepsle and Weingast 1984). To avoid these governance costs of shared decision making, organizations may use the arbitration mechanism, which represents the second axis of the matrix in Figure 9.1.

**FIGURE 9.1: Corporate Governance Framework**

<i>extensive</i>  Shared Decision Making  <i>little</i>	<b>II.</b> <b>Stakeholder Voice</b> Weak-form stakeholder mode	<b>IV.</b> <b>Stakeholder Inclusion</b> Strong-form stakeholder mode
	<b>I.</b> <b>Shareholder Primacy</b> Strong-form shareholder mode	<b>III.</b> <b>Team Production</b> Weak-form stakeholder mode
	<i>little</i>	<i>extensive</i>

Arbitration

*Arbitration* implies that the organization’s management balances the conflicting interests of various stakeholders when making decisions. Corporate law can foster arbitration by imposing fiduciary duties on the organization’s directors and managers. Following Clark (1985), corporate directors and managers in the United States have fiduciary duties to the corporation and to its shareholders. Although some scholars interpret these fiduciary duties in terms of shareholder value maximization (e. g., Dooley 1995), others suggest that directors and managers are required to act in the joint interests of all stakeholders that contribute to organizational value creation (Blair 1995; Blair and Stout 1999).

The team production theory of corporate governance elaborates on the latter interpretation of fiduciary duties (Blair and Stout 1999; Franck 2011; Lan and Heracleous 2010; Walgenbach 2011). This theory posits that multiple stakeholders form an organizational team whose joint interests need to be protected in order to foster their firm-specific investments. To facilitate the maintenance of relational contracts, the theory suggests that directors and managers need to be insulated from pressures to give primacy to any particular stakeholder's interests.

Both directors and managers play an important role in protecting relational contracts because the board of directors is the ultimate decision making body of the corporation (Clark 1985), whereas the managers typically take a central position in shaping strategic decisions and in concluding contracts between the organization and its stakeholders (Williamson 1985). According to Schwartz, corporation statutes in the United States historically provided that the board of directors shall manage the business of the corporation, but "today, the identification of the governing body is more complex because we recognize a role for management, not a formal body acknowledged by statute, but nonetheless the dominant governing force" (1984, 545). Similarly, Clark posits that "even with respect to the broadest business policies, it is the officers who generally initiate and shape the decisions" (1986, 108). These considerations are important to avoid confusion because team production theory is sometimes associated with "director governance."

Besides team production theory, which builds on the economic theory of incomplete contracts, Stout (2011a) maintains that there are four other lines of argument suggesting that directors and managers need to be insulated from shareholders' pressures. This insulation can enable them to arbitrate independently among the potentially conflicting interests of various stakeholders. Such conflicting interests can arise either between different types of shareholders or between shareholders and non-shareholder constituencies.

The first line of argument concerns the inefficiency of stock markets. In an efficient stock market, a company's stock price incorporates all relevant information, and therefore the current stock price reflects the company's long-run value. However, new

approaches in financial economics are questioning the efficient-market hypothesis (Stout 2003). Fuller and Jensen recognize that managers can influence stock prices in the short term and therefore suggest, “managers must abandon the notion that a higher stock price is *always* better” (2010, 59, emphasis in the original). Because current stock prices can deviate substantially from the company’s long-run value, a conflict of interests can arise between short-term investors and investors holding their shares for the long run. Specifically, short-term investors may push for managerial actions that produce immediate stock price increases at the expense of long-term value. The arbitration mechanism is one possible solution to solve the conflict among these two types of shareholders.

The second line of argument refers to capital lock-in (Blair 2003a; Demsetz 1995), which means that shareholders cannot unilaterally withdraw their capital from the corporation. Capital lock-in is beneficial for funding long-term projects that require high investments in firm-specific assets. Therefore, individual shareholders have incentives to commit to the capital lock-in *ex ante*. However, these shareholders might still try to withdraw their capital *ex post*, thereby threatening the long-term projects and the other shareholders’ welfare. In contrast to a partnership, the corporation as a legal form does not enable shareholders to withdraw their capital unilaterally. Although shareholders can sell their shares to other investors, the capital remains locked in the corporation. Thus, capital lock-in protects firm-specific assets against opportunistic actions by individual shareholders. According to Stout (2011a), capital lock-in supports the more general claim that shareholders may benefit when ceding control rights to directors and managers who protect the firm’s specific assets and long-term projects.

The third line of argument addresses the role of the “Universal Investor”, which is an investor with a large, highly diversified portfolio such that this investor has an interest in the healthy development of the economy as a whole (Hawley and Williams 2000). Universal Investors have become increasingly common due to the large accumulation of wealth by pension funds and other institutional investors. These investors experience a disutility when one stock increases

in value at the expense of other stocks or bonds in their portfolio. For example, one firm might try to establish a monopoly and thereby impose higher costs on the firms that purchase its products. Or a firm might pursue business strategies with extremely high risks that reduce the value of the firm's bonds. In these cases, the Universal Investor's aggregate wealth might remain constant or might even decline. Furthermore, the actions of firms in the Universal Investor's portfolio can affect the Universal Investor's beneficiaries, who might be employees or customers of these firms. The arbitration mechanism may represent a potential solution to further the interests of Universal Investors and their beneficiaries.

The fourth line of argument concerns the proclivity of prosocial investors to contribute to the public good. Although prosocial behavior is more likely to be observed when people have personal contacts, Frey and Meier (2004) show that many people are willing to contribute to the public good even under anonymous conditions. For example, investors are showing increasing interest in various forms of "green" and "social" investments (Williams 1999). However, it is often difficult for prosocial investors to verify whether the firms they invest in really live up to their preferences. As agency theory illustrates, aligning the monetary interests of managers and investors is already fraught with challenges. Aligning non-monetary interests might be even more difficult due to the problems of visibility and measurability, as experienced by the misuse of green labels. Therefore, the arbitration mechanism might provide a solution to serve the monetary as well as the prosocial interests of investors.

It is important to note that in all four lines of argument, there are also other solutions available besides the arbitration mechanism. Regulations concerning the design of long-term managerial compensation might mitigate the problems of stock market inefficiencies. With regard to capital lock-in, it might be argued that the corporation as a legal form offers enough protection against capital withdrawal and that shareholders should retain control over all other business matters. Anti-trust legislation might alleviate some of the problems concerning Universal Investors. Social investment fund managers might specialize in monitoring corporations, thereby assuring the beneficiaries that

their prosocial preferences are taken into account. Thus, the arbitration mechanism just serves as an alternative solution. As noted earlier with regard to shared decision making, arbitration too has its advantages and disadvantages. The main advantage is that arbitration can serve the interests of multiple stakeholders while avoiding the governance costs of collective decision making. The main disadvantage is that the insulation of directors and managers from shareholders' pressures potentially can lead to high agency costs.

#### **9.4.2. Influence of organizational arrangements**

Within the legal boundaries, there are many options to enhance or reduce the use of shared decision making and arbitration. The organization's owners and managers may write specific charter terms, which deviate from the default terms or the minimum requirements provided by law. They may also go further and choose a distinct governance structure, such as that of a cooperative or a partnership. Moreover, the organization may have various agreements with its stakeholders, such as the recognition of unions as bargaining partners or the choice of long-term suppliers. And finally, the organization's ownership structure itself "is an increasingly influential form of corporate governance" (Connelly, Hoskisson, Tihanyi and Certo 2010). Some of these institutional choices are illustrated below.

*Shared decision making* can be induced, for example, by voluntarily offering board seats to various stakeholders. During the economic slowdown in the United States in the early 1990s, Porter suggested that publicly traded corporations should offer board seats to significant owners, customers, suppliers, employees, and community representatives because "directors from these categories are likely to have the company's long-term interests at heart and to encourage management to make investments that will improve long-term competitive position" (1992, 81). Of course, such practical suggestions are often inspired by the countries that show a relatively better economic performance at a particular point in time. In this case, Porter (1992) attempted to borrow elements from the German and Japanese economies in order to create a superior American system that combines the best of both



worlds. However, it is unclear whether such a combination would adversely affect complementarities and produce unintended inefficiencies (Hertig 2005). As the United States economy strongly recovered toward the end of the 1990s, the recommendations typically flowed the other way. Experts were urging Germany and Japan to adopt a shareholder primacy model (Blair 2003b; Stout 2011a).

Even when organizations are based in countries with co-determination laws, voluntary arrangements are still possible and do happen. Höpner (2004) reports that a number of German companies exceeded the minimum requirements of the 1976 co-determination law in several ways. Many companies did not use their latitude to reduce the catalogue of business dealings that were subject to mutual approval, and some companies even enlarged this catalogue. Furthermore, there were companies that chose as deputy chairman an external trade union official, who is likely to negotiate more persistently with the shareholders than an employee who works within the company's hierarchy. Although these organizational arrangements might not always result from the management's initiative, they do represent voluntary arrangements in the sense that they exceed legal requirements.

Organizations may also have a governance structure, such as that of a worker cooperative or a partnership, in which the organization's owners are its workers. In these cases, an important challenge is to reconcile the owners' interests as financial beneficiaries with their interests as workers. Because the same people represent two different stakeholders, the organization needs to cope with high costs of collective decision making. Hansmann (1990) examined various such organizations and found that they typically featured a small workforce with highly homogeneous interests in order to keep governance costs within bounds. When these organizations were large and heterogeneous, workers' control rights were substantially attenuated.

Another example for shared decision making is the recognition of unions as bargaining partners to negotiate on wages, conditions of employment and protection against layoffs. These protections impose rigidities on the firm that need to be weighed against the incentives for investment in firm-specific human capi-

tal (Blair 1999). However, the benefits from union recognition do not arise automatically. It seems that companies in Europe have often made better experiences with unions than those in the United States. According to Baron and Kreps (1999), the so-called bread-and-butter unionism in the United States, originally restricted to highly skilled workers, had a strong desire to avoid being perceived as a socialist movement at its inception. Therefore, union members accepted shareholders' control over firms and were only interested in negotiating on bread-and-butter issues like wages and benefits. The restraint of union members from discussing production-related issues might be a reason why many companies mainly experienced one face of unions, giving power to workers, but not the other face, voicing concerns to improve production efficiency (Freeman and Medoff 1979). Hence, companies in the United States allocated large amounts of resources to a sophisticated union avoidance industry, consisting of consultants, law firms, industry psychologists, and strike management firms (Logan 2006).

*Arbitration* can also be influenced by organizational arrangements. A controversial question is whether actors in organizations can modify the fiduciary duties imposed by corporate law. On the one hand, the contractarian view holds that fiduciary duties are the same sort of obligations as other contractual undertakings and therefore may be modified or eliminated contractually (e. g., Easterbrook and Fischel 1993). On the other hand, the anti-contractarian view submits that the basic fiduciary duties of good faith and loyalty have a moral function, which cannot be contracted away (e. g., Johnston 2005). Blair and Stout highlight this moral function, emphasizing that a fiduciary needs to behave as if she had other-regarding preferences, and "if she fails to do this, the courts condemn her in terms that are didactic and full of moral fervor" (2001, 1783). Hansmann (2006) appears to be taking a middle course between these two views, suggesting that the owners of an organization can choose the recently established legal form of a statutory business trust, which offers complete contractual freedom even with regard to fiduciary duties. However, this legal form barely provides default terms and thus lacks the benefits of the delegated third-party contracting discussed above.

Fiduciary duties are a direct way of mandating directors and managers to arbitrate among stakeholders' conflicting interests (if one follows Blair and Stout's (1999) interpretation that directors and managers owe fiduciary duties not only to shareholders but to the corporation as a whole). Beyond fiduciary duties, there are also more indirect ways of fostering the arbitration mechanism, namely by granting managers a greater discretion to serve the multiple stakeholders' interests.<sup>2</sup> Shen and Cho (2005) posit that managers in low-discretion situations face strong pressures to maximize firm performance; otherwise they may be punished or may lose their jobs. Granting managers high discretion may increase agency costs by making it possible for managers to pursue personal objectives. But high discretion may also enable managers to balance the multiple stakeholders' interests more effectively.

One possibility to enhance managerial discretion is to select governance rules that limit capital market pressure. Corporations in the United States may choose to incorporate in states that offer strong protection against hostile takeovers. According to Stout (2002), these states tend to be more successful in attracting and retaining corporations than states that facilitate hostile takeovers. Furthermore, corporations may select charter terms that inhibit hostile bids or shareholder activism. From a shareholder primacy perspective, such charter terms would be undesirable and would reduce a corporation's stock market value. Surprisingly, Coates (2001) finds that many companies adopt takeover defenses prior to initial public offerings (IPOs). Moreover, he reports that charter terms banning poison pills are extremely rare even though such charter terms would be relatively easy to draft.

Although Coates (2001) interprets these empirical results as evidence for agency costs between owner-managers and their lawyers, Stout's (2011a) interpretation is that takeover defenses may be efficient and that shareholders may actually prefer these defenses. She admits that shareholders may push for the removal of

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<sup>2</sup> We use the notion of managerial discretion as it is used in the economics literature, referring to the latitude managers have in pursuing objectives other than maximizing corporate financial performance (Williamson 1963). In contrast, in the management literature managerial discretion commonly refers to the range of strategic options available to managers (Hambrick and Finkelstein 1987).

takeover defenses after other stakeholders have made firm-specific investments, because hostile takeovers may enable shareholders to expropriate quasi-rents from other stakeholders (Shleifer and Summers 1988). However, *ex ante* it might be better for shareholders to tie their own hands and to allow takeover defenses in order to induce other stakeholders to make firm-specific investments. According to this interpretation, owner-managers would not be losing money when allowing takeover defenses prior to an IPO and thereby granting corporate managers high discretion.

Another factor that may influence managerial discretion is the corporation's ownership structure (Connelly et al. 2010). Recently, researchers have increasingly recognized that shareholders are heterogeneous with respect to their objectives and time horizons. David et al. (2010) posit that relational shareholders, who hold their shares for the long term and have strategic interests in the organization, typically are more supportive of relational contracts and facilitate greater value capture by stakeholders than transactional shareholders, who hold their shares at arm's length and are primarily driven by financial interests (Aguilera and Jackson 2003). This important distinction between relational and transactional shareholders is likely to play a significant role in future research.

#### **9.4.3. Influence of social norms**

Traditional economic research on corporate governance often focuses on formal institutions, such as corporate law and organizational arrangements. However, informal institutions too can influence the ways in which relational contracts between the organization and its stakeholders are supported. Indeed, Hill submits that "while the formal institutional structure of a society is important, informal institutions may constitute a more effective and less costly mechanism for governing exchange and facilitating cooperation" (1995, 121).

Informal institutions, such as social norms and shared values, may influence the choice of statutory provisions and other formal institutions within a society. But they may also directly influence the use of shared decision making and arbitration. Applied to Zingales' (1998) definition of corporate governance, social norms and a shared value system represent an informal set of con-

straints that influence the ex post bargaining over quasi-rents. In particular, these informal constraints may constrain opportunism and may reduce holdup risks for the contracting parties, thereby facilitating firm-specific investments (Hill 1995).

*Shared decision making* can be induced by social norms that pressure managers to invite stakeholders to participate in decision making, even when these stakeholders do not have formal control rights. For example, Araki (2005) maintains that Japanese corporate law views the corporation as shareholders' property and does not provide employees with control rights. Nevertheless, large Japanese corporations often feature a distinctly employee-centered type of corporate governance with employee involvement in important managerial decisions (Aoki 1996; Dietl 1998). The widespread enterprise unions as well as the social norms importantly contribute to the use of shared decision making.

*Arbitration* can be fostered by social norms, such as those relating to long-term employment, which pressure managers to abstain from breaching relational contracts with stakeholders (Ahmadjian and Robinson 2001). Further, a professional managerial code of conduct can induce managers to balance the potentially competing claims of various stakeholders (Gintis and Khurana 2008). Khurana and Nohria (2008) have recently suggested that a Hippocratic Oath for managers needs to be established because managers may have lost their legitimacy over the past decade. In their proposed oath, future managers would explicitly acknowledge that the corporation's objective is to enhance value for society as a whole, and that the manager's task is to balance and reconcile the interests of many different constituencies. Khurana and Nohria (2008) posit that such an oath can have an enormous influence on managerial behavior because it can trigger a sense of professional pride as well as strong emotions of shame and guilt. These emotions may prevent managers from deviating from their professional ideal to protect relational contracts with stakeholders.

## 9.5. Conclusions

In this paper, we have distinguished different types of stakeholder relations depending on how the organization supports its incom-

plete contracts with various stakeholders. Based on theoretical considerations as well as empirical evidence, we have discussed a variety of formal and informal governance institutions that influence the organization's stakeholder relations. These governance institutions can be attributed to three main categories, namely state regulations (in particular, corporate law), organizational arrangements (such as the writing of specific charter terms or the recognition of unions as bargaining partners), and social norms (such as the norms arising from a professional managerial code of conduct). All these governance institutions taken together produce a large potential for diversity in corporate governance arrangements.

We suggest that the association between different corporate governance arrangements and different types of stakeholder relations has important implications for future research. First, researchers may examine how alternative corporate governance arrangements may require different types of managerial motivation in order to sustain the firm's stakeholder relations. Further, within the framework of upper echelons theory, future endeavors may analytically compare the demographic characteristics of executives across different corporate governance arrangements (Hambrick 2007; Hambrick and Mason 1984). Second, future research may investigate the contingencies under which alternative corporate governance arrangements perform better. The preferred corporate governance arrangements may depend on how comprehensive the performance measures are. Future research is likely to benefit from complementing traditional shareholder value measures with measures of stakeholder value creation (Coff 1999), as well as stakeholders' life satisfaction (Blanchflower and Oswald 2011; Frey and Stutzer 2002).

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## 10. How to Overcome Herding Behavior in Firms

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AGGREGATING the knowledge of many people is a powerful tool, especially if you know how to aggregate the private information efficiently.<sup>1</sup> Otherwise, if a firm does not use its employees' private information efficiently, the information will be lost, and the firm will not have it available for its decision processes. Every employee, when contributing information to an organization's information pool, faces the risk of getting into trouble because some other employee might be offended and could react harshly. Economically speaking, an employee has to bear various kinds of costs if he chooses to say something. These costs can effectively silence the employee. For example:

I raised a concern about some policies and I was told to shut up and that I was becoming a trouble maker. I would have pursued [the issue] further but presently I can't afford to risk

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We would like to thank all the participants of the 2nd International Conference on Humanizing the Firm and the Management Profession held at IESE (Barcelona, Spain) for their helpful comments. For specific remarks on Hirschman's (1970) theory of exit, voice, and loyalty, the idea that herding is also a perception problem, and the hint at empowerment of employees, we are grateful to Peter Moran, Raymond Miles, and Antonio Argandoña.

