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INSTRUMENTAL STAKEHOLDER THEORY: A SYNTHESIS OF ETHICS AND ECONOMICS

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This article is intended to enhance the position of stakeholder theory as an integrating theme for the business and society field. It offers an instrumental theory of stakeholder management based on a synthesis of the stakeholder concept, economic theory, behavioral science, and ethics. The core theory—that a subset of ethical principles (trust, trustworthiness, and cooperativeness) can result in significant competitive advantage—is supplemented by nine research propositions along with some research and policy implications.

Even before Preston (1975) issued an intellectual call-to-arms, scholars in the field of inquiry called *business and society* sought a paradigm or an integrating framework for topics thought to be central to the discipline. Various models—*corporate social performance, social control of business,* and *stakeholder*—have been advanced as part of this search. This article attempts to advance the case for using the stakeholder model as an integrating theme for the field by proposing a formal *instrumental theory* of stakeholder management. The theory represents a synthesis of the stakeholder concept, economic theory, insights from behavioral science, and ethics. The argument begins with a brief history of the search for a paradigm in the business and society field followed by a discussion of the stakeholder model as theory. Assumptions that underlie the theory are then offered along with discussions of the nature of contracting, efficient contracting, and the role of ethics in efficient contracting. An argument is presented for corporate morality as an analog to individual morality. At this point, the instrumental stakeholder theory is formally presented, followed by several research propositions. Implications and extensions of the theory and a brief conclusion complete the article.

THE QUEST FOR A BUSINESS AND SOCIETY PARADIGM

Although the business and society field has had at least a nominal presence at numerous business schools for over two decades and has experienced considerable growth since then in terms of faculty membership in academic organizations and numbers of outlets for scholarly ar-

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ticles, it has been plagued by the lack of a widely accepted paradigm or integrating framework. Preston (1975) crystallized the views of many scholars in the field when he challenged them to develop such a paradigm. Carroll (1979) provided an initial impetus for these efforts by proposing that *corporate social performance* could serve as an integrating theme for the field. Jones (1982) offered a *social control of business* framework as an (implicit) alternative to Carroll's proposal. Jones's model appeared to be a mirror image of Carroll's model because it was focused on the firm from a vantage point that was largely external to the firm, whereas the corporate social performance model was focused directly on the firm. It seems that Carroll's view has been more widely accepted because other scholars subsequently have developed and refined his central ideas in the management literature. Major works by Wartick and Cochran (1985) and Wood (1991a, 1991b) exemplify this development. Tellingly, Wood's (1991a) recent exposition of the corporate social performance theme is thought by business and society scholars to be more likely (by a wide margin) than other recent works to influence scholarship in the field in the coming years (Carroll, 1994).

The corporate social performance model may have to share the intellectual limelight, however. The *stakeholder* model, introduced by Freeman (1984), has spawned several attempts to integrate the field, including works by Jones, Hill, and Kelley (1989), Brenner and Cochran (1991), and Hill and Jones (1992), each of which purports to be "a stakeholder theory of the firm." Work by Clarkson, Deck, and Shiner (1992) and Preston and Sapienza (1990) also has addressed the stakeholder concept, albeit from an empirical perspective. Development of the stakeholder model was also the central theme of two "miniconferences" held in Toronto in 1993 and 1994.

A problem common to all three models advanced thus far, however, is that they offer no testable theory. The *social control of business* model (Jones, 1982) consists only of a framework that ties together major themes in the field. The *corporate social performance* model, although rich in detail and thorough in coverage in its current version (Wood, 1991a), offers no formal theory. Similarly, the *stakeholder* model leaves theory largely implicit. This article is intended to further develop the stakeholder model by offering an instrumental theory of stakeholder management. In the process, additional insights also may be drawn for the corporate social performance model.

THE STAKEHOLDER MODEL AS THEORY

Pioneering work in the area of stakeholder management was provided by Freeman (1984), who outlined and developed the basic features of the concept in a book entitled *Strategic Management: A Stakeholder Approach*. Freeman's work, even though it formally recognizes the importance of corporate constituents in addition to shareholders, leaves the status of the stakeholder concept *as theory* unclear. Donaldson and Preston (1995) argued that stakeholder theory explicitly or implicitly contains theory of three different types—descriptive/empirical, instrumental, and normative. *Descriptive/empirical* formulations of the theory are intended to describe and/or explain how firms or their managers actually behave. *Instrumental* theory purports to describe what will happen if managers or firms behave in certain ways. *Normative* theory is concerned with the moral propriety of the behavior of firms and/or their managers. Briefly summarized, descriptive/empirical, instrumental, and normative theories address the questions: what happens? what happens *if*? and what should happen?, respectively.