<sup>1</sup> See, for example, Sunstein's (2006) analysis of the new and revolutionary methods of information aggregation thanks to the worldwide web and the new applications therein like Wikipedia.

my job. This has made me go into a detached mode, making of me a “yes man” (male respondent, Information System).<sup>2</sup>

This mechanism leads to two problems in organizations: First, the more employees remain silent, the weaker the information content of the decision process. Second, the more employees remain silent and fail to criticize the prevailing opinion in an organization, the more the dominant opinion is perceived to be the correct one. In a dynamic process, this silence in organizations leads to herding behavior because the prevailing opinion becomes more and more established and employees follow in order not to be perceived as mavericks or troublemakers (Morrison and Milliken 2000, 2003). This dynamic also can be seen as a risk-sharing mechanism: Expressing one’s own beliefs and opinions always bears the risk of being offended. Furthermore, if the individual statement leads to a change in the decision process, the employee has to bear the responsibility for the decision. Economically speaking, if an employee deviates from the prevailing opinion—although the deviating input might have value for the whole group or organization—the employee has to bear the cost of not following the herd alone. Therefore, the costs of non-herding behavior are the employee’s costs associated with expressing an opinion or having a voice in an organization.

By lowering the costs of having a voice and therefore fostering the employees’ participation, the organization not only can aggregate more information and improve its decision processes but also can create a “more human” environment for the employees. In their seminal article, Morrison and Milliken (2000) explain that humanizing the firm by allowing employees to raise their voice better motivates the employees. They emphasize three effects: the employees’ feelings of not being valued, the employees’ perceived lack of control, and the employees’ cognitive dissonance. All of which can be negatively affected if the opinions and the feedback of the employees is discouraged in an organization. This weakens employee motivation and hinders employees from efficiently contributing to organizational success (Premeaux and Bedeian

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<sup>2</sup> Quoted from Milliken, Morrison and Hewlin (2003, 1453). See the literature review in the next section for models about “yes men” behavior due to reputation-based herd behavior in organizations (Prendergast 1993).

2003). Analogously, happiness research in economics provides evidence that an employee's perception of higher self control and autonomy fosters an employee's job satisfaction and motivation at work (Benz and Frey 2008; Frey 2008).

This paper tackles the costs of raising one's voice, which might be the reason for the silence in organizations. In the next section, we preview the existing literature on herd behavior and voice in organizations focusing on the costs of voice for the individual employee. In the third section, we formulate propositions about possible individual determinants of employees lowering or increasing the costs of voice in an organization. In section four, we challenge our propositions by comparing them to the interview statements of chairpersons and high ranked executives working in the financial industry. Also, we identify the extent of the cost of voice in practice. In the last section, we conclude by summarizing our results and incorporating them into the idea of humanizing the firm and the management profession.

### **10.1. Literature on herd behavior and voice and silence in organizations**

The famous French sociologist Le Bon (1895) and the legendary political economist Veblen (1899), were early precursors in the research on herding behavior and the psychology of the crowd. In his book *La Psychologie des Foules*, Le Bon described the socio-political dangers and risks evoked by human herding behavior, whereas Veblen, in his book *The Theory of the Leisure Class*, analyzed the herding behavior of different social classes with regard to their consumption.

After the shock of the terrifying side of herding behavior during the first and second World Wars, scholars turned again to research on human herding behavior. In the fifties, Leibenstein (1950), took up Veblen's (1899) idea on mass consumption and developed the theory of the *bandwagon effect* where people tend to go along with what others do or think although they as individuals would do or think differently. In other words, they "jump on the bandwagon".

At the same time, Asch (1951), provided the first evidence on the herding behavior of individuals with his seminal group ex-



periments and thus began a new chapter in socio-psychological research in this field. Festinger (1954) and later Bandura (1965, 1976) developed a positive view of herding behavior in their *social learning theory*; today, many economists use social learning theory in their work on herd behavior (see, e. g., Hirshleifer and Hong Teoh 2003). In sociology, Granovetter (1973), developed his threshold model, and Burt (1982), advanced research on herding behavior by studying peer groups. Based on this literature, three social-psychological concepts emerge that are important for the study of the herding behavior of employees in organization with respect to the costs of voice.

Janis (1972) formulated his *Groupthink* theory of conformist behavior during group deliberation processes;<sup>3</sup> a concept used until recently (Baron 2005). It suggests that participants in group decision processes miss important alternatives because they do not deliberate or discuss the “usual” solutions critically enough because they are pressured to conform in order to avoid conflict among the group members. Janis (1972, 209–216), described some institutional factors which can be used to change the pressure to conform on individuals in decision groups.

In a similar way, Noelle-Neumann’s (1974, 1984) theory of the *Spiral of Silence* described a phenomenon in opinion research: In a dynamic process, various players start to adopt the opinion that they assume to be the future majority opinion although they have contrarian views. According to Noelle-Neumann’s explanation, the players do so because they try to avoid conflict and do not want to feel isolated and perceived as mavericks. This theory has been applied to financial markets (Aspara et al. 2008), and it also has been applied to the costs of voice in organizations (Bowen and Blackmon 2003).

During the eighties, studies of diversity research started to evolve and provided a different perspective on herding behavior in organizations: More diverse teams, with respect to gender, education and social background, were assumed to decide better in crisis situations than more homogeneous teams (Bantel and Jackson 1989). Early empirical surveys supported this view, sug-

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<sup>3</sup> For a comprehensive discussion of the term, see Sunstein (2006, 9–10).

gesting that members of more diverse teams processed similar information in more diverging ways and, hence, were less prone to herd behavior. Newer studies challenged this view and exhibited a more critical view on diversity and its impact on conformity and herd behavior (Ely 2004).

In the late eighties, the topic of herding behavior was revisited. The analysis of lock-in effects showed that a whole industry could adapt to certain standards although they were not the best ones in technical or in economic terms (Arthur 1989; David 1985; Frank and Cook 1988; Katz and Shapiro 1985). In the nineties, Scharfstein and Stein (1990) as well as Banerjee (1992) and Bikhchandani, Hirshleifer and Welch (1992), advanced the topic of herding behavior in economics: While the model of Scharfstein and Stein followed the logic of principal-agent problems and, hence, described a *reputation-based herding* of employees, Banerjee (1992) and Bikhchandani et al. (1992) explained the herding behavior based on information cascades, where rational agents follow the strategy of the first mover in a game ignoring their own private information. As a result, *information-based herding* can occur, although all of the players have contradictory private information.

Models based on *information cascades* nicely show the negative implications of herding behavior in organizations. Beyond a certain threshold, the cascade begins to evolve and the players' private information is no longer taken into account in the decision process. These models have been amended by introducing information costs, imperfect information about the decision process of the other players, heterogeneous possibilities to decide and adaptive markets (see, e. g., Bikhchandani, Hirshleifer and Welch 1998; Avery and Zemsky 1998). Kuran and Sunstein (1999) showed how *availability cascades* could have a similar effect as information cascades. Availability cascades focus on the publicity of an investment opportunity and reveal that the better the publicity the more funds that can be raised for an investment project although there is no objective reason to favor one specific project over another.

*Reputation-based* models play a crucial role when analyzing voice in organizations. The strategic actions of employees, who want to push their careers or gain a reputation, can evoke harmful herding behavior in organizations (Scharfstein and Stein 1990; Pren-

dergast 1993; Zwiebel 1995).<sup>4</sup> In a complex work environment, the principal often is not able to measure individual employee performance (e. g., for a stock market trader if the financial market itself deteriorates). Therefore, the principal wants to benchmark an employee's performance using the output figures of other employees performing similar tasks. The problem of herding behavior occurs in this context if the other employees' performances are measured in the same way: In that case, all of them have the same reason to follow the same decisions in order to mask their possible incompetence relative to their principal(s). As a consequence, they go with the herd, which, at the same time, is the principal's benchmark to measure their performances. The employees act fully rational and use the herd as a risk-sharing mechanism. For example, research by Graham (1999) and Hong, Kubik and Solomon (2000), empirically supports the existence of *reputation-based* herding of financial analysts and reveals the different incentives at work depending on the stage of the analyst's career and other individual determinants. Similarly, Chevalier and Elliston (1999) showed that the same holds for portfolio managers.

In the literature, there are many other empirical studies focusing on herding behavior in financial markets (see, e. g., Christie and Huang 1995; Grinblatt, Titman and Wermers 1995; Lakonishok, Shleifer and Vishny 1992; Nofsinger and Sias 1999; Wermers 1995). However, empirical tests cannot fully reveal the existence of truly harmful herding as it is very difficult to distinguish harmful, or *spurious*, herding from *intentional* herding that evolves due to new information in the market and which shows the fully rational adaption process of many market participants to the new information (see Bikhchandani and Sharma 2001; Hirshleifer and Hong Teoh 2003).

Actual experimental studies were partially able to show the herding behavior of market participants. However, the experimen-

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<sup>4</sup> Here we do not think of a harmful action, which might be subject to legal or moral issues and would make the case for whistle blowing. Although whistle blowing is a closely related topic, we do not consider it here. We follow the argument of Prem-  
eraux and Bedeian (2003, 1538) and define speaking up and voice as evolving "from a desire to improve an organization by suggesting different approaches" rather than evolving from a "perceived violations of personal principles," as in the case of whistle blowing (Miceli, Near and Dworkin 2008).

tal testing of the different models showed that herding behavior could be explained with both informational-based (Drehmann, Oechssler and Roider 2005) and reputation-based models (Hey and Morone 2004), whereas the more realistic experiments favored the latter models (Cipriani and Guarino 2005).<sup>5</sup> Alevy, Haigh and List (2007) provided evidence from a field experiment that under specific circumstances, professionals were not so prone to information cascades as inexperienced persons (e. g., students).<sup>6</sup>

Closely related to the topic are several socio-psychological surveys approaching the subject of *hidden profiles*. Starting with Strasser and Titus (1985), this strand of the literature tries to unveil the decision processes in groups—how information is shared and aggregated. At the beginning of the experiment, each member of the group receives only a piece of the whole information that the group needs to solve the problem. During the experiment, the researchers analyze how the various members of the group contribute their private information in order to guide the group through the decision process and to find the proper solution. As every group as a whole has the information necessary to find the proper solution, it is interesting to see that many of them fail to aggregate the information properly. Some members do not want to come into conflict with others and therefore do not contribute their contradicting but important information to the group decision process. The results of these experiments support the notion of the costs of voice and explain the resulting problems for decision processes in organizations (see, e. g., Schulz-Hardt et al. 2006).

As a next step, we combine the socio-psychological and the economic literature and add the literature on management studies and organizational science. Starting from the two concepts of herding behavior in economics—*information-based* herding and *reputation-based* herding—it becomes apparent that the former plays only a minor role in the socio-psychological literature and in the management studies. Although one could think of the problem of an information cascade in everyday business, the cascade and the

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<sup>5</sup> Celen and Kariv (2004) demonstrated how to distinguish reputation-based herding and information-based herding, based on Smith and Sorensen (2000).

<sup>6</sup> However, Drehman et al. (2005) offer contradictory evidence to these findings.

resulting herding behavior of the supervisors create no problem as long as the solution taken by the first supervisor is the proper one. However, whenever the chosen and adopted solution leads to wrong outcomes, then harmful herding behavior deteriorates an organization's performance. The questions then become: Did someone realize that the solution was not the proper one? Why did that person not intervene? The first question goes beyond the topic of this paper but the second one points to the reputational concerns of individuals, which leads us to *reputation-based* herding.

In theory, the mechanism of informational cascades is fascinating; however, in everyday business, the question is not whether such herd behavior exists but how to overcome it. The literature on management studies and organizational science focusing on voice and silence in organizations takes up all of the above described socio-psychological approaches in one way or another. In their seminal paper on silence in organizations, Morrison and Milliken (2000), touched on Janis' (1972) idea of *Groupthink* and the research on diversity in management teams (Bantel and Jackson 1989). In a special edition of the *Journal of Management Studies* on the topic of the dynamics of voice and silence in organizations, some authors refer to Noelle-Neumann's (1974) *Spiral of Silence* too (see, e. g., Bowen and Blackmon 2003). They use Noelle-Neumann's theory to describe the dynamics of silence in organization or, in other words, the evolution of herding behavior within an organization.

Throughout the literature on silence and voice in organizations, Hirschman's (1970) concept on *exit, voice and loyalty* serves as a general framework. Particularly interesting for our purposes, the associated empirical literature reveals valuable insights on the individual determinants of employees' probability to use their voice in an organization (see, e. g., Tangirala and Ramanujam 2008; Withey and Cooper 1989). However, Hirschman's concept has been adjusted and modified in order to adapt to today's view of voice and silence in organization.<sup>7</sup> In 2001, Banerjee and Somanathan wrote their paper "A Simple Model of Voice" and completed the circle

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<sup>7</sup> See, for example, how Premeaux and Bedeian (2003) differentiate between Hirschman's (1970) notion of voice and their own expression of speaking up, which takes into account only that an employee uses voice to make an improvement and not to express dissatisfaction with an organizational issue.

starting with Banerjee's (1992) "Simple Model of Herd Behavior." Paraphrasing Hirschman's concept of voice in organizations, Banerjee and Somanathan provided a model that relies on reputation-based herding without stating it explicitly. Members of a group can contribute more or less private information to the decision-process and thereby influence more or less the decision taken by the leaders. The decision about the amount of information contributed is based on the cost for their communication to the members of the group and their leader. This framework is in line with the studies on employee silence of Ryan and Oestreich (1991) or Milliken et al. (2003), which show in qualitative studies that employees often fear to speak up, in particular upwards (to their supervisors), because they figure that they will face negative consequences and will be perceived as troublemakers.

In the next section, we draw on the literature reviewed to develop our propositions on individual determinants of employees with regard to the costs of voice in organizations.

## **10.2. Costs of voice: determinants and propositions**

The costs of voice can be affected by various determinants. We pool the determinants of the costs of voice into two categories: individual and organizational determinants.<sup>8</sup> Individual determinants influence the costs of voice due to the employee's personality, experience and knowledge and also due to the personalities, experience and knowledge of the employee's coworkers or supervisors. Organizational determinants influence the costs of voice for a specific individual due to the institutional factors of the organization, such as human resource management or the wage policy.

In this paper, we want to focus on individual determinants. As shown in earlier papers, human resource management, in particular, the careful selection of people can help to reduce the costs of voice in organizations (see Cueni and Frey, forthcoming). We want to differentiate between the three sources of individual determinants for the cost of voice.

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<sup>8</sup> See the more extensive discussion of the topic focusing on organizational determinants in Cueni and Frey (forthcoming).

Depending on self-perception, role behavior and identity, the costs of voice can affect the individual employee in different ways (see, e. g., Morrison and Milliken 2000; Premeaux and Bedeian 2003; Withey and Cooper 1989). People who like to expose themselves or see their role as the devil's advocate perceive the costs of voice to be lower than assumed, for example. Subsequently, the employee's perceived cost of voice might be influenced by individual determinants like, for example, age, tenure with the company, experience in the job, or level of education. We consider these determinants to be the first source of the costs of voice and want to focus on them in our qualitative study.

Another source for the costs of voice lies in the relationship between the employee and the employee's coworkers or peers. In order to function, teams or committees experience a pressure to be uniform and the members create their own social identity. The more homogeneous a team is with respect to important individual aspects (professional background, education, gender, etc.) the more likely groupthink occurs (Bantel and Jackson 1989; Janis 1972; Withey and Cooper 1989). These diverse phenomena of social interactions in teams influence the individually perceived costs of voice; the more conformity is needed to be accepted as a member of the team, the higher are the costs if the individual employee deviates from the prevailing opinion. Employees are usually in competition with peers, which can reduce the costs of voice as it provides an incentive for the employees to speak up and distinguish themselves. In contrast, competition also can raise the costs if the employee and peers are rated by a superior manager using a benchmark, as discussed above (see Scharfstein and Stein 1990).

The last source of voice costs stems from the character of the principal-agent relationship. In addition to the above-mentioned sources, the relationship between the employee and superior as well as the employee's and the supervisor's personality, experiences and view on leadership have a massive influence on the costs of voice (see, e. g., Milliken et al. 2003; Ryan and Oestreich 1991). If the superior has to evaluate the employee's performance and if this evaluation determines bonus payments, future project assignments, or promotions, the employee's voice costs strongly increase. Due to career and reputational concerns, the

employee's incentive to contradict the supervisor on a project is likely to vanish. If the superior is accorded much respect in the committee due to an impressive track record and extensive experience, the employee's costs to speak up increase even further.

These sources spawn a wide variety of the employee's costs for speaking up starting with small hostilities to mobbing and sidelining or even towards a career-ending transfer of the employee or dismissal. We analyze the possibilities to reduce the costs of non-herding by selecting people with specific individual determinants. In particular, we focus on the first source of the costs of voice in organizations, namely of the individual determinants of the employee themselves. In order to develop quantitatively testable propositions, we focus on easily measurable determinants.

As an employee's age is simple to assess, we formulate our first proposition on the relationship between an employee's age and the individual costs of voice. Theoretically suggested in Scharfstein and Stein (1990) and empirically examined for the herding behavior of financial analysts in Hong et al. (2000), younger employees have higher costs not to herd. According to this empirical finding, we generalize in our first proposition about the relationship between an employee's age and the costs of voice.

*Proposition 1: The older the employee, the lower the costs of voice, holding all other factors constant.*

The next proposition is related to Proposition 1 as it takes the employee's experience into account. Clement and Tse (2005) as well as Hong et al. (2000), showed empirically that the more experienced sell-side analysts did not exhibit herd behavior to the same extent as inexperienced analysts. This is mainly due to career concerns: If less experienced analysts have a lower forecast accuracy, they are punished more severely than the more experienced analysts with a higher reputation due to their track record. In particular, the less experienced analysts have a higher probability of being dismissed.

*Proposition 2: The more experienced an employee, the lower the costs of voice, holding all other factors constant.*



As education contributes, at least to some extent, to an employee's reputation in the organization, better educated employees should remain less silent. The employee might use a higher reputation in the organization in order to reduce the costs of voice. Although we do not understand the education-based reputation as the same quality as the one stemming from experience, we think that an employee can draw on education likewise. Furthermore, we expect better educated people to be more eloquent thus lowering the cost of voice.<sup>9</sup>

*Proposition 3: The better educated an employee, the lower the costs of voice, holding all other factors constant.*

The longer people have worked together, the more they know about their coworkers' opinions and attitudes. This should lower the cost of voice, but in contrast, the better that people know each other, the more they might be threatened by the idea of dissent (Janis 1972). In line with Morrison and Milliken (2000), we argue that longer tenure in an organization does not lower the cost of voice. Over time, the employees share more and more entrenched views and are not willing to reconsider and adjust their opinions.

*Proposition 4: The longer the tenure of an employee with an organization, the higher the costs of voice, holding all other factors constant.*

The propositions presented in this section are now confronted with statements made by practitioners.

### **10.3. Practitioners' view on the costs of voice**

To check if our theoretically derived propositions on the costs of voice are in line with practice, we conducted semi-structured interviews with practitioners in the financial industry.<sup>10</sup> From June to August 2010, during the first wave of our study, we interviewed six practitioners in the greater area of Zurich, Switzerland's banking capital. To attain a reasonably broad insight into the various types

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<sup>9</sup> We are not aware of any literature that explicitly stated the relation between employee's education and voice in organizations.

<sup>10</sup> The description of the interview data in this section is based on an earlier version of Cueni and Frey (forthcoming).

of financial institutions, we interviewed two people from big Swiss banks, two from a mid-sized regional bank, one from a large Swiss insurer, and one manager from a small hedge fund. In addition, our sample varied with respect to the positions of the people and the sector in which they were working. Two analysts worked in the investment banking sector, two managers in the private banking sector, one person was involved in the top management of a universal bank, and the remaining person managed a company in the hedge fund industry. The sample was comprised of one woman and five men and included companies ranging in size from 30 to over 60,000 employees. The median number of employees was 7,500 and the mean around 24,000.

An outline was used in all the semi-structured interviews, but the order in which the questions were posed varied depending on the course of the conversation. The shortest interview lasted about an hour, the longest about one and a half hours. The interviews were analyzed by applying structured content analysis.

In general, all participants confirmed that a problem exists with voice provision in the decision-making processes of the various organizations. They agreed that there were individual costs involved leading to silence and herding behavior. Explaining the various costs of an employee's voice, all managers stated that they experienced a wide range of costs during their careers starting with delicate psychological pressure to conform and culminating in dismissal. Several respondents offered such remarks as the "troublemakers got sidelined" or "everybody knew the mavericks and sooner or later they were no longer part of important work groups" or "from then on your days are numbered".<sup>11</sup> These answers reveal additional types of costs, such as a corrosion of career opportunities due to criticism and insinuated troublemaking.

All of the six people interviewed mentioned various institutional factors to reduce the costs of voice when asked broadly how to lower them. Two managers reported that they were aware of implemented human resource strategies to select people with individual determinants supporting voice. As a result of the specific personnel selection, critical thinking and deliberating in the organization

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<sup>11</sup> The citations are translated as literally as possible by the authors.

should be promoted. One of the interviewees even introduced such a policy in his firm. He strongly promotes the idea of a careful selection of employees according to their predisposition towards speaking up in organizations and even called it vital for the functioning and the continued existence of the organization; this statement is in line with the ideas advanced by Morrison and Milliken (2000).

Regarding our propositions of the individual determinants of employees with lower costs of voice, the respondents presented a more heterogeneous picture. The majority did not support the first proposition—*Proposition 1: The older the employee, the lower the costs of voice, holding all other factors constant*. Four out of six managers denied the positive influence of age on employee voice. One manager, a former Chairman of a large global insurer, even answered: “Age is not supporting voice. It can lead in the opposite direction. You get tired and you don’t want to write a motion or another criticism and remain silent.”

*Proposition 2: The more experienced an employee, the lower the costs of voice, holding all other factors constant* was affirmed by five of the six respondents. A comparison of the two propositions supports the high correlation of age and experience. Hong et al. (2000) found empirically that older financial analysts were more willing to resist the prevailing opinions. They faced a lower probability of being dismissed after having lower accuracy; hence, they bore lower costs of voice. The respondents did not support this view. The discrepancy is solved if one takes into account the selection process during an employee’s career. The notion of “being experienced” points strongly towards the employee’s reputation in the organization.

The individual determinant *age* can be understood similarly because, if an employee at the end of that employee’s working life is still in the same position and in charge of the organization, the job was done well otherwise the employee would have been dismissed. The interviews revealed that it was the experience in connection with the high reputation that produced lower costs of voice provision for older employees, not their *age* itself. This statement is in line with the literature on reputation-based herding (Scharfstein and Stein 1990) and on voice and silence in organizations (Morrison and Milliken 2000).

*Proposition 3: The better educated an employee, the lower the costs of voice, holding all other factors constant* was not supported by the respondents. Only two out of six managers agreed on the proposition, whereas three remained undetermined and one manager even denied the relationship between an employee's education and the costs of voice. As we cannot draw on the literature related to costs of voice of an individual education, we need to reconsider this argument.

*Proposition 4: The longer the tenure of an employee with an organization, the higher the costs of voice, holding all other factors constant* received only ambivalent support by the managers. Three managers stated that the effect of a higher tenure leads in another direction: The longer the tenure, the lower the costs of voice for the employee. They argued that the costs of speaking up is lower for an employee who has been with the organization for a long time as the employee must have "survived" many years and thus enjoys a particular status and a high reputation within the organization. One manager with a big Swiss bank stated: "There were issues, a year ago, I deferred to give comments on because I knew exactly that I am the newcomer and all the other co-workers know much more than I do. Now, after one year, I have a much higher impact on the decision processes and dare to speak up."

This example reveals a u-shaped relationship between tenure and the costs of voice in an organization. In the beginning, the growing tenure lowers the employees' costs of speaking up. After some time, the positive impact of tenure on the costs of voice reaches its maximum and starts shrinking again to the point where the costs of voice are as high as in the first year on the job. Therefore, we assume that there exists a golden mean for the positive impact of *tenure* on the costs of voice.

#### **10.4. Discussion and conclusion**

Employee's herd behavior has to be overcome for organizations to be efficient. Whenever employees exhibit herding behavior in an organization, they hide their private information and do not contribute their insights to the decision processes. This loss of information deteriorates the organization's decision processes as

the decisions taken rest upon a lower information basis (Argyris and Schön 1978; Glauser 1984). The question is: Why do the employees not contribute their private information and hide in the herd. We argue that there exist costs for an employee if that employee does *not* follow the herd. Further, we argue that these costs can be influenced by certain institutional factors in organizations and vary over different types of employees. In this paper, we examine the various individual determinants that lower the employees' costs of speaking up and illustrate further implications.

The literature in economics as well as the literature on management studies and organizational science both contribute intensively to the topic. The former strand of the literature approaches the issue from the point of view of *herd behavior*, whereas the latter uses the terminology of voice and silence in organizations, dating back to Hirschman's (1970) seminal work on *exit, voice, and loyalty* in organizations. We identify the costs not to herd, or, in the terminology of organizational science, the costs of voice to be the overarching concept in both strands. Either way, the employee's costs of speaking up are key in overcoming herd behavior in organizations.

The costs of voice lead to pressure on the individual employee to remain silent. Morris and Milliken (2000) list three implications of the costs of voice and the resulting pressure on employees. First, employees have feelings of not being valued. Second, employees perceive a shortage of self control. Third, employees experience cognitive dissonance. These impacts of the costs of voice deteriorate the organization's performance in an indirect way, thus reducing an employee's motivation at work (Parker 1993). Further, happiness research in economics provides evidence that an employee's perception of higher self control and autonomy fosters an employee's job satisfaction (Benz and Frey 2008; Frey 2008).

Using in-depth interviews with high-ranked executives and analysts in the financial sector, we explored the various facets of the costs of voice. The managers stated that they experienced a wide range of costs during their careers starting with delicate psychological pressure to conform and culminating in a call to quit the job or even in dismissal. The analysis of the interviews revealed that individual determinants like *experience* or *tenure* lowered the costs of

voice in organizations. *Experience* has a negative linear relationship with the costs of voice, whereas *tenure* shows a u-shaped relation. At the beginning of a new job, employees face high costs of voice. Decreasing over time, the costs reach a minimum and then start to increase again. According to the managers, the minimum is usually reached after one to two years with the specific organization. Assuming decreasing marginal returns to experience, the effect of tenure will become dominant over time. As a result, older employees start facing higher costs of voice towards the end of their careers.

These insights should be used in practice. In order to employ more information for the decision processes and to bring forth happier and more motivated employees, managers ought to reduce the costs of voice of their employees. Lowering the costs would humanize the firm by simultaneously enhancing its efficiency in the decision processes. Other studies have analyzed how managers can further voice in organizations by changing their beliefs, practices and fear of negative feedback (Milliken et al. 2003; Morrison and Milliken 2000). Our study provides insights on the specific types of employees that managers should focus on. Employees with less experience and shorter tenure are more prone to remain silent due to the higher costs of voice. The same holds for employees with considerably longer tenure. Managers should favorably support these types of employees to overcome their fear of speaking up and remain motivated at work. Future research should explore the relationships between the various institutional factors, the different individual determinants and the diverse practices of managers in order to establish a new theory of the firm.

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# 11. Firm Evolution and Learning in a Market Economy with Bounded Rationality

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## 11.1. Introduction

The familiar economics-based model of the firm stands on the assumptions that firms attempt to maximize profits, subject to a production function that is supposed to express the technologically feasible combinations. Thus, if they have identical technology, firms are identical as well. In equilibrium, all firms have “zero (economic) profit”, i. e., the excess of their revenues over the best alternative foregone is zero. This happens with all the firms in every industry because if one firm had a cost advantage because of a different technology, all other firms would bid for that technology, and thus, when equilibrium is reached, they all would have it and the competitive pressure would have reduced the profits to zero (in terms of opportunity cost, i. e., over and above the profit opportunities of possible alternatives).

This makes things rather simple for a theory of the firm; no problem with different strategies, no problem with different objectives by different firms and no problem with internal organization: they all maximize profit and achieve it with efficient use of the technology. With these assumptions, microeconomic theory is able to show that the profit maximization goal (or, in a more modern formulation, firm’s value maximization) also maximizes social welfare (see, for example, Jensen 2000 for a brief statement of the argument).

The internal organization of the firm and the problems of short *versus* long run are completely absent from this model. In fact, the modern Economics of Organization (see, e. g., Milgrom and Roberts 1992) is an attempt to incorporate some of these realistic factors by relaxing some of the classical economics assumptions. From a practical point of view, it suffices to look at any book or journal on strategic management to see that setting objectives for the firm is far more complex than the profit maximization objective would suggest and besides, the profit maximization hypothesis has been severely criticized as being “too difficult, unrealistic and immoral” (Anthony 1960). Forty years later, Senge (2000), stated that manipulating profits over the short term is much easier than building wealth over the long term and thus, whether intentionally or not, firm value maximization will almost always become, by default, short-term profit maximization (Senge 2000, 63–65). More recently, Canals (2010) has been extremely critical of the profit or value maximization approach, showing its limitations and alternatives, mainly from the point of view of “implementation and achievability”. Jack Welch, who championed the notion of shareholder value in the 80’s, has said recently that this was “a dumb idea” and that value maximization “is a result, not a strategy” (Welch 2009).

In this paper we depart from conventional assumptions and try to conceptualize how heterogeneous management decisions give rise to results in an economy, taking into account dynamic aspects resulting from learning. In particular, we consider that the long-run value of a firm depends on other intangible variables related to learning and to the capabilities built by the firm.

But we go beyond that. There is a vast literature in management (mainly in the OB field) showing how some practices that can be qualified as “humanistic” may be highly profitable, giving the firm a competitive advantage, mainly in the long run, or even that some of these practices are indispensable to achieve good economic performance consistently through the years (see, for instance, Collins 2001; Collins and Porras 1997; Pfeffer 1994; Pfeffer 2007; Pfeffer and Sutton 2006; Sutton 2007). The idea is well founded in research about both such practices and the long-run performance of the firms but does not intend to analyze how

the market evolves in relation with firms adopting or not these practices. More specifically, all this literature ignores in general the reaction of other firms. What happens if other firms want to do the same? The implicit and intuitive idea from elementary economics is simply that if a firm does something "right", this gives it a competitive advantage and so this firm will obtain better results than the others. Then, the competitive advantage may decrease or disappear to the extent that other firms decide to do the same and are successful at that.

However, casual observation shows how firms that do not have that type of values and that do otherwise often do quite well (better than the others), mainly in the short run. What kind of learning will this fact induce in firms? What aspirations will managers have and how will this condition their decisions on investment projects? Is it always the case that short-run focused, self-interested firms outperform the others?

The matter is both an interesting and difficult one as well. Suppose, for instance, that we want to study how taking into account identification with organizational objectives or developing a distinctive competence has an impact on the success of the firm and to the reaction of other firms in the market as well. Suppose further, that we want to study how the nature of firms in the market changes when learning is introduced under conditions of imperfect information and bounded rationality. The resulting problem is important but very difficult to analyze. Ideally, one should be able to find a way to do so analytically but the problem is complex enough to be intractable for the time being.

An empirical analysis is not only difficult but probably impossible given (a) the qualitative nature of relevant variables, (b) the complexity of the relationships and (c) the difficulties in following the evolution of firms (a good number of them) in the long run. Consequently, we put forward that simulation may be a good way to start a rigorous analysis of these problems. Eventually, this approach might lead to a new and more realistic theory of the firm than the conventional economic approach.

To this end, we develop a model, exploited by simulation, of an economy in which capability building and firm performance occur as a consequence of learning and the dynamics of manage-

ment decisions. In our case, decisions refer to projects that their firms will undertake. We assume that decisions are made with a variety of objectives in mind—in particular those having to do with the development of firms' motivational capital and its potential for future performance.

Thus, the purpose of this paper is to investigate how management decisions in firms shaping up an economy influence the aggregate economy performance both in the short and the long term. This requires taking into account realistic details of management decision making processes (bounded rationality, imperfect information and goals and criteria other than strict profit maximization) together with their implications at the firm level (mainly learning and capability building beyond efficiency improvement) before considering aggregate performance. At the onset, this implies recognizing firms' heterogeneity.

## **11.2. Modeling considerations and general model structure**

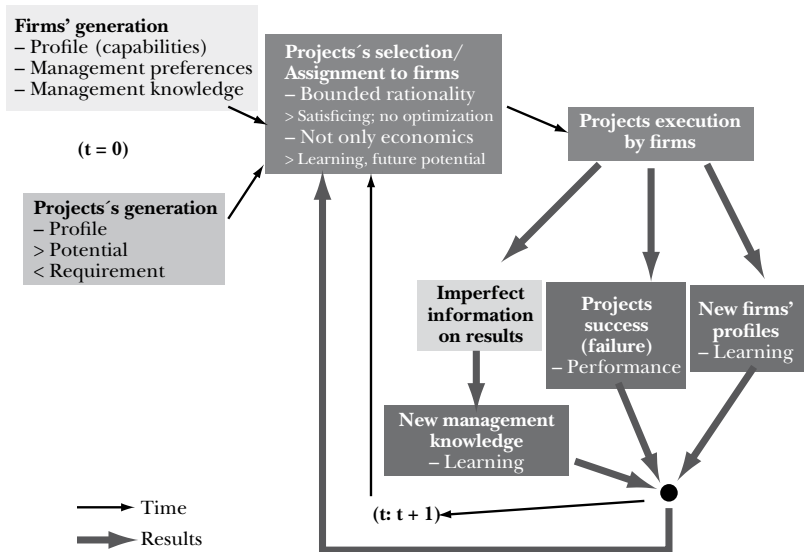
The model deals with a population of companies evolving in time, which is simulated as increasing unit by unit. Every company evolves according to the same general laws but each particular evolution path is different because it depends on each firm's objectives, preferences, information assimilation and learning.

Conventional economic models make a few very simple hypotheses that simplify the resulting mathematics even at the cost of being unrealistic from the standpoint of firm behavior. The classical modeling approach has tried to keep the underlying mathematics simple, to the point of precluding the analysis of a number of features present in real life that turn out to have a profound impact on the solution. The complexities involved are not just model refinements, they tend to have a profound impact on its qualitative and quantitative behavior. Ignoring these complexities dramatically affects the degree of approximation of the whole model.

In contrast, we forsake mathematical restrictions by simulating the behavior of the model and analyze its behavior in situations nearer real life. We do not try to mimic precisely real life in full detail, as this could make the model slow, complicated and un-

wildly.<sup>1</sup> In a sense, we include just enough complexity to feel its effects. The overall structure of the model (which we call PARRS) is schematically depicted in Figure 11.1, and its main characteristics are explained below.

**FIGURE 11.1: Overall structure of the PARRS simulation model**



The use of simulation in management and economic dynamics research is not new, even to set the basis for theory development; see for example Davis et al. 2007, 2009, Harrison et al. 2007, Gilbert 2008, Miller and Page 2007.

Recently, Coen and Maritan (2011) have also used a simulation model to study resource allocation dynamics to invest in capability building. They also model firms with heterogeneous capability endowment and study the capability building process dynamics in a competitive environment subject to budget constraints. However, they do not give special meaning to the firms' capabilities, which are implicitly assumed to be all of the same "type" ("operational capabilities that a firm uses in its day-to-day productive activities").

<sup>1</sup> With models of this kind, there is always a risk of them running more slowly than real time!

As we explain in following sections, the model presented here goes significantly beyond such an assumption.

The capability building process can be thought in the context of the well established resource based view of the firm framework (Wernerfelt 1984, Amit and Shoemaker 1993, Barney 1991, Diecrickx and Cool 1989, Teece et al. 1990), including its learning aspects (Andreu and Ciborra 1996) and the management role in it. As Argawal and Helfat (2009), we assume that the process of “strategic renewal” capability has “potential to substantially affect (a firm) long term prospects”.

### 11.3. Firms in the “PARRS world”

This section describes in some detail how firms’ behavior are dealt with in the model, and how they evolve as a result of decisions made by their management, including how they learn and how their short term performance and long term potential is computed at each stage of their evolution in the context of what we call “the PARRS world”.

#### 11.3.1. Modeling firms

The basic structure of the model regarding firms’ behavior can be described in three parts: (a) The evolution of the companies’ states; (b) the companies’ decisions made at each time period; and (c) the subsidiary effects resulting from these decisions, including the induced learning. We treat each of them in turn in the following paragraphs.