Donaldson and Preston pointed out that Freeman, individually and with various colleagues (Evan & Freeman, 1993; Freeman & Gilbert, 1987; Freeman & Reed, 1983), has incorporated all three types of theory into the stakeholder concept. Proponents of stakeholder theory strive to describe what managers actually do with respect to stakeholder relationships, what would happen if managers adhered to stakeholder management principles, and what managers should do vis-à-vis dealing with firm stakeholders. Donaldson and Preston (1995) concluded that normative concerns underpin stakeholder theory in all of its forms. Although quality scholarship on the normative facets of stakeholder theory is indeed needed, instrumental and descriptive/empirical aspects need attention as well. Thus, this article focuses on the instrumental realm.

It should be noted that the term *instrumental theory* is used here in a manner that differs from its historical usage. Traditionally, in the philosophy of science literature, instrumental theories were deemed useful for explaining certain phenomena *regardless of their truth or falsehood* (Angeles, 1992). In short, they worked, albeit (perhaps) for the wrong reasons. The theories themselves were used as instruments to achieve some ends. The usage of instrumental theory employed in this article follows that used by Donaldson and Preston (1995), which appears to be original. For these authors, instrumental theory establishes (theoretical) connections between certain practices and certain end states. There is no assumption that the practices will be followed or that the end states are desirable. In instrumental theory, statements are hypothetical—*if* X, *then* Y or *if* you want Y, *then* do X. In this sense, X is an instrument for achieving Y. The truth or falsehood of instrumental theories of this latter type *is* an important issue.

ASSUMPTIONS: STAKEHOLDERS AND ECONOMIC THEORY

Before any theory of stakeholder management can be advanced in a convincing manner, certain assumptions must be made regarding the economic and social conditions that provide context for the model. Assumptions appropriate for the purpose of this article have been drawn mainly from economic theory and the stakeholder concept. Collectively, they give a picture of the firm and its relationship to its environment.

> *The firm* is characterized by relationships with many groups and individuals ("stakeholders"), each with (a) the power to affect the firm's performance and/or (b) a stake in the firm's performance (Freeman, 1984). In many cases, both conditions apply. Stakeholders include, but are not limited to, shareholders.
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> *The contract* is an appropriate metaphor for the relationships between the firm and its stakeholders (Eisenhardt, 1989). Ample precedent exists for a broad definition of "contract" (Dunfee, 1991; Jensen & Meckling, 1976; Ross, 1973; Williamson, 1984, 1985). Contracts can take the form of exchanges, transactions, or the delegation of decision-making authority, as well as formal legal documents.
>
> The *firm* can thus be seen as a *"nexus of contracts"* (Jensen & Meckling, 1976) between itself and its stakeholders.
>
> Top corporate managers, because they (a) contract with all other stakeholders either directly or indirectly through their agents and (b) have "strategic position" (Herman, 1981) regarding key decisions of the firm, can be considered the *contracting agents* for the firm. The firm is thus recast as a nexus of contracts between its top managers and its stakeholders.

This last assumption is somewhat controversial. At one level, controversy still exists as to who "controls" the large corporation (Berle & Means, 1932; Domhoff, 1967; Jones, 1979; Larner, 1970; Zeitlin, 1974). Herman's (1981) concept of "strategic position" renders the argument largely moot for the purposes of this article, however. He argues that managers make the vast majority of important decisions on behalf of the firm, even though shareholders may be able to wrest control from them under extreme circumstances by gaining control of the board of directors. (Top management and the board of directors are distinct entities, although their memberships often overlap, sometimes extensively.) In terms of shareholders being able to *influence* managerial decisions, the point is readily conceded. Indeed, the definition of "stakeholder" (above) explicitly recognizes the influence of individuals and groups on firm (managerial) decision making.