- a) *Companies’ capabilities, states and evolution.* To avoid unnecessary technical difficulties we assume that a company either has a capability or it doesn’t, with no intermediate states.<sup>2</sup> The state of a company summarizes its past evolution and provides all information needed to project the evolution into the future. The state is thus a sort of a sufficient statistic for the evolution process, which we assume given by the

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<sup>2</sup> This apparently bang-bang behavior is much smoothed by the probabilistic nature of the transitions, as we explain below.

status (“presence” or “absence”) of three capabilities called Unity, Attractiveness and Effectiveness;<sup>3</sup> see Appendix 1 for a detailed explanation of these capabilities and how and why a hierarchy is defined among them. In each simulated period, a company may change from its starting state to a (different) state described by its final capability configuration. For instance, if a company is in state  $(U, \bar{A}, E)$  at the beginning of period  $t$  (that is, it has all capabilities but Attractiveness), it may jump to some other configuration in period  $t+1$ , say  $(U, A, E)$  with some probability, jump to  $(U, A, \bar{E})$  with some other probability, etc., or stay the same with still another probability. To be sure, these probabilities depend on the decisions made in the firm during the period.

- b) *Decisions: undertaking projects.* In each period, every company selects a single project to perform. Project *types* are specified in terms of the same three capabilities used to define a company’s state as described in (a). A project type thus defined, must be understood in two complementary ways: On the one hand, the “presence” of a given capability means that a firm having that capability has a larger probability of being successful if it decides to undertake that project. On the other hand, it has to do with the project’s propensity of inducing a change of state in the firm that undertakes it in one direction or another. For example, if a given firm undertakes a project of type  $(U, A, E)$ , the probability of that firm developing (or maintaining) A(ttractiveness) is higher than if it chooses to undertake a project of type  $(-, \bar{A}, -)$ , and similarly regarding the probability of “losing” a capability if it undertakes a project without the corresponding capability in its type. This amounts to learning going on in the firms as a result of undertaking one type of project or another; see (c) below for other types of learning and the following subsection for more details.

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<sup>3</sup> In the following, we abbreviate the existence of a capability by its initial. Thus, A denotes the existence of Attractiveness and the same for the other capabilities. To denote the absence of a capability, for example A(ttractiveness), we use the abbreviation  $\bar{A}$ .



Firms choose projects from a series of candidates available in the environment. For this purpose, projects are evaluated through two different criteria. One criterion has to do with the immediate economic result for the company, measured by the probability of success if the firm undertakes the project. The second criterion relates to the aspirations of the company's management team. Each company is assumed to have a set of preferences defined over the possible firm states; for example, a firm with a dominant preference for state  $(\bar{U}, \bar{A}, E)$  would be an extremely greedy company with the philosophy that Attractiveness and Unity just add cost and reduce margin. Now, one of the basic hypotheses in economics is profit maximization, which assumes unbounded knowledge about the problem. In sharp contrast, we assume that project selection, after their valuation, takes place under some degree of bounded rationality, as explained below.

- c) *Subsidiary effects and additional learning.* This refers to the increase of knowledge resulting from learning from experience in operating the company. Viewed as a repository of competitive advantage, knowledge could be considered a part of a company's state. However, doing so complicates things unnecessarily so that it pays to consider it independently. Learning is assumed to take place in two main areas: (1) management teams are assumed to have only imperfect knowledge about the state of their companies and they refine it through information regarding the aggregate evolution of firms and (2) managers also learn about how successful a project type can be by observing whether other exemplars of the said project are successful or not and drawing conclusions. A third additional kind of learning occurs through the firms' evolution process in the sense that when a firm undertakes a project of one type or another, its state (i. e., its "profile") in terms of capabilities is updated as a consequence of its cumulative experience with projects of that type.

### 11.3.2. Structure of the "PARRS world"

This section describes the structure of the "PARRS world", with emphasis on the structures of the model that capture the features

of the real world considered relevant for our purposes. The following list includes these features, their implementation and the reasons for choosing them.

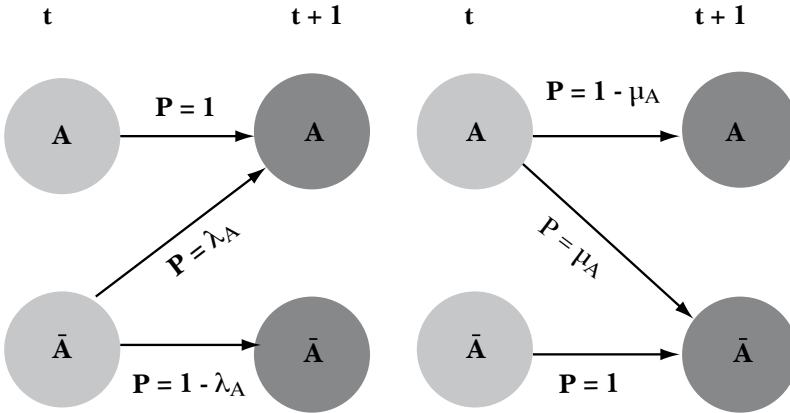
1. *Sample firm population.* We have chosen a firm population consisting of 1,000 companies, with initial states uniformly distributed. 1,000 enterprises is a sufficient population size to get significant samples while processing can be still done in a reasonable time. However, changing the number of companies can be easily done and is an option in the model current implementation. In our experience so far, with as few as 300 firms, the model already produces good quality results.
2. *Random world.* Real life is not deterministic. It is unreasonable to assume that management decisions lead to the same results even if “situated” in the same time and space. Not taking into account random behavior in a model like the one we propose results in anomalies.<sup>4</sup> Also, in a determinist population, all companies evolve exactly in the same way if they start at the same state. They pick the same projects and suffer the same state changes. This is contrary to intuition, since companies among other things are affected by “luck”. In fact, Darwinian evolution asserts that the source of all differentiation is just “luck”.
3. *Influence of the projects in the evolution of firms.* Figure 11.2 summarizes the logic of firms’ changes of state a consequence of having undertaken a project of a given type (the figure refers to just one characteristic (A) of the company, since the logic is exactly the same for the other two). Part (a) of the figure depicts how transitions happen when the chosen project exhibits characteristic A, and part (b) specifies the same when it doesn’t. There are two possible initial states

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<sup>4</sup> For instance, in a deterministic evolution process between two possible estates defined on a  $\{0,1\}$  state space, the only possible transitions from 0 are either always go to 0 or always go to 1. Likewise for state 1. This gives rise to four types of transitions, with the result of very simple dynamics. One of the processes stays forever at the initial state, two other processes for every initial state go to the same state in just one transition and stay there forever and the fourth alternates between states 0 and 1 at each transition. In addition the time it takes to reach a state is either 0 or 1. Not a very exciting behavior!

for the company, either having A or not having A ( $\bar{A}$ ), with the same possible states after the transition.

**FIGURE 11.2: (a) Chosen project favors A (b) Chosen project doesn't favor A**



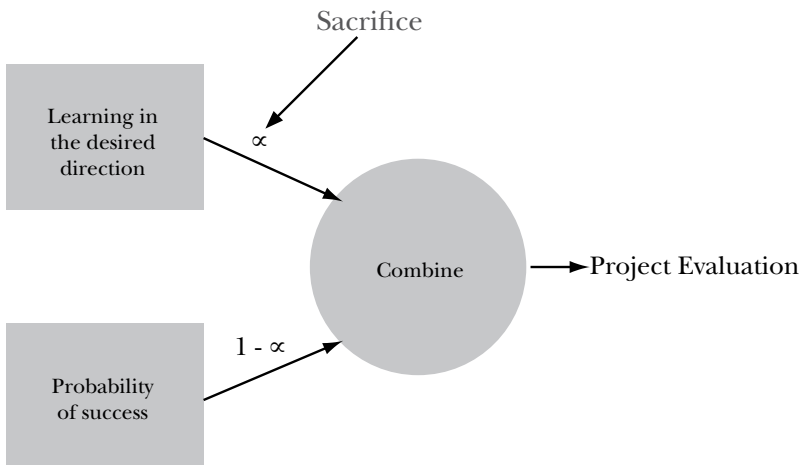
The arrows represent different transition possibilities and they are qualified by the probabilities of selecting each arc when proceeding from a given state. Notice the simple structure. If the firm already has an attribute and the project favors that attribute, with probability 1 you end up having the attribute. That is, no change is produced. Not having the attribute is slightly more interesting since in this case you may gain the attribute with probability  $\lambda_A$  (a given number). Of course the probability of not gaining the attribute is  $1 - \lambda_A$ . The case for the project not favoring the attribute is very similar but here the interesting probability is that of losing the attribute if you have it, given by  $\mu_A$  (in general a different probability value).

4. *Independent transitions.* This is a crucial but habitual hypothesis. It assumes that the above probabilities are independent. There are a number of considerations that favor it, although we must acknowledge that none is perfectly satisfactory. Foremost is the increased complexity when they are not independent, because then one needs to specify not

just the elementary transitions for each characteristic, but also their mutual dependencies. The net result would be a somewhat “more realistic model” adding only marginally in terms of its behavior.

5. *Non-monetary benefits.* Decisions to assign projects to firms are taken at each period according to a set of criteria. From a financial literature point of view, the decision should be based on the discounted value of each alternative project. This would ignore the tastes and aspirations of the company. Instead, we assume that the criterion used to choose projects takes into account that the world does not end after a decision and that resulting capabilities in the firm remain there for future endeavors. To this end, we have selected a combination of short term and long term criteria that take into account both the rational and the non-rational aspects of the decision, as shown in Figure 11.3, where “ $a$ ” is the weight (“sacrifice”) assigned to the criterion of long-term learning and  $1-a$  is the weight assigned to the immediate success.<sup>5</sup>

**FIGURE 11.3: Project evaluation procedure**



<sup>5</sup> As a proxy of this success we use the success probability of the projects. This coincides with its expected return if it is a unit project (i. e., with a unit margin).

The criterion of long-run learning is not monetary but “aspirational”: it essentially states that management wants to develop some capabilities in the long term through the learning of people in their firms. To the extent that those capabilities match the nature of future projects, they will eventually produce more value because the company will be in this sense “better” at being successful with projects (because the probability of a project’s success is dependent on the capabilities present in the company). We do this by stating a preference of the decision maker for the capabilities to be present in the company. It requires some sophisticated technical manipulations, but it can be handled efficiently.

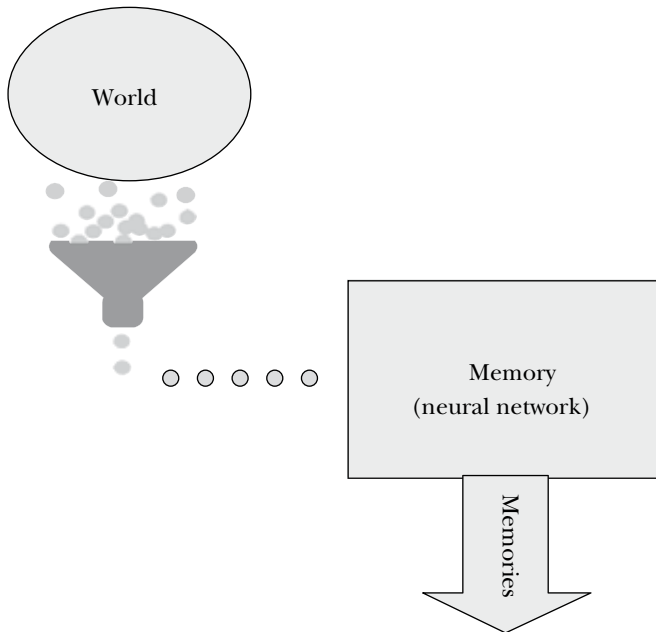
Dealing with heterogeneous firms’ objectives permits to systematically explore the trade-off between short term and long term objectives and how management decisions and preferences affect it in a way reminiscent of the classical distinction between exploration and exploitation (March 1991).

6. *Learning.* Conventional economic models take for granted that decision makers have full information about the state of the world. In our model, this is equivalent to assuming that they know the state their company is at each point of time and that they know the performance resulting from the selection of a given project. In our approach, we are running an uncertain world and managers are endogenous to the economy. Thus, they see what is going on and can react to events. Therefore, we must acknowledge that the decision makers’ uncertainty changes over time, as the results of running the model pile up before them. Therefore, imperfect information requires the introduction of yet another type of learning, the refining of the probabilistic information as time goes by. So, learning is introduced not just because it is a realistic feature, but, and this is important, because it is “almost” required by the dynamic structure of the decision making process.

Learning on uncertain attributes is such that a single type of learning scheme is not adequate for all situations. We have to distinguish between “rote learning” (Figure 11.4)

resulting just from the piling up of experience coming from the environment and “reasoned learning” (or logical learning)—the capability of logically revising one’s beliefs about the world as observations are collected, interpreted and assimilated. This kind of rote learning simply follows from observing a random phenomenon, even if its probabilistic structure is unknown. In this case we use a simple type or learning device: a Neural Network (NN).<sup>6</sup> We assume that the “brain” of the decision maker can be modeled as a NN that takes care of this rote learning.

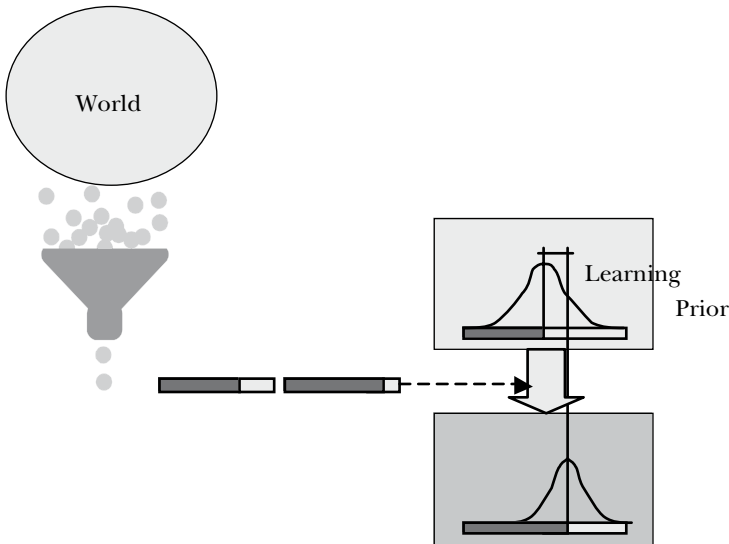
**FIGURE 11.4: Rote learning resulting from simple environment observation**



<sup>6</sup> A neural network is an object with exogenous inputs and outputs. Some of the inputs and all the outputs are used for learning. They are supplied with the actual data and result of an experiment and the internal structure of the network is modified accordingly to provide the best fit for the new observation. Whenever a prediction is needed, inputs are supplied, a prediction is requested and the network uses its internal structure to actually predict the required result. The internal structure is essentially a nonlinear least squares model, recalculated for each new piece of evidence. The same least squares structure provides the computational machinery for the prediction.

“Logical Learning” (Figure 11.5) takes place when the underlying probabilistic structure of the observed, uncertain phenomenon is known to the extent of being able to use logical rules<sup>7</sup> to update the personal view of the world. In this case, we assume a logical mind in the manager that can ascertain changes in initial beliefs produced by a given piece of information. A real life manager, of course, may not have enough knowledge to be able to literally apply, say, Bayes’ Theorem. However, quick and dirty reasoning based on logical rules is often used in anticipating the value of a random phenomenon (Pearl 1998).

**FIGURE 11.5: Logical learning—updating beliefs after observing the world**

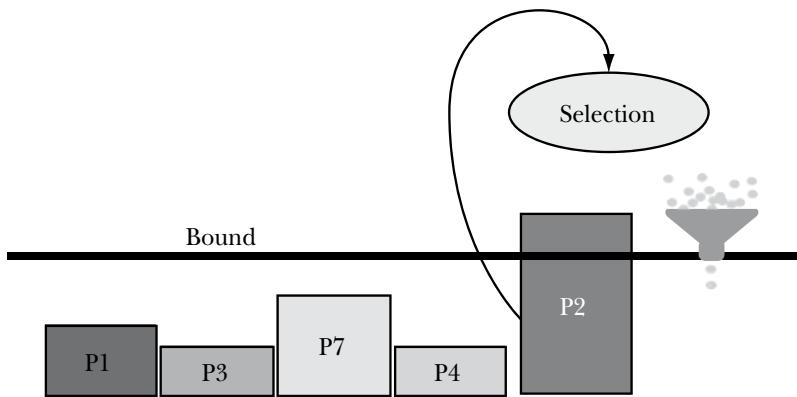


7. *Bounded rationality*. There is uncertainty, of course, and the decision processes by managers are not completely rational, which means that they cannot, and will not, extract all logical consequences from any given situation. This precludes the possibility of making the “best” decision in any one case.

<sup>7</sup> Like Bayes Rule.

We consider this a crucial property of the model.<sup>8</sup> Typically, logical optimizing behavior is too terse. This means that the properties of the policies being adopted (the decisions being made) can be catastrophically different for small changes in the data. This is a paradigmatic case in the theory of catastrophes. Managers (Kahneman and Tversky 2000), tend to rely in abstract categories that do not change in the short range, with such bang-bang effects.

**FIGURE 11.6: Bounded rationality in project selection based on a threshold value**



There are many ways of modeling bounded rationality (Rubinstein 1998). Perhaps the simplest one is the original Simon formulation of satisficing behavior (1955) schematically depicted in Figure 11.6: it consists of fixing a lower bound (threshold) on the value of the project to be selected. It is not necessary to evaluate the whole set of projects from where to choose; it suffices to stop as soon as one project exceeds the threshold. Thus, essentially, the first project that exceeds the bound is the winner and it is selected to be performed.<sup>9</sup>

<sup>8</sup> A difficult one to handle formally, as it introduces non trivial non-linearities and discontinuities.

<sup>9</sup> Obviously, the order in which projects are evaluated is then important for the evolution of the company. We have chosen to use a random order. Changing this decision is relatively easy given the implementation of the model, though.



8. *Emphasis on trajectories, not in steady state.* Often, people are only interested in the steady state solution to dynamic problems. In contrast, we are interested in the dynamics of the evolution, not as much on steady behavior, because results are path dependent when learning is involved as you go along. Since the population is large enough, the results at each step of the simulation are a combination of many companies (and random variables). By averaging them over the population, we obtain statistics of various types, for instance, the fraction of companies in each class in the population, with a relatively small variance. This allows us to study the evolution just by plotting the average quantities at different points in time. In this way sensible trajectories are produced that can be used to understand the dynamics of the situation.

A formal and much more detailed description of the model is included in Appendix 2.

#### **11.4. Using the model: exploring results and insights**

Using the model is straightforward in its current implementation, as illustrated below. For the purposes of this chapter, we use a set of “baseline” parameters that remain constant and explore how the model reacts to a few representative changes in just a couple of them, namely “Sacrifice” (S or  $a$ ) and “Threshold” or “Satisficing Level” (T or SL) in the terminology used in preceding sections. We discuss the results and comment on the kind of insights that they can bring about, thus illustrating the usefulness and potential of the modeling approach employed.

##### **11.4.1. Baseline parameters**

Unless otherwise stated, we work with  $N = 1000$  companies, which interact for a rather large number of periods (simulation rounds). For simplicity we assume that all projects take one period complete, and thus firms undertake only one project per period. All projects are assumed to have the same economic value and

require the same investment conditions, independent of which company undertakes them. This means that the number of successful projects in a simulation round is a measure of the aggregate economic value generated in the economy.

Since the profile of a firm may change as a consequence of the projects it undertakes, we consider the distribution of company profiles at the end of a round as a measure of the future potential of the economy, as the capacity of a company to successfully undertake any type of project is higher as its profile is closer to (1,1,1).

In the example runs reported below, we keep things simple, although the implementation of the model is very general and allows exploring more complex situations. In particular, we use the following settings:

1. The initial distribution of firms is uniform;
2. All firms have the same preferences regarding target profiles;
3. All management teams have the same initial perception regarding the profile of their firms (same prior probability distributions);
4. Changes in firms' profiles resulting from undertaking projects are governed by the same transition matrix for all companies. This assumption can be interpreted as depending on the "environment," rather than decided by managers. We use the following values (see Appendix for the exact meaning of these parameters):

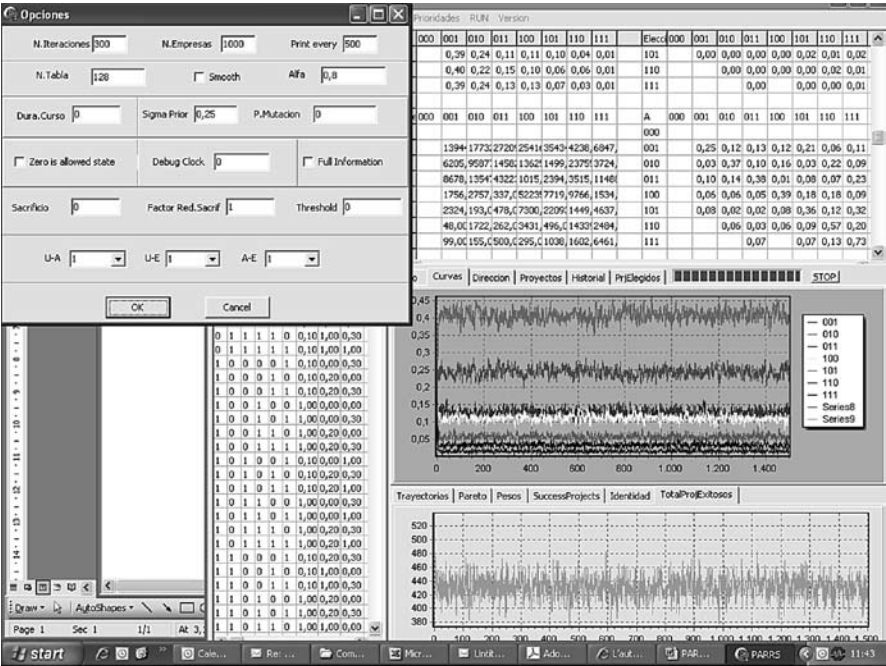
$$\lambda_E = 0.1, \lambda_A = 0.2, \lambda_U = 0.3$$

$$\mu_E = 0.9, \mu_A = 0.8, \mu_U = 0.7$$

#### 11.4.2. Model inputs and outputs

Figure 11.7 illustrates the results produced by the model, corresponding to values of Sacrifice and Satisficing Level (Threshold) equal to zero ( $a = T = 0$ ). Although its current implementation also produces a number of additional outputs, many of them are of a rather technical nature, beyond the scope of this paper.

**FIGURE 11.7: Typical model output. ( $T = a = 0$ )**



These results should be read as follows: The window at the top left allows the input of relevant parameters. Of interest in the following discussion are the values for “Sacrifice” (*Sacrificio*, or  $a$ ; which is 0 in the figure) and for Threshold  $T$  (also taken to be 0). Just beneath that window appear the values for the entries of the chosen transition matrix.

Two relevant graphs describe the results of simulation runs. The one at the bottom right depicts the number of successful projects per round as successive rounds unfold—i. e. describes how the economy performs in aggregate economic terms; thus, it can be interpreted also in social terms because it measures value created by the economy that reverts to society. In the figure, since there are 1,000 firms operating and all projects are of the same size, about 43+ % of the projects undertaken were successful; values fluctuate around this figure due to the probabilistic nature of the model.

The graph above shows the evolution of the firms’ population in terms of their profiles as time goes by. It can be seen that pretty

soon firms of type (0,0,1) dominate representing some 40% of the population. They are followed by about 25% of (0,1,0) firms and so on. In this simple case the distribution remains stable, only affected by random fluctuations.<sup>10</sup>

This result is only logical, as the situation can be considered a base-line case:  $T = 0$  implies that firms undertake the first project that they (randomly) get, and  $\alpha = 0$  means that management is not ready at all to forego immediate economic results in order to develop “better” firms’ profiles for the future. The model then translates into a simple classical Markov Decision Problem (Sobel 1993) that can be solved analytically,<sup>11</sup> with a limiting steady state distribution of types in the population of firms, in this case a mix of not only “high potential” types (note, for example, that the “full potential” (1, 1, 1) firms represent only a stumpy 1% of the population). Furthermore, the firms population cannot achieve a high proportion of economic success, as the number of successful projects stays around 43% of the total. In a sense, thus, we can only improve from this situation.

#### 11.4.3. Illustrative scenarios: simulations, results and insights

In his section we report a few results obtained from some simulation runs. We proceed from the baseline case in Figure 11.7 and systematically investigate how that economy behaves when two decision making parameters are changed, namely Sacrifice ( $\alpha$ ) and Threshold ( $T$ ).

$\alpha = 0,9$ ;  $T = 0,1$  (Figure 11.8).

The situation here assumes that firms are willing to forego immediate results to a large extent (as they, with  $\alpha = 0,9$ , mainly take into account future potential when evaluating projects) while not being very demanding as to the kind of projects they choose (i. e., they pick projects almost on a first come—first undertaken basis). The result illustrates how a low Satisficing Level ( $SL = T = 0,1$ ) can be compensated by a high willingness to look after building future

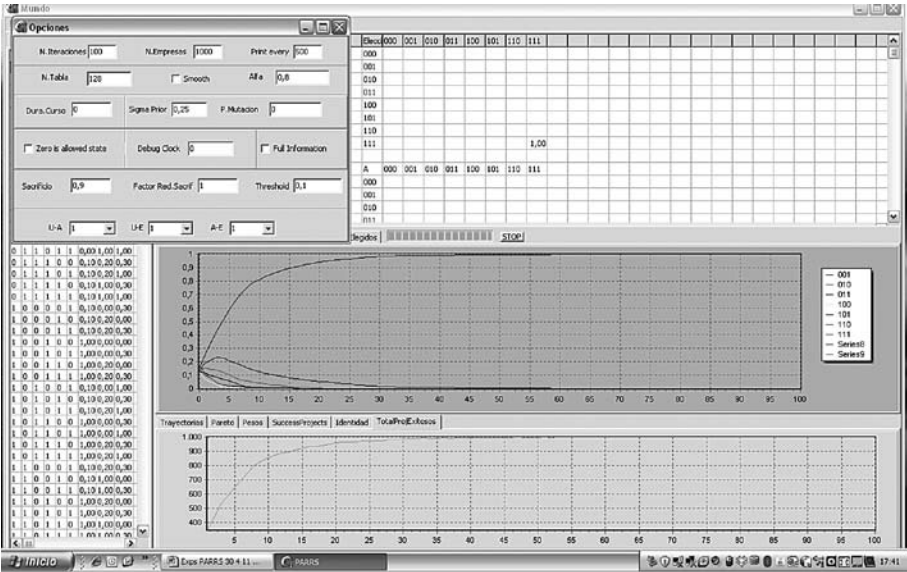
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<sup>10</sup> In this particular extreme case the model reduces to a single class recurrent Markov chain.

<sup>11</sup> Thus one can compute the steady state distribution and check the model for coincidence. We have performed the comparison and it checks with the simulation results.

potential: The population of firms is quickly dominated by full potential (1,1,1) firms and in addition performance as measured by successful projects gets to 100% (again logically, as full potential firms can undertake *any* kind of projects successfully).

**FIGURE 11.8: Output for  $\alpha = 0,9$ ;  $T = 0,1$**

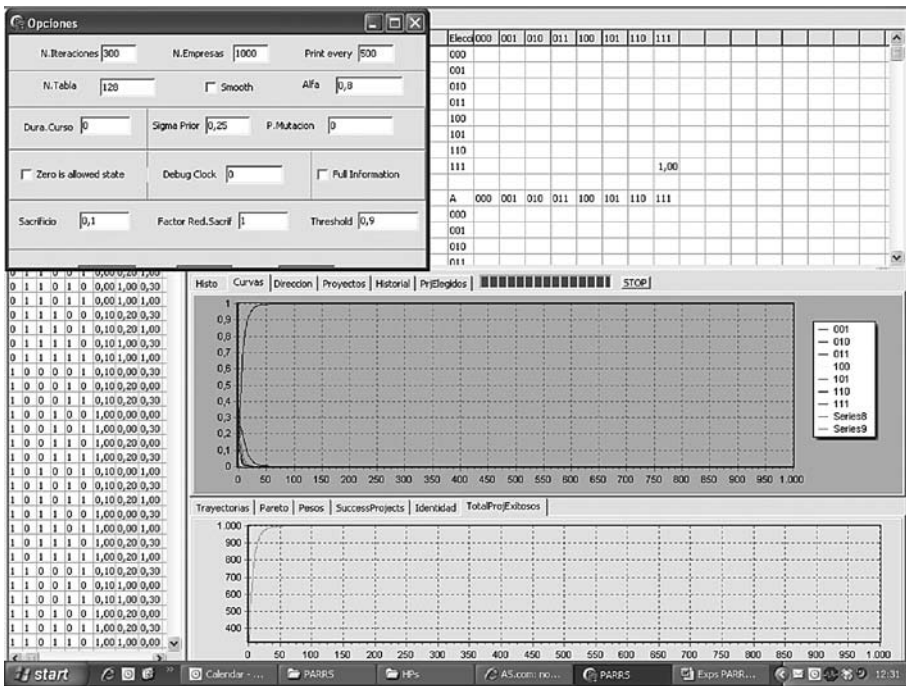


Note:  $\alpha = 0,1$ ;  $T = 0,9$  (Figure 11.9).

We next assume a situation symmetrical with respect to the previous one, that is, we suppose that firms are capable of almost optimizing project selection, while they are much less willing to forego short term performance in exchange for future firm potential in the form of stronger profiles ( $\alpha = 0,1$ ;  $T = 0,9$ ). It turns out that the resulting outcome is very similar to the one in (a) above. In other words, being very demanding on the quality of projects to undertake, takes the firm population to a situation where (1,1,1) profiles quickly dominate and at the same time performance reaches the maximum value. Thus, for values in a certain range, one can decrease  $\alpha$  and increase  $T$  and obtain similar results. In a sense, though, such combinations of  $\alpha$  and  $T$  values are not very coherent: A low  $\alpha$  value and a high  $T$  value would correspond to a situation where

management would set evaluated project evaluation guidelines by giving preference to short term performance while people in the trenches would then devote a lot of effort to optimize project selection, with the result of rare but good-for-the-future projects being chosen and the associated learning bringing firms up to a (1,1,1) profile, which happens to be “good for everything”, the short term as well as the future. The case in (a) represents the contrary situation, then: very stringent project evaluation guidelines and far from optimizing project selection practices.

**FIGURE 11.9: Output for  $\alpha = 0,1$ ;  $T = 0,9$**

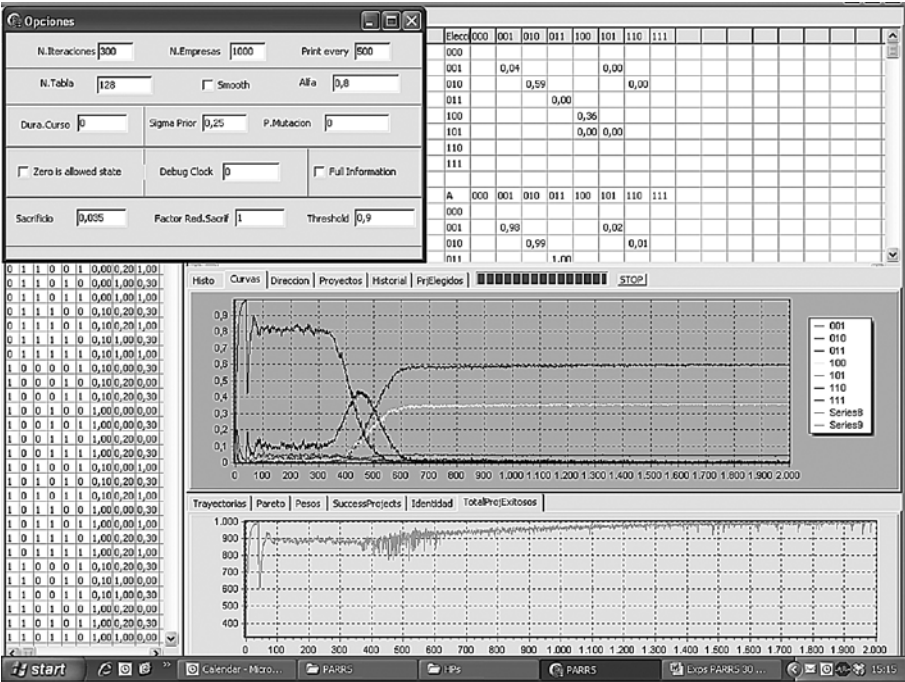


Note: (a)  $\alpha = 0,035$ ;  $T = 0,9$  (Figure 11.10).

Intermediate results can be more interesting. See for example Figure 11.10. If from the situation in (b) we keep diminishing the value of  $\alpha$ , that is, making firms less and less ready to “sacrifice” while maintaining the level of optimizing, interesting emerging behaviors and firm evolution appear. In the case depicted in Figure 11.10 we

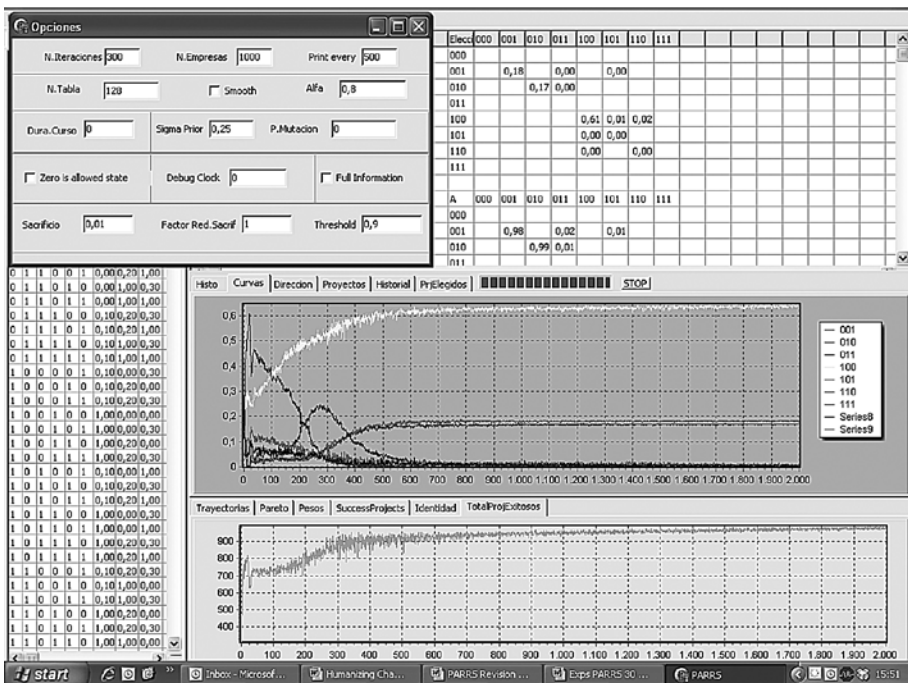
can see that for a very short period of time firm population gets to a 100% of (1,1,1)'s and performance to 100% of successful projects and then, suddenly, that proportion of very good profile firms falls, stays for a while at about 80% and then collapses, giving rise to a rather unstable period that eventually (after a quite long time) takes firm population to a very different, although stable, population structure that approaches 100% performance in terms of project success. Similar evolutions, although with different intermediate and final results, emerge from different pairs of values ( $\alpha$ , T). Although this kind of phenomenon deserves further and deeper examination, it illustrates appealing model features like the presence of emerging behavior, the importance of transitory, unstable evolution until (definitive?) stability is again reached, and the appearance of catastrophe-like short time drastic changes in firm population which have to do with learning and un-learning phenomena (which detailed analysis and explanation falls well beyond the scope of this chapter).

FIGURE 11.10: Output for  $\alpha = 0,035$ ; T= 0,9



Just to illustrate, Figure 11.11 depicts another situation, with very different transient evolution and final stable firm population. Again, initially (1,1,1)'s population goes up, although without reaching 100%. The evolution that follows ends with the population of (1,0,0)'s dominating together with smaller proportions of (0,0,1)'s and (0,1,0)'s, after a period of turbulence that also marks a change in the number of successful projects for the better: the corresponding proportion practically reaches 100%. Once more, the details and causes of such a behavior are not straightforward and are beyond the scope of this chapter.

FIGURE 11.11: Output for  $\alpha = 0,01$ ;  $T = 0,9$



Without making use of other model possibilities, like changing the transition matrix, management's preferences and their prior distributions regarding their knowledge about the true state of their firms, the foregoing examples already illustrate the variety of behaviors that the model can produce and how they can suggest insights



regarding how an economy may evolve in response to management decisions and the learning that can occur in firms as a consequence of experience with different types of projects as they become firms of one type or another with the passage of time.

In the next section we advance some of these insights from a real life standpoint, putting them in the form of propositions that would apply to a market economy with bounded rationality, learning and purposeful management decision making.

#### **11.4.4. Summary of insights: Conjectures for a bounded rationality economy**

The majority of interesting phenomena in the evolution of the firm population conforming an economy as described in the preceding sections stem from (i) the assumptions regarding bounded rationality in the decision making processes taking place in firms, (ii) the learning that they experiment both as a consequence of gaining experience from projects, and (iii) the objectives set by firms' management. In particular, bounded rationality seems to play a central role: without it the model would in essence assume an optimizing criterion as a consequence of fully rational decision making that would probably quickly result in a firm population always eventually dominated by the best profile —(1, 1, 1)—.