A second controversy arises regarding the firm's managers as contracting agents for the firm instead of as a class of stakeholders. Williamson (1984) explored this dilemma in a discussion of representation on the board of directors, but he did not resolve it. Although he said that "our understanding of the contract between firm and manager is complicated by the fact that managers apparently write their own contracts with one hand and sign them with the other. Also, management is often encouraged, for good reason, to think of itself and the firm as one" (1984: 1216). Williamson subsequently discussed contracting between the "firm and its managers" as if they were separate entities.

In this article, top managers and the firm will be considered as a single entity. Although top managers are technically stakeholders, their primary role is one of contracting on behalf of the firm (directly or indirectly) with other stakeholders as well as with themselves. Top managers are at the center of a "hub and spoke" stakeholder model of the firm because they contract with all other stakeholders. Relationships between or among nonmanagement stakeholder groups surely exist as well; in some cases, memberships in these groups may overlap. However, in this article, the focus is on the bilateral relationships between managers and stakeholders. Further, the term *stakeholder* applies not only to groups easily characterized by words such as *customers* or *employees* but also to subgroups of customers (e.g., buyers of over-the-counter medicine and buyers of shampoo) and employees (e.g., shopworkers and middle managers) who may have distinct (and competing) interests. Terms like *customers* and *employees* are used here for heuristic purposes only.

> *Markets* are characterized by a *tendency toward equilibrium*, as postulated by the Austrian school (Jacobson, 1992; Kirzner, 1979), not equilibrium, as assumed in neoclassical microeconomics.

This market assumption is critical. Equilibrium in markets would imply that inefficient contracting mechanisms and power differentials between the contracting parties could not exist. Efficient markets would drive out inefficient contracts, leaving only those in which neither party had significant discretion. If, instead, markets *tend toward* equilibrium, the pressure to contract efficiently will be less intense. Where market discipline is less sure and less swift, a rough sorting out of efficient and inefficient contracts will occur, but only over longer time periods. There will be a *tendency toward* efficient contracting, but inefficient contracts may endure over significant periods of time. Similarly, power differentials between contracting parties certainly exist, perhaps for several years.

No behavioral assumption is made. Because the theory that is advanced in this article is instrumental, the descriptive outcomes predicted by the theory are *contingent* on certain behaviors. According to the theory, *if* certain types of behavior occur, certain (favorable) outcomes become more probable; it does not assume that the desirable behaviors *will* occur.

Collectively these assumptions describe the relationship between the modern corporation and its environment.

1. Firms have relationships, called contracts, with many stakeholders.
2. Firms are run by professional managers.
3. Firms exist in markets in which competitive pressures do influence behavior but do not necessarily penalize moderately inefficient behavior.

Despite the fact that some firms have few stakeholders, some firms are run by their stockholders, and some markets are highly competitive and swiftly and surely punish inefficient behavior, these assumptions are an adequate general description of the modern corporate economy. Taken together, they create the context for development of an instrumental stakeholder theory of firm behavior.

THE NATURE OF CONTRACTING

As discussed previously, the relationships between corporate stakeholders and the firm's top managers can be described using the contract as a metaphor. These contracts vary greatly in terms of degree of formality and extent of specificity. Some contracts, say between a firm and its neighboring community, are relatively vague and informal; certainly, no documents exist to describe these contracts. Contracts of this type have been called *relational contracts* by Macneil (1978) and Williamson (1985). At the other end of the spectrum are formal and specific contracts; the contract between a firm and its bondholders is an example. Contracting between the firm and its stakeholders also can vary in the frequency and regularity of the transactions or exchanges. At one extreme are continuous and ongoing relationships like those between managers and employees. The other extreme could be represented by an isolated parts order to a vendor that the firm normally does not deal with. Contracts that represent repeated or ongoing transactions are constantly being reaffirmed or reinterpreted. For such contracts that are also formal, the terms *honored* or *broken* can be substituted for *reaffirmed* and *reinterpreted,* respectively.

The nature of the contracts I have outlined has been described by economists using three basic theoretical frameworks—agency theory (Jensen & Meckling, 1976; Ross, 1973), transaction cost economics (Coase, 1937; Williamson, 1975), and team production (Alchian & Demsetz, 1972). Each theory applies to certain types of contracts, but all have common threads.