In what follows, we characterize some of these phenomena from a general standpoint and give real life interpretations of what they mean. As a set of propositions we enunciate them as follows:

1. "Coherent" combinations of values for  $\alpha$  and  $T$  (like high values for both) tend to produce stable and predictable evolutions in the firm population, as well as results in terms of successful projects. However, it is possible to *compensate* a limited willingness to forego immediate results (a low value of  $\alpha$ ) with a more demanding satisfying level or threshold (higher values of  $T$  meaning decision making processes closer to optimization) in order to get a population of companies with better future potential.
2. In unstable situations, the transient period until a new stable situation is reached is the interesting part of the story. In a sense, the model and the simulation-based approach

taken to implement it allow to better analyze not as much the final equilibrium but the way in which it is reached and why. The idea that in real life we never reach an equilibrium because we tend to be continuously in a transient state triggered by different circumstances like innovations, bubbles, and so on, make this possibility attractive.

3. Once the evolution of the firm population starts getting “bad”, turning it around turns out to be difficult in terms of both economic performance and potential for the future. Transitions from a stable, good situation to worse ones can come about unexpectedly, in a sort of catastrophic development that we must investigate further but that involve strong discontinuities likely to stem from bounded rationality and poor learning.
4. An interesting additional reason why a stable situation may eventually end in an instable evolution has to do with the information available in the environment: If all firms are of the same type and they all chose the same types of projects, the observed behavior and performance of firms lacks variety, so that it gets harder to distinguish between alternative choices. This opens the door to project evaluations getting very close and eventually allowing, if firms are not 100% demanding (i. e., not optimizing) in project selection (because of bounded rationality, again) to eventually choose one that may lead to learning in another direction. Once uniformity is broken, diversity takes over and a whole new dynamics unfolds.
5. Such behavior can also be interpreted the other way around: returning to instability can be seen as “regenerating” the economy after a period of “too much” stability and low levels of innovation, if the projects that initiate the transition are “innovative”.

Of course, these insights deserve further development and analysis both from the modeling and from the empirical, real life perspectives, on which we are already working. In addition, further use of the model with different parameter settings can give rise to additional conjectures and insights in the future. Without being exhaustive, the following can for example be easily formulated:

- a) Characterizing innovative projects and experimenting with “throwing some of them at the economy” in order to provoke pioneering disruptions is an idea that could be pursued without difficulties.
- b) Management’s imperfect knowledge about their company type is also likely to have a “catastrophic” effect on the evolution of firms, in the sense that a large change may arise from a small modification in the parameters. The reason is simple but interesting. Management has a prior on the company type. Unless it is very sharp around the true value, the distribution gives weight to the other types. As managers estimate company type by computing the expectation over the prior, the expected company type comes up to something else than the true value. This leads to selecting projects with poor actual match with the company profile, resulting in a positive probability of losing some attributes. Once lost, it is difficult to recover them. In practice, managers who have a diffuse knowledge about their companies make poor decisions. Further, everything can be much worse if management only considers the effectiveness attribute, ignoring attractiveness and unity.
- c) Investing in order to learn more about one’s own company profile is then worthwhile. A widespread tendency to “follow the leaders” runs the risk of overreaching unless managers have a precise evaluation of their company profile.
- d) If “the environment” is better for the purpose of learning from projects (represented by a transition matrix with higher probabilities of learning from them), reflecting a “better training, more focused to society’s needs”, the future potential of the economy will probably improve and at the same time its short term performance could also be better.
- e) On the other hand, an “environment” with more inertia in un-learning will likely produce better future potential of the economy and perhaps a somewhat lower short term performance.

## Appendix 1: Firm's capabilities

One of the model's main choices has to do with the capabilities that we have chosen to characterize the companies' profiles. We decided to use the approach pioneered by Pérez López (1993), and further developed by Rosanas (2008). Following this approach, we characterize firms according to three capabilities: (a) *Effectiveness*, or the degree by which a company is able to achieve measurable (typically financial) results; (b) *Attractiveness*, or the degree by which employees develop professionally and enjoy their jobs; and (c) *Unity*, or the degree by which employees identify with organizational goals and values and with the other members of the organization.

These three capabilities originate in different types of motives that a person may have. The distinction between "intrinsic" and "extrinsic" motives comes from the psychological literature of the 50's and 60's of last century (see, e. g., Saleh and Hyde 1969, and Lawler 1969). Ryan and Deci (2000) and Lindenberg (2001) distinguish between "intrinsic motivation, which refers to doing something because it is inherently interesting or enjoyable, and *extrinsic motivation*, which refers to doing something because it leads to a separable outcome." Frey (1998), Osterloh and Frey (2003), and Gottschalg and Zollo (2007) take into account also that intrinsic motivation may have an hedonic component of *enjoyment*, while at the same time there is a normative intrinsic motivation out of a sense of *obligation*.

Our approach is parallel to those distinctions, with the additional idea that the obligation motives may be enjoyable as well: whenever we do something we dislike in itself not because of an obligation but because we are happy to satisfy someone else's needs. That is what Pérez López (1993) and Rosanas (2008) have called "transcendent" motives.

In fact, as noted by Simon (1997, Chapter 6), the group of people that predominantly have a direct interest in the organization objectives are customers; employees are directly interested in (tangible and intangible, i. e., extrinsic and intrinsic) rewards derived from inducements offered by the organization. Therefore, if we want people in the organization to really pursue the organi-

zational objectives we need them to identify with them (Simon 1997, Chapter 10). Hence, what we call *unity* (identification of all organization members with organizational objectives) is something essential for the firm's survival in the future and is based on the transcendent motives. Attractiveness (or enjoyment, or hedonic motives) plays an important role in obtaining the desired output, although sometimes shifts the individual's attention to the satisfaction of his egoistic's needs instead of customer satisfaction. Finally, effectiveness being the ability to obtain short-term, measurable results, will be important in satisfying extrinsic motives.

Several authors have recently touched upon some of these aspects although from slightly different perspectives. For example, Giancola (2001) discusses issues close to the attractiveness concept, while Shuck and Wollard (2010), Choi and Wang (2009) and Hekman et al. (2009) arguments are reminiscent of the unity concept.

Notice that there is a hierarchy in the three capabilities above: unity (or identification) is more important than attractiveness (it may be at the origin of part of the attractiveness), and attractiveness is more important than effectiveness: unity and attractiveness in the short-run create effectiveness in the long run.

We adopt the Pérez-López and Rosanas approach because of three reasons. First, it is a comprehensive model of the interaction between decision making, managing a business and improving the capabilities of the company, firmly rooted in mainstream theories of the firm. Second, because of Occam's razor: the model explains a lot of the individual and organizational behavior in terms of only three capabilities that summarize the whole structure of a company; the model is thus very powerful and at the same time simple enough to understand and be used. Thirdly, it puts emphasis on an often forgotten variable in strategy: the effects of, and the people involved. This is introduced mainly by alterations in decision making and the performance of the company, resulting from the increase in knowledge in both managers and operational people (i. e. people doing things). The approach does this by making explicit the interactions between the active agent, making the decision and the reactive agent, involved in its implementation, and learning, resulting as a consequence of the decision.

Thus, the model explicitly contemplates how decisions are made in the real world, how learning occurs in both the active and the reactive agent and how it impacts on economic results. It also allows us to improve our understanding of the influence of satisfying and other forms of bounded rationality in the resulting evolution. The following paragraphs describe how the model cogitates all these topics.

In the simulation implementation presented in this chapter, the hierarchical relationships between the three capabilities are enacted through constraints put on the corresponding values allowed for probabilities  $\lambda$  and  $\mu$  (Figure 2 above). Table A.1 below makes explicit how these probabilities are not permitted to take any value, in relation to values assigned to others.

**TABLE A.1: Constraints on possible values for probabilities  $\lambda$  and  $\mu$**

$\lambda E$	<	$\mu E$
>		<
$\lambda A$	<	$\mu A$
>		<
$\lambda U$	<	$\mu U$

In plain words, the two columns in the table indicate that learning unity is supposed to be less probable (harder) than learning attractiveness, which in turn is harder to learn than effectiveness. Also, “unlearning” unity is easier than attractiveness and efficiency. Horizontally, the table reads that it is always “harder” to learn any capability than unlearning it.

**Appendix 2: Formal model structure**

What follows is a detailed and more formal description of the model.

**Firms and projects**

Recall from section 2 that we use the letter  $x$  to designate a generic firm,  $x=(x_1, x_2, x_3)$ , with the three basic capabilities, Unity,

Attractiveness, and Effectiveness (U, A, E). Projects are also characterized in terms of effectiveness, attractiveness, and unity, and are represented by  $y = (y_1, y_2, y_3)^{12}$ .

### Management knowledge, preferences and learning

Each management team has preferences with regard to the type of company they would like to be. These preferences are described by

$$\square\gamma = (\square\gamma_1, \square\gamma_2, \square\gamma_3, \square\gamma_4, \square\gamma_5, \square\gamma_6, \square\gamma_7) \quad (1)$$

where each component represents the relative importance that managers assign to each of the seven company types. The values of these parameters remain fixed throughout successive rounds.

In addition, management teams have uncertainty regarding

- (i) the company's actual profile;
- (ii) whether a certain project will succeed if undertaken by a given firm;
- (iii) the potential of a certain project to develop certain capabilities in a given firm if it were to undertake that project.

We assume that managers allocate their time, resources, and efforts in such a way that the results satisfy (not necessarily maximize) their goals or expectations, and that are willing to forego short term results in exchange for learning and future firm's potential. While the target profile  $\square\gamma$  remains fixed throughout the simulations, the knowledge mentioned in (i) and (ii) above may evolve through time, so that companies and managers can and will learn.

On the one hand, managers learn about their own company type and they also learn about the success probability of the different types of projects.

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<sup>12</sup> For notation reasons, in this appendix we refer to subindices U, A and E as 1, 2 and 3.

The process by which managers select projects depends on three elements: the type of company they would like to be in the future; the (incomplete) knowledge they have about the company's profile, which is updated along the way; and the (incomplete) knowledge they have about the success probability of a project, which is also updated along the way.

### **Updating management's knowledge of their company's profile**

A key element of the model is the way in which managers form their beliefs about the actual type of company they run. As they do not know the true profile of the firm, we endow managers with a prior (a probability distribution)  $\pi$  defined as follows:

$$\pi(x) = \pi(x_1, x_2, x_3) = P(\text{true profile of the company is } (x_1, x_2, x_3))$$

We assume that the initial distribution is uniform over all possible profiles, which is a non-informative prior distribution, a reasonable assumption in decision making under uncertainty (which may be easily modified at a later stage, on the basis that management is supposed to know better than that). As new information becomes available, the probability distribution is updated in a Bayesian way.

### **Probability of succeeding when a given project is undertaken by a firm**

Another important element is the way in which managers form their beliefs about the possibility of success with a specific project. Denote by  $P_T(x, y)$  the "true" probability of success, defined for all pairs  $(x, y)$  as

$$P_T(x, y) = P(\text{success} \mid \text{company} = x, \text{project} = y) \quad (2)$$

The subjective perception that managers have of (2) will be denoted by  $P_S(x, y)$ . Note that, while managers make their decisions based on  $P_S$ , the actual frequency of successes and failures



in the simulations will happen according to  $P_T$ . The process by which managers form their subjective perceptions is modeled by means of a neural network. In particular, the system makes public all quadruples

{Initial Profile of firm; Project Type; Success or Failure; Final Profile of firm}

generated during each simulation round. Based on this information, companies update their knowledge (thus simulating the learning process of their management teams). For simplicity, we assume that the learning process is the same for all companies, in the sense that it is the same type of neural network that processes the information in all firms. We thus deal with three probability measures:

- $P_T(x, y)$ , the “true” probability that a company with profile  $x$  succeeds when it undertakes a project with profile  $y$ . This probability is assumed to be a feature of the “environment,” determined by the modeler.
- $P_S(x, y)$ , the subjective estimate that a company of type  $x$  will succeed if it undertakes a project of type  $y$ . This measure is updated as new information and is generated by the environment in each round, and it should converge to  $P_T(x, y)$ .
- $P_F(x, y)$ , a frequency. It tells us how often a type  $y$  project  $y$  has actually succeeded when undertaken by a company of profile  $x$  during the different rounds. As time goes by, it should converge to  $P_T(x, y)$ .

### **Evolution of firms’ profiles**

A third key characteristic of the model is the fact that, after working on a project, a company may develop a desired attribute or it may lose it (because its choice of project was excessively short-sighted or just plainly inappropriate).

The modification of profiles is modeled by means of a transition matrix that specifies the probability that a company evolves, in one period, from one profile to another as a consequence of

undertaking a specific project. Consider a company with profile  $x = (x_1, x_2, x_3)$  that undertakes project  $y = (y_1, y_2, y_3)$ . The profile at the end of the round will be denoted by  $x^+ = (x_1^+, x_2^+, x_3^+)$ :

$$(x_1, x_2, x_3) \xrightarrow{(y_1, y_2, y_3)} (x_1^+, x_2^+, x_3^+)$$

The new profile is modeled by drawing from the probability distribution

$$P[x^+ = (x_1^+, x_2^+, x_3^+) \mid x = (x_1, x_2, x_3), y = (y_1, y_2, y_3)]$$

where we explicitly assume that the new value of each attribute is independent of the new value of the other attributes. The probability that after one round  $x_1^+ = 1$  (that is, that after having worked at a project, the company has acquired unity) will be denoted by  $g_1(x_1, y_1)$ . In an analogous way,  $g_2(x_2, y_2)$  and  $g_3(x_3, y_3)$  will denote the probability that the company has acquired attractiveness ( $x_2^+ = 1$ ) and effectiveness ( $x_3^+ = 1$ ). In general,

$$g_i(x_i, y_i) = P(x_i^+ = 1 \mid x_i, y_i) \quad (3)$$

where  $g_i \in [0, 1]$ . Given the independence of the attributes, if a company chooses to undertake project  $(y_1, y_2, y_3)$ , each attribute of the company (each  $x_i$ ) will evolve according to a controlled Markov chain<sup>13</sup> with transition matrix  $A_i$ :

$$A_i = \begin{bmatrix} P(x_i^+ = 0 \mid x_i = 0, y_i) & P(x_i^+ = 1 \mid x_i = 0, y_i) \\ P(x_i^+ = 0 \mid x_i = 1, y_i) & P(x_i^+ = 1 \mid x_i = 1, y_i) \end{bmatrix}$$

Using (3), this matrix can be written as

$$A_i = \begin{bmatrix} 1 - g_i(0, y_i) & g_i(0, y_i) \\ 1 - g_i(1, y_i) & g_i(1, y_i) \end{bmatrix} \quad (4)$$

Note that it is the project that determines the matrix, and recall that the matrix is unknown to managers (i. e., its components are a feature of the environment, determined by the modeler).

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<sup>13</sup> See Chung (1982), Taylor and Karlin (1998), or Heyman and Sobel (2003).

In order to simplify notation, we let  $\lambda_i$  denote the probability that a company lacking an attribute may acquire it after working on a project with that attribute. That is, for  $i = 1, 2, 3$ ,

$$\lambda_i = g_i(0,1) = P(x_i^+ = 1 \mid x_i = 0, y_i = 1)$$

Likewise, we let  $\mu_i$  denote the probability that a company may lose an attribute after working on a project that does not have it:

$$\mu_i = 1 - g_i(1,0) = P(x_i^+ = 0 \mid x_i = 1, y_i = 0)$$

for  $i=1, 2, 3$ .

We impose the following conditions on these parameters:

1. *Invariance*, which requires that attributes cannot change when the initial company value and project value are the same. In particular, for  $i=1, 2, 3$ :

$$g_i(1,1) = P(x_i^+ = 1 \mid x_i = 1, y_i = 1) = 1$$

and

$$g_i(0,0) = P(x_i^+ = 1 \mid x_i = 0, y_i = 0) = 0$$

2. *Entropy*, which means that a weak project attribute is less determinant of the final result than a weak company attribute. For  $i=1, 2, 3$ , we assume that

$$g_i(0,1) \leq g_i(1,0)$$

3. *Difficulty*, which states that improving effectiveness is easier than improving attractiveness, and this in turn is easier than improving unity. We also require that losing unity is easier than losing attractiveness, and this in turn is easier than losing effectiveness. We write:

$$\lambda_1 \leq \lambda_2 \leq \lambda_3 \quad \text{and} \quad \mu_1 \geq \mu_2 \geq \mu_3$$

## Decision making

Two criteria are used to choose projects and assign them to specific firms. One captures the idea that managers would like to

choose the project that maximizes expected NPV. This, however, would require them to compute the success probability  $P_T(x, y)$ , which is not observable. A solution could be to use the subjective perception  $P_S(x, y)$ , but the problem is that managers do not know the true profile of their firm. We thus consider the following version of the Expected NPV,<sup>14</sup>

$$V(y) = NPV(y) \cdot \sum_{all\ x} P_S(x, y) \cdot \pi(x)$$

As we are assuming that the financial value of all projects is the same, we may assume  $NPV(y)=1$  for all  $y$ , which yields

$$V(y) = \sum_{all\ x} P_S(x, y) \cdot \pi(x)$$

The other criterion has to do with managers' aspirations (goals) regarding the type of company they would like to have in the future, thus modeling the idea that managers are also interested in projects that will bring their firm closer to their goal. We proceed in two steps: First, we take into account the wishes or desires of the management team, represented by  $\square\gamma$ ; second, such desires are tempered by the "imitation effect," which is the attraction that managers may feel toward projects that successful companies chose in the past.

To start, note that:

$$\sum_{\substack{all\ projects\ y \\ undertaken\ by\ x}} P_T(x, y)$$

is an estimate of the success of a company with profile  $x$ . As  $P_T(x, y)$  is not observable and  $P_S(x, y)$  is different for each company, we use the frequency measure  $P_F(x, y)$ . If one considers the expected net present value of a project as a measure of success, since all projects are alike, the above expression is a proxy for the total value earned by a company in a given simulation round. In an analogous way,

$$G(x) = \sum_{\substack{all\ companies \\ of\ type\ x}} \sum_{\substack{all\ projects\ y \\ undertaken\ by\ x}} P_T(x, y)$$

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<sup>14</sup> Note that the summation has seven terms, for there are only seven company profiles.

is a proxy for the total value earned by all companies of type  $x$ . The function  $G$  is used to model the inclination to imitate other companies. Note that  $G(x)$  can be computed from the data generated by the system in each round.

Managers' preferences regarding future company profiles were given by (1), where the components,  $\square\gamma_x$ , represented the relative importance that they assign to each company type. These preferences, which remain fixed throughout successive rounds, should be combined with the fact that managers are not blind to what goes on in their environment (imitation effect).<sup>15</sup> How to combine both variables is open to discussion but in line with the tradition of System Dynamics (see, for example, Meadows (2008)), we adopt a multiplicative approach. We therefore define  $\gamma_x = \square\gamma_x \cdot G(x)$  so that

$$\gamma = (\square\gamma_1 G(1), \square\gamma_2 G(2), \square\gamma_3 G(3), \square\gamma_4 G(4), \square\gamma_5 G(5), \square\gamma_6 G(6), \square\gamma_7 G(7))$$

The second criterion used by managers to choose projects is thus:

$$\begin{aligned} W(y) &= \sum_{x^+} \gamma_{x^+} \cdot P(x^+ | y) \\ &= \sum_{x^+} \gamma_{x^+} \left( \sum_x P(x^+ | x, y) \cdot \pi(x) \right) \end{aligned}$$

where the probability is to be understood as an (observed) frequency.

Note that we have developed two indices,  $V(y)$  and  $W(y)$  that characterize a project  $y$ . The first one is related to the project's effectiveness (its capacity to generate short-term profits), and the second one captures how the project is aligned with the preferences that managers have regarding the future of the company. We combine both indexes as follows:

$$D(y) = (1 - \alpha) \cdot V(y) + \alpha \cdot W(y)$$

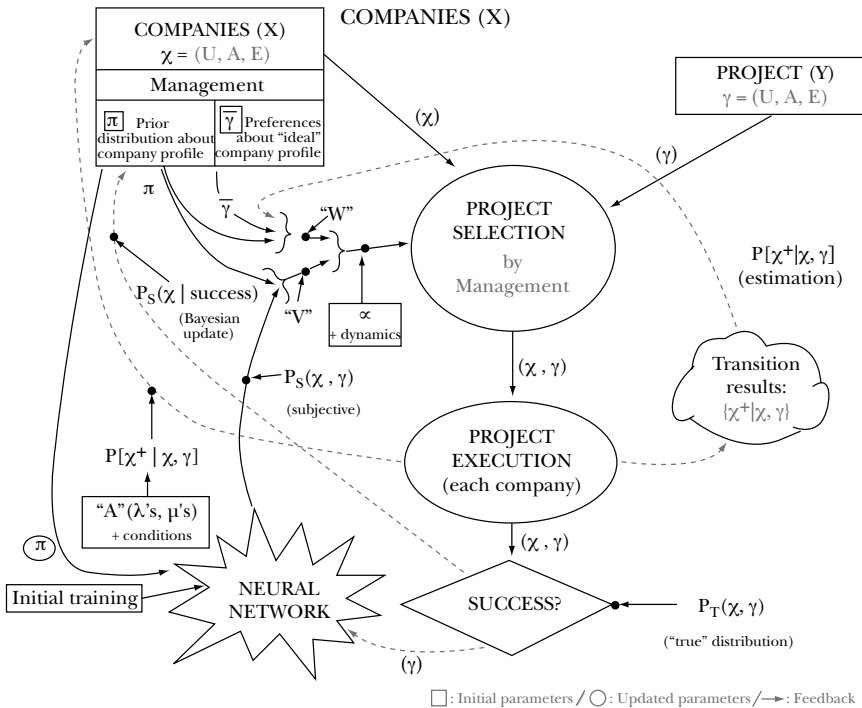
where  $\alpha$  is the managers' willingness to sacrifice short-term profits in exchange for a better company profile in the future.

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<sup>15</sup> This approach goes beyond the concept of mimesis in neo-institutional theory (Di Maggio and Powell 1983).

In the process of project selection, managers do not maximize this index. They rather fix a threshold  $T$ , and choose the first project for which  $D(y) \geq T$ .<sup>16</sup>

**FIGURE A.2. Detailed model structure**



If  $\alpha = 1$  (complete willingness to sacrifice immediate profits), the decision criterion becomes  $D(y) = W(y)$ , meaning that the weight in the decision making process is carried by the managers' long-term vision of the type of company they would like to be in the future. If  $\alpha = 0$ , the decision index would be  $D(y) = V(y)$ , meaning that managers exclusively seek short-term profits. Figure A.2 below shows a detailed structure of the model consistent with the discussion above.

<sup>16</sup> Projects of different types are successively "offered" to each company in a random order.

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## 12. The Effects of Organization Design on Employee Preferences

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### 12.1. Introduction

Inducing high levels of employee effort is a primary goal when managers put together a firm's organization design. It has been argued that managers often make poor design choices because they wrongly assume that employees are just-selfish (Ferraro, Pfeffer and Sutton 2005; Ghoshal 2005). In this chapter, we argue that managers sometimes make poor design choices, because they wrongly assume that employees' preferences are fixed. More generally, we look beyond the problem of a static mismatch between design and employee preferences: we seek to lay out a research program for studying how organization design affects employee preferences.

For example, individual incentives, low discretion and close monitoring may, over time, lead employees who exhibited moderate degrees of altruism, trust and trustworthiness—henceforth cooperative types or cooperators—to increasingly resemble just-selfish employees. This introduces a dynamic strategic consideration. Organization design should be chosen not only with respect to employees' current preferences but also with respect to each design's implications for future employee preferences. For exam-

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ple, even when managers, faced by a high fraction of just-selfish employees, can maximize short-run profits by designing an individualist incentive structure, this design choice may be myopic if it leads the cooperative or decent employees to gradually become just-selfish.

The graveyard of failed businesses is replete with firms that failed to keep their employees well motivated. It is always difficult to adapt to the transition from an exciting and perilous start-up period (in which working as a cooperative team was crucial to short-term survival) to a longer-run and more stable phase with a larger and often more heterogeneous workforce. We suggest that a common transition error is to emphasize organizational designs geared towards individual incentives and neglecting their dynamic consequences.

A common, stylized example goes like this. A cooperative individual (one who reliably cooperates in typical work situations) joins a new company. This individual encounters an environment that is less cooperative than the environment he has experienced in the past. For a few months he continues to behave as in the past: he helps coworkers when the opportunities arise and he works conscientiously even in situations where the firm cannot observe or measure either individual efforts or results. Most other employees act in markedly different ways; they focus their efforts on what is directly compensated, neglecting unrewarded contributions to the organization. At the end of the year, this individual does not receive a raise, in contrast to most selfish coworkers, many of whom benefited from this individual's unilateral contributions. Our individual continues with his cooperative behavior for a while, driven by his understanding of the world and notions of appropriate behavior but his enthusiasm takes a hit. After a subsequent disappointing, below-average results-based raise, this individual starts to feel increasingly resentful that so many coworkers who contribute less to the company receive better compensation despite the fact that his own efforts obviously help many of the coworkers and the company at large.

The story now diverges for different sub-types of cooperative individuals. One option is to quit, but we assume that the individual has poor outside options and chooses to stay. In addition,

the individual may plan to exit after waiting to see if the situation can be improved, but preference changes may kick in during the wait. As we will see, preference change is often unintended and unanticipated, so individuals may quit less readily than they would if they were fully aware of the implications of staying.<sup>1</sup>

Another option is to try to improve the adverse work environment, either by trying to convince the bosses to change the incentive structure (and complementary aspects of organization design) or by seeking to convince coworkers to behave more cooperatively (perhaps through sanctions, perhaps through moral suasion). Individuals with strong values for cooperation may have the motivation to try to persuade others to become more pro-social but this option is typically beyond the realms of feasibility. Certainly, the scope for such a solution is very low when there is a high proportion of just-selfish workers and the bosses are confident about their design choices or suspicious of their subordinates. So for the remainder, we neglect both the “exit” and “voice” options and we focus on stayers who take their new environment as exogenous, but are not necessarily “loyal.”

As the employee becomes increasingly resentful, seeing no option for exit or voice, he may consciously resolve to avoid letting himself be exploited. He can do this by behaving like the majority of his coworkers, concentrating his efforts on his own work and on measurable outcomes. This may also occur unconsciously: when people feel powerless and unhappy with their initial mode of interaction they tend to conform with common norms of behavior in their organization. Reinforcement learning offers another unconscious mechanism: whenever the individual adopts a cooperative attitude, it leads to feelings of frustration. As shown formally in Ellman (2003), this can also lead to suppression of the coop-

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<sup>1</sup> The converse of this case (excess quitting) is well recognized, because there is strong evidence that people sharply underestimate the degree of their advantageous hedonic adaptation to disadvantageous changes such as a disabling accident (see, for example, Lowenstein, O'Donoghue and Rabin 2003). Our distinct point is that the cooperative individual may disapprove of becoming less cooperative even if such preference changes improve his (future self's) hedonic experience of the workplace. Self-aware individuals who strongly disapprove of noncooperation are very likely to quit. Unfortunately, awareness of preference change risks (applied to oneself) is usually very limited.

erative attitude. Habit can cement a change in behavior. If the employee acts selfishly when in a bad mood (see Isen 2000 for evidence), this selfish approach to working may become a habit and therefore endure beyond the period of adaptive behavior. (Notice that the worker may be worse than selfish and actually feel a desire to exact revenge or retaliation. If such behaviors become habitual, the firm will become more dysfunctional than suggested by simply converting cooperative into just-selfish employees.)

Finally, sometimes the individual attempts to balance the cooperative and self-interested modes of behavior but this leads to frustration. This individual is hurt by the conflict between wanting to behave cooperatively and being resentful of the negative consequences, for him, of such behavior given the incentives in the company in which he works and the preferences of his just-selfish coworkers. This individual learns to behave equally selfish like other employees, but feels resentful and out of place, and dissatisfied, but gradually learns to think like a non-cooperator, and after a period he regards himself as one of the crowd, and doesn't feel any compunction to help nor to work harder than what is being explicitly rewarded. He changed his worldview, assimilated into the culture of the company, or as economists would say, his preferences changed.<sup>2</sup>

In this paper we seek to explain how such change in preferences can be understood from a behavioral economics perspective, based on mechanisms identified in the psychology literature (elsewhere employed to interpret different phenomena). The standard economic approach can deal with changing workplace behaviors (such as a shift from mostly cooperative to mostly uncooperative) but only up to a point. In our application, the economic story would run as follows. Individual employees seek to maximize their own utility within the structure of the organization. Their utility functions (or preferences) are fixed, but their understanding of

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<sup>2</sup> There are many other scenarios that bear similarity to the one described above, with the main difference lying in the stimulus. Consider an organization that has for a long time been generous with its employees and maintained an organization structure that emphasized employment security policy, and which at some point decides to drastically change its structure towards a more individual-oriented structure. Long-time employees, who have been cooperative and operating reliably without monitoring, need to adjust to this new environment.

how to maximize this function evolves with experience. Employees interact with each other and their superiors within a structure characterized by the allocation of decision-making, incentives, monitoring and other elements designed to induce useful employee effort. Employees learn what they like and do not like. That is, they learn what their own preferences are. They also learn about their environment from experimentation and by observing the experience of other employees. In particular, they learn about which actions lead to which outcomes and they learn about their coworkers' strategies. So, if over time, cooperative behaviors lead to increasingly undesirable outcomes (defined in terms of a typical employee's fixed preferences) while uncooperative behaviors appear to generate more desirable outcomes (again in terms of the fixed preference ranking), then employees will shift towards uncooperative behaviors.<sup>3</sup>

Learning about the environment can explain many instances of change, but testimonials from employees and managers suggest that changes in employees' preferences are also important for explaining behavioral change in many cases.<sup>4</sup> These testimonials describe in detail, preference changes that follow from exposure to uncooperative workplace practices and peer influence or arise as the endpoint in a complex set of reactions to the organizational experience. We provide a theoretical framework that rationalizes these testimonials and our interpretations of them in section 3 after first discussing the related literature and general evidence on preference change in section 2. In section 4 we provide a concrete illustration of how organization design may affect employees' preferences, and in section 5 we

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<sup>3</sup> For instance, even just-selfish employees might initially act cooperatively to satisfy a boss's requests and thereby avoid being punished; after discovering that punishments are rarely forthcoming (perhaps by observing another employee's intentional or mistaken transgressions); such employees will become uncooperative (breaking unenforced requests from their organization).

<sup>4</sup> We have had many opportunities to talk to employees and managers, especially in human resources. They tell their stories without reference to preferences or similar constructs, but do frequently refer to how people change over time in the fashion described in the text. We have searched the literature for empirical investigations of changes in preferences in the workplace and consulted scholars who do ethnographic work in organizations, but so far failed to identify studies that bear directly on our issue.

offer policy recommendations for fa-sighted managers who seek to manage strategically their organization's design in view of its dynamic and long-term effects.

In this paper we focus on providing an explanation for endogenous change in preferences associated with *peer interactions* in organizations. We exclude selection and screening of new employees as well as laying-off on the basis of their preferences. To focus on what is novel in our approach and we exclude changes in preferences that may result directly from the provision of rewards and punishments (financial and otherwise) that are aimed at encouraging or discouraging certain behaviors; see Bowles and Polania 2009, for an extensive discussion of these and other related situations). Economists such as Gneezy and Rustichini (2000) argue that crowding-out (Frey and Jegen 1997) can best be interpreted as the result of signaling. In such models, the effects are instantaneous, unlike our gradual preference change, mediated through aversive interactions with work colleagues and bosses. We also limit our attention to three dimensions of preferences: self (vs. other) regarding, trusting and trustworthiness.

## 12.2. Literature review

Stigler and Becker famously suggested that changes in consumption patterns can be understood without reference to changes in preferences. To them, behavior changes reflect changes in the technology of consumption, changes in relative prices, or accumulation of the human capital employed in consumption (Stigler and Becker 1977). This argument has posed a challenge to social scientists that have been perhaps too facile in attributing changes in behavior to changes in preferences (or culture or other phenomena that we will term for convenience "preferences"). In contrast, other economists have argued that markets and diverse social, cultural, political and educational institutions affect preferences (see the surveys by Bowles 1998, and Fehr and Hoff 2011; see also Bisin and Verdier 2010, Ben-Ner 1987).

At the level of organizations, it has been argued that exposure to particular types of incentives, monitoring and certain behaviors by co-workers shapes individual workers' preferences. For ex-

ample, it has been argued that prolonged exposure to individual financial incentives tends to displace intrinsic motivation (Deci, Koestner and Ryan 1999), and more generally such incentives may crowd out process-regarding preferences (Deckop, Mangel, and Cirka 1999; Osterloh and Frey 2000; Bowles and Hwang 2008). Frey (1993 and 1997) argues that monitoring and other activities that reduce the autonomy and self-control of individuals make them less trusting and less virtuous. As we discuss below, economic models of crowding out and other work on cognitive dissonance argue for mechanisms where the incentives signal something about the incentive provider, the environment or the incentivized agent (see Bowles and Polania 2011, for a thorough review and clear account). As such, the phenomena can occur instantaneously. However, much of the evidence suggests a more gradual process.

Another strand of economic theory—following much emphasis on emotions in psychology—emphasizes the role of emotional responses. Levine (1998) models altruism and spitefulness that vary for a fixed preference function with the individual's belief about the altruism of each partner. This provides a way to explain reciprocal behaviors without need for the more complex approach pioneered by Rabin (1993), where beliefs about opponent's beliefs enter the utility function (see also Dufwenberg and Kirchsteiger 2004). Rotemberg (2008), fits the evidence more carefully with a nonlinear variant on this idea: people feel angry when others break their standards on minimal appropriate levels of altruism. Again, this explanation assumes an instantaneous response to unkind behavior (once perceived). The same goes for models of conditional cooperators which we discuss below (see also Cervellati et al. on the idea of endogenous sentiments.)

A number of papers make the point that preferences can change. For recent surveys, see Fehr and Hoff (2011), Bowles and Polania (2011) and Bowles (1998). Change is particularly visible during childhood (influential economics studies that examine parental and educational impacts include Bowles and Gintis (1976) and Bisin and Verdier (2010)). For our study, we need to focus on changes that occur during an individual's adult life. The excellent survey of endogenous preferences by Bowles (1998) is focused on



the impact of markets and legal institutions on preferences, but also discusses some studies on the consequences of hierarchy. He distinguishes five broad channels through which institutions can affect preferences: framing and construal, reward, evolution of norms, task experience and cultural transmission (such as inculcation of norms).

Breer and Locke (1965) experimentally varied the type of task that people engaged in. They observed change, within a four hour experiment, in people's attitudes to organizing a group and even more abstract values. Their focus was on individual versus group work, but similar effects have been observed for other types of task (e. g., Goodman and Theodore 1973 look at attitudes to delayed rewards in a controlled field setting). The claim is that experience with specific types of tasks in specific contexts can have durable effects on behavior by influencing people's beliefs, preferences and modes of construal (that is, how they frame their decision problems in ambiguous or complex environments).

To say that an impact is durable is essentially to say that it applies in contexts different to those that created the impact, or "taught the lesson" (if cognitive mediation is sufficient to make this language reasonable). In other words, the lesson learnt is "generalized" to a broader set of contexts. Durable effects are especially important because they are much harder to undo (this is relevant if the effects are negative and the firm later realizes its error), because they can impact on behavior when individuals quit and move to future organizations and because they can impact on other spheres of activity, such as the domestic, social and political lives of the individuals affected.

Evidence on these effects is naturally somewhat limited because it is difficult to use controlled studies; learning processes typically take a long time and to verify that their effects are truly durable requires a further long period of observation. Nonetheless, existing studies (albeit imperfect) offer some support. Bowles points to ethnographic support such as Edgerton's evidence that living as a herder rather than a farmer seems to generate quite general values for independence. He suggests that strategies learnt to be successful in one sphere of life are generalized to other realms of

life. Henrich et al. (2005) find correlation between the physical environment, institutions and preferences.

Some have even tried to test for such generalization phenomena within the laboratory. For instance, Frohlich and Oppenheimer (1995), motivated by the metaphor of a moral muscle, study the impact of experience with a revised public goods game in which free-riding incentives are removed. They find that players do less well in a subsequent standard public goods game. They argue that experience in the revised game leads players to learn that self-interest is an appropriate approach to the group problem. Applying this lesson to the standard game, leads them to suffer from higher than standard levels of free-riding, or as the authors put it, the incentive-compatible institution undermines “ethical reasoning and behavior”.

For our interest in organizations, Kohn and coauthors’ studies of hierarchy are particularly relevant. Kohn et al. (1990) finds that (self-reported) occupational self-direction is associated with specific personality traits and suggests a causal effect of the organization on personality using regression analysis in longitudinal data. In particular, lack of self-direction in the workplace tends to raise conformity, which carries to other sphere of life, beyond the workplace. Similarly, Karasek (1978) uses panel data from Swedish firms to show how exogenous rises in job passivity lead to greater passivity in political and leisure practices. Again we refer to Bowles (1998) for a valuable summary.

Evidence about changes in factors underlying preferences supports the general claim that durable change in preferences is possible. One study finds that personality changes over the life cycle (Srivastave et al. 2003). Recent studies suggest that “talk therapy” has not only effect on behavioral changes but has also measurable physical impact on the brain, from blood flow changes (Furmark et al. 2002) to changes in the function of the brain (Frewen et al. 2008). That changes originating in physical impact on and in the brain can change preferences is known (e. g., Miller et al. 2001) but that interaction with other individuals has similar effects, while widely believed, was not shown before. Whether these changes are durable is still not entirely proven but important steps have been taken towards finding support.

## 12.3. Theoretical framework for analyzing change in preferences

### 12.3.1. Preferences and adverse inequity aversion

We conceptualize an individual's preference function *on the domain of the individual's attitudes in relation to others*, specifically how to treat them. This preference function features three parameters which we refer to as self-interest (vs. other-regarding, depending on the identity of specific others), trusting and trustworthiness. The respective weights of these preference parameters vary across (types of) individuals.<sup>5</sup> We assume that individuals are identical in all respects other than these parameters.

To give a sense of what these preference parameters mean more concretely, consider two examples of types of individuals. An individual with no weight attached to trusting and trustworthiness is “just-selfish”. Other types of individuals who are also other-regarding to a limited degree, as well as somewhat trusting and largely trustworthy may be variously termed “common employees,” “decent” or “cooperative” employees. We will refer to this type of employee as “cooperative”.<sup>6</sup>

We assume that all individuals are *averse to adverse inequality*.<sup>7</sup> In our case, inequality concerns differences in the reward-input ratio. There is a lot of evidence that almost all individuals are averse to adverse inequality defined by having a lower payoff than relevant others (see e. g., Bolton and Ockenfels 2000), also termed “behindness aversion” (see Fehr and Schmidt 1999, who provided evidence that some people are also averse to being ahead of others) or “inferiority averse” (Ellingsen and Johannesson 2004).

<sup>5</sup> This is obviously not a complete characterization of an individual's values or social preferences, but they capture three central features of an individual's preferences and there is notable correlation with other features.

<sup>6</sup> A concrete example of a cooperative individual would be someone who would keep around 70–80% of an endowment in a standard anonymous dictator game where the recipient is a coworker, would send about 40–60% of the endowment in a standard symmetric-endowment trust game (with a tripling of investment), and would return to the sender in a trust game at least as much as it is required to leave the sender with a small surplus over the initial endowment.

<sup>7</sup> It is not necessary for the just-selfish to be averse to adverse inequity. We assume that only in order to treat this aspect symmetrically for the two types; strictly speaking, only the cooperative type need be inequity averse for our analysis.

By introducing effort considerations and decency into the social comparison, we move in the direction of equity theory in psychology (Adams 1965) but we retain the concreteness of the economic approach by formulating a concrete, measurable definition.<sup>8</sup>

Since part of the suffering of cooperative types is simply behindness aversion, it is necessary to characterize who are the “relevant others” against whom the individual compares his outcomes. One possibility is to weight equally all coworkers. Another two are to compare with the modal type of worker’s outcomes or the average outcome. In all cases, reducing the number of cooperative types at least weakly increases the degree of behindness and with it the pain of inequity. Changes in the distribution of worker types in the organization have less impact on the adverse inequity measure if it simply asks how the organization treats a hypothetical/given cooperative worker relative to how it treats a hypothetical/given just-selfish worker.

An important contrast with economic models of inequality aversion is that we consider *the pain from inequity to act as an input* into a process of preference change. There may be immediate action consequences as in the standard model: the cooperativeness of cooperative types would be attenuated or disappear at once. However, our motivating evidence suggests a gradual process. As noted above, if it takes time for cooperative types to realize that they are being unfairly rewarded compared to others or that most others are acting selfishly, cooperative types might take time to stop cooperating. However, such delays for this type of learning are implausible. The testimonials reflect that many cooperative types become frustrated and feel aggrieved soon after joining their firms (implying that they realized the inequity of the organization quite quickly), yet continue to exhibit notable degrees of cooperativeness or decency for a long time. In addition, in a standard story with learning about the environment and adapting behavior to it, the cooperative types would get notable payoff increases when they cease to behave cooperatively which would

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<sup>8</sup> Notice that we implicitly attribute any difference in ratios to decency or the tendency to cooperate. This is because we assume that all individuals have the same abilities. If ability is heterogeneous, we would consider an “effective effort” variable that factors in for the greater productivity of effort from more able workers.

occur when they learn. However, in many cases, the discomfort or bad feelings suffered by cooperative types are actually larger when the individual starts to behave uncooperatively. This is consistent with our preference change story in which the behavioral change creates a sharp dissonance with cooperative values, that become less painful gradually as the result of dissonance reduction (associated with a change in workplace attitudes, that is a change in preference).

### **12.3.2. Perceived inequity triggers anger**

An individual who is averse to adverse inequity will react negatively to situations in which her ratio of inputs-to-rewards is inferior to that of others with whom she interacts and who are similar to her. The source of the inequity may be a systematic bias against the individual, a random shock (that on the long-run may not be biased), or the individual's own actions. We are focusing on the latter possibility that is linked directly with our concerns in this paper: inequity arising from a combination of individual preferences and a certain organization design. The combination of preferences consists of cooperative and just-selfish types, and the organization design consists of allocating some discretion to employees and rewarding individual performance, which is observable, rather than behavior, which is not consistently and reliably observable by supervisors.

In a pure utility maximization framework, individuals make constrained choices so they can't get everything they want. Individuals may well accept (perhaps even universally) the notion that they *have to* choose among different goods and the quantities they consume, and the consequence of such constrained choices may be (mild) frustration that diminishes with growing emotional and intellectual maturity. So whereas a young child may throw a tantrum if he's not able to have both toys that were presented to him, a more mature person will readily accept the necessity of choice.

Such acceptance is less likely to emerge when adverse inequity aversion is concerned because he finds the situation unfair. In particular, "cooperative" may feel that he has helped others, worked harder than others, and his financial rewards are smaller in comparison to others who exercised no greater effort. The

neoclassical just-selfish utility maximization framework makes no prediction of any effect, so we turn to psychological mechanisms. Whatever the source of the inequity, it triggers anger and other negative emotions for many, probably most, people (see Tyler 2005, on justice in psychology, and Rotemberg 2008, for experimental economics papers where unfair play triggers anger). In sum, an individual feels anger if his effort, all other things equal, yields a lower reward than the *identical* effort of *another* person in the same environment. The anger increases in the proportion of people in a group who have a better reward to their effort than the individual in question.

### **12.3.3. Individuals seek to correct adverse inequities**

Informally, an individual chooses how to allocate his/her inputs, such as effort expenditures used in production. This discrete decision problem is repeated indefinitely and its outcome—how much input to expend, and in what fashion—depends on the rewards and the actions of other persons that affect the utility from self/other-regarding, trusting and trustworthiness preferences, as well as inequity aversion. Inputs can be directed over time at satisfying different preferences.

Individuals with different preferences choose different levels of inputs. For example, in an interaction between “just-selfish” and “cooperative” they will choose different levels of effort and will allocate them differently, so that “just-selfish” will direct all her inputs to production that rewards her solely, whereas “cooperative” will use some of her inputs to benefit “just-selfish.” Under a common allocation of rewards, “just-selfish” will get greater rewards than “cooperative,” entirely as a function of their individual choices driven by their preferences and without any preferential treatment by the organization of “just-selfish” over “cooperative.”

In the rest of this section we investigate mechanisms that can cause a change in the degree of their self-interest vs. other-regarding, trusting or trustworthiness as a consequence of interactions between individuals. In the next section we will examine this issue in greater concreteness, focusing on interactions between a “just-selfish” employee and a “cooperative” employee who work together in an organization.

We distinguished two aspects of preferences. One concerns preferences for how to treat others. The cooperative type's preferences include a limited degree of altruism and some value for obeying social norms that define appropriate organizational behavior. The second aspect is not a relevant feature of the preference ranking in the static case (given that we rule out the options of exit and voice/influence). This might simply represent a negative utility shock associated with adverse inequity, but crucially we view it as an input into preference change.

The negative utility shock plays a role in the various preference change mechanisms. In the reinforcement learning mechanism, the emotional pain acts as the (negative) reinforcer. In the dissonance reduction mechanism, this is the dissonance that motivates change (whether, as noted above, reflective consideration of the applicability of cooperative values to the workplace or a subconscious process involving attitude suppression). In the conformity mechanism, the negative emotions generated by adverse inequity encourage the individual to consider change and to look for ways to fit in better.<sup>9</sup>

We emphasize the emotional nature of the responses of cooperative types because they feature prominently in the testimonials and we have seen, emotional feedback plays a significant role in the preference change mechanisms. One plausible reason is that emotions generate very fast reinforcements and are therefore particularly effective in eliciting change (Glomb and Hulin 1997). On the relevance of emotions in cognitive dissonance we refer the reader to Festinger, Riecken and Shachter (1956).<sup>10</sup>

The conflict between an individual's behavior (emulating the behavior of persons with different preferences) and the behavior dictated by his preferences is not the same as the conflict between wanting to have more of two consumption goods with a given budget. This is an instance of cognitive dissonance rather than one of making adjustments in the allocation of resources to dif-

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<sup>9</sup> Strictly speaking, conformity could lead to preference change without this second aspect of preferences, but evidence suggests that emotional dissatisfaction is a strong catalyst in conformity/assimilation processes.

<sup>10</sup> The mechanism of habit creation and the related notion of a moral muscle can enhance the durability of any changes from the above mechanisms.

ferent uses within a given common constraint. The desire to act in ways that are incompatible creates an incentive to make some adjustments in one's beliefs, to adapt one set of preferences to make it compatible with the other (Elster 1983).

This cognitive dissonance-conflict may be resolved in two principal stages. First, the person could try to repress the anger by paying no attention to social comparisons but this is usually too difficult.<sup>11</sup> People have strong self-protection motives and as the literature (cited above in the context of adverse inequity aversion) suggests, being mistreated is not something people take lightly. Even if a person resolves to "turn the other cheek", this is not a sustainable option for most people.<sup>12</sup>

Second, the person could change ideologies, worldview, his understanding of how one should act in the world—or in the context that we are discussing here—how to treat others with whom he interacts.

In sum, we expect differences in reactions that vary with individual differences in secondary psychological mechanisms: (a) dysfunctional behavior, (b) leaving the organization and (c) adjusting preferences. The pace of change of preferences and the durability of the change depends on the frequency and stability of interactions. We conjecture that sustained interactions over the long run in a stable environment are likely to lead to change in preferences that will be faster and more stable (harder to change or reverse) than casual; short-lived interactions that take place across diverse environments.

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<sup>11</sup> Anger may be manifested in sabotage of others, or as Fehr and Schmidt (1999) put it, inequity aversion manifests itself in the "willingness to sacrifice potential gain to block another individual from receiving a superior reward."

<sup>12</sup> Those who have suffered from prolonged experiences of powerlessness may become accustomed to being the object of unfairness but without heavy indoctrination, they generally do what they can to evade the unfairness. Perhaps after steeling themselves to stand by their commitments, they succeed in maintaining their decency norms, but typically resentment will still be felt. They may become depressed and socially withdrawn; such experiences can have long-standing effects even if the person continues to do cooperative actions while on the job. Notably, a person following this strategy who does not have a "Buddhist" ability to avoid judging others and feeling angered by unfairness against the self, is apt to become withdrawn and depressed. Typically, they will lose their motivation or ability to do a good job. Even though they decide to stay, they are likely to be fired because depression makes them too unproductive to compensate for any organizational gains from their decency.



## 12.4. How organization design may affect preferences—an illustration

We develop here a simple and transparent example that helps establish the mechanisms of changes in preferences discussed above in the context of an organization and that of a specific organization design. The example echoes the employer testimonials presented in the Introduction. Our theoretical framework attempts to capture the basic substance of the realities captured in these testimonials. The dynamic story of our framework fits well with what seems to be a prevalent case in actual workplaces.

Consider a *new* organization of  $N$  employees; most of them are just-selfish, are not trusting at all and are/not trustworthy and a few, cooperative. Think of  $N$  as a small number, say 10, of whom 8 are “just-selfish” and 2 “cooperative,” so that they all have to interact in the course of their daily work. The organization produces a good, say software programming. Each employee has a specific task and component to produce but because the tasks are complex and the components ultimately have to be assembled into a final common piece of software, the employees can benefit from each other’s advice, experience and comments.

The organization is designed optimally for just-selfish employees: individual decision-making regarding one’s own tasks, informal non-binding consultation among the  $N$ , individual incentives based on quantity of output, subject to certain quality standards and supplemented by supervisor evaluation and monitoring by the supervisor.

The individual chooses the level of effort in response to organization design as well as the actual and promised level of effort of coworkers, and his own promised level of effort. We compare the rewards of two types of employees, just-selfish and cooperative, and show that the better effort-rewards ratio that just-selfish enjoy arouses anger in cooperative employees. The cognitive dissonance between wanting better rewards and holding cooperative preferences is resolved by gradually altering preferences, hence cooperative employees slowly but surely become just-selfish.

In the beginning, the two cooperative employees offer a few ideas to the just-selfish majority who do not reciprocate, as the

culture of the organization is dominated by them. But the cooperative are happy to give suggestions, promise and deliver help, and expect—but do not get much—from others. This, in and of itself, does not cause problems to cooperative workers who even feel themselves as particularly useful; the problem-solvers of the organization.

At the end of the annual evaluation the just-selfish receive raises based on individual productivity. The cooperative receive lower raises because their productivity has been comparatively lower, although they do receive praise from the supervisor for being helpful to others or general good citizens.

Just-selfish employees are happy with the outcome, and being adverse-inequity averse, they have no reaction to the inputs/rewards ratio comparison between them and cooperative because it favors them. The opposite is true of cooperative employees who put in at least as much effort in the organization—most of it into their own work but some of it into assisting others—but received lower rewards. The “cooperative” are unhappy and are grumbling among themselves.

After a while, perhaps a few years, the cooperative continue to grumble and are looking for improvements. They talk to each other, to coworkers and to management, but to make a long story short, the only support they get is from each other. The cooperative employees start their internal struggle for the optimal reaction that suits them: (a) dysfunctional behavior, (b) dropping out and (c) adjusting preferences. For a while, one cooperative employee tried to give bad advice and it worked but eventually his just-selfish coworkers caught up with that and stopped listening to him and he became an embittered person. This cooperative employee, who withdrew his decency and began undermining others, ultimately left the organization, with encouragement from the supervisor. The other cooperative employee started telling himself that helping others is not a good idea because the just-selfish don't deserve the help anyway (sour grapes), and concentrating on his own work will do better for his rewards, and so on and so forth. After a while, and after the other cooperative left the organization, he joined in after-hours outings with his coworkers and was accepted as one, and became one of them. The cooperative em-

ployee who remained in the organization understood emotionally and perhaps intellectually that the simplest course is to adapt and adopt a philosophy that fits with his environment and he became just-selfish. The organization lost the benefits from the voluntary cooperation associated with the cooperative workers.

## 12.5. Conclusions and policy recommendations

In this paper, we have focused on the problem of myopic design leading to negative preference changes. Now we ask how far-sighted organization design might improve matters. To contrast with Hume, our suggestion is not to design a constitution for knaves but rather to design a constitution that prevents the knaves from abusing the cooperators.

At one extreme, removing all individual discretion from workers would prevent abuse of cooperators, but also prevent cooperators from using their discretion to help improve the firm. In addition, cooperators do not like to be controlled. The firm's bosses cannot give discretion just to cooperators because they cannot fully distinguish the two. Nonetheless, by spending more on monitoring against abuse, the bosses may reduce cheating and abuse of cooperators without restricting too far the discretion of those who are cooperative.

An alternative approach is for firms to support mutual monitoring. Team incentives may endogenously empower the good team players. Cooperators are likely to feel legitimated to act on behalf of their peers, unlike in the individualist incentive design where interfering with others is often looked down upon. By directing their sanctions against the abusers only, cooperators may be able to resolve adverse inequities without hurting the firm or, otherwise, breaking some sense of duty or some values.

In addition, team incentives imply lower-powered incentives, so just-selfish can gain by saving on effort costs but at least their monetary reward is not higher. This may lower the perceived level of inequity. Also, cooperators may care more about social status—they value recognition by the firm unlike a pure just-selfish. After all, the just-selfish types know that any plaudits they win are largely undeserved. So firms can give non-financial recognition. In this

case, the cooperators are more likely to be applauded because while monitoring may still be far from perfect, the just-selfish types would have much lower incentives to lie to gain non-financial recognition (Kosfeld and Neckermann 2011).

In practice, there are shades of selfishness and decency. Another risk of high powered incentives that encourage manipulative strategies is that the higher the powering, the greater the temptation of moderate cooperative types to start being selfish. Since our mechanism is predicated on social comparison, sufficient temptation that turns some/many temptations into non-cooperative players, the impact on the social norm in the workplace is particularly damaging.

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*with Terrorism–Stick or Carrot?* (2004), *Economics and Psychology. A Promising New Cross-Disciplinary Field* (co-edited with Alois Stutzer, 2007), *Happiness: A Revolution in Economics* (2008) and *Glück: Die Sicht der Ökonomie* (with Claudia Frey Marti, 2010).

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Most prior discussions regarding the “theory of the firm” have emphasized economic rationales. This book authored by Ricart and Rosanas and others offers a perspective for a new and important “theory of the firm”. Their perspective suggests the need for a more humanistic approach to understanding how firms should and do operate. Organizations are composed of people and all things are done by and through people. Thus, human capital in the firm and how this capital is managed largely determine firm success. As such, their call for a more humanistic view of management and for explaining firm behavior provides a more balanced and realistic view of how firms should be managed. This book should be on the “must read” list for all students of business and management.

**Michael A. Hitt**

Distinguished Professor Chair in Business Leadership  
Texas A&M University (U.S.)

What is a firm, what is its social function and how well that function is performed are key questions in the quest for a restoration of the social contract between business and society. This book contains a set of contributions in which leading business scholars answer these and other questions in an insightful and forward-looking prescriptive way. Although authors differ in their diagnosis and remedies for the current mistrust of capitalism and the capitalist firm, its most distinctive institution, there is a general consensus that economics has had too much influence on the theory, education and practice of management and that, in future, the other social sciences, including humanities, should be more prominent in the management field. In short, an illuminating book for times of darkness.

**Vicente Salas Fumás**

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