Agency theory applies to relationships in which "one party (the principal) delegates work to another (the agent), who performs that work" (Eisenhardt, 1989: 58). In Mitnick's (1982) abbreviated terminology, the agent "acts for" the principal. Two problems exist in agency relationships. First, the agent and the principal have conflicting goals, and it is difficult and/or expensive for the principal to verify the agent's activities. Second, the principal and the agent have different propensities to accept risk. The central question of agency theory becomes: What type of contracts best suit agency relationships of various types (Eisenhardt, 1989)? Some contracts focus on the agent's *behavior,* and others focus on *outcomes* of interest to the principal. Contracts are thought to be efficient if they minimize the sum of the following agency costs:

1. *Monitoring costs* borne by the principal to reduce agent actions that would harm the interests of the principal
2. *Bonding costs* borne by the agent to guarantee that the agent will not take actions to harm the interests of the principal

3. *A residual loss* incurred because monitoring and bonding may not fully align agent behavior and principal interests (Jensen & Meckling, 1976).

Several mechanisms exist to either monitor or bond the behavior of agents. I will discuss some of these mechanisms in a later section.

There exist two general types of reasons for agent failure to adequately pursue the interests of the principal. *Moral hazard* exists due to a lack of effort (shirking) on the part of the agent. Stated differently, the principal cannot adequately verify the agent's effort. *Adverse selection* exists when the agent misrepresents his or her ability or, more generally, does not behave in the manner preferred by the principal (Eisenhardt, 1989). Agency costs are incurred in order to reduce or eliminate the effects of moral hazard and adverse selection.

Proponents of *transaction cost economics* share many of the assumptions of agency theory but focus on the *boundaries* between contracting parties rather than the contracts per se. Transaction costs stem from the need to negotiate, monitor, and enforce the implicit and explicit contracts required to bring resources together and utilize them efficiently. Williamson (1975) used transaction costs as the focal variable in the determination of the choice between contracting externally (markets) or internally (hierarchies). The choice, in Williamson's theory, is dictated by relative efficiency in transaction costs; that is, cheaper forms will drive out costlier forms. Transaction costs are significant and variable for two reasons. First, the seller of a resource has more information about it than does the buyer and may opportunistically misrepresent its value, either in terms of quality or, in the case of labor resources, its (his/her) propensity to shirk. Transaction costs, borne under these circumstances in order to reduce uncertainty in evaluating these resources, include (a) search costs, (b) negotiating costs, (c) monitoring costs, (d) enforcement costs, and (e) a residual loss.

A second source of transaction costs is the hold-up problem (Williamson, 1985). Hold-up problems impede investments in specialization, which would reduce production costs by increasing productivity. Investments in specialization (a) have increased value to specialized users (relative to less specialized resources) and (b) have reduced value to alternative users. Thus, if producer A invests in a specialized resource (an asset or a skill) of value to consumer B, the resource is of high value to B but of lower value to consumers C, D, E, and F. (The term *consumer* applies to consumer of the resource, which may mean industrial or commercial consumer.) This value differential exposes A to hold-up by B because B knows that A cannot easily sell his or her resources elsewhere. Therefore, producer A may be reluctant or unwilling to make specialized investments for B for fear of B's reneging on pricing agreements. Thus, the hold-up problem results in either (a) reduced investment in specialization or (b) expensive investments in preventing hold-up. The latter category includes the making of credible commitments, "exchanging hostages," and the negotiating, monitoring, and enforcing of contracts—in short, transaction costs (Williamson, 1975, 1985). Williamson (1975) argued that transaction costs often can be reduced through the use of hierarchy (merging consumer and producer), although hierarchies have governance costs that cannot be ignored.

Team production also can be described in terms of contracts and, thus, contracting problems can be illuminated using theories of team production. Team production problems arise in situations in which each individual team member's contribution to team output cannot be measured precisely (Alchian & Demsetz, 1972). The team's output, although clearly a function of each individual member's input, cannot be accurately attributed to each individual in proportion to the individual's input. If rewards to team members are in proportion to *team* output, not *individual* output, which by definition cannot be measured, team members will have an incentive to shirk on the job. That is, individuals can receive rewards disproportionate to their efforts by contributing less than they are capable of contributing. This phenomenon is similar to the well-documented "free rider" problem in economics and to problems of collective action (Olson, 1965). Further, if the problem is reversed by viewing the individual's contribution to collective output as the individual's consumption of collective resources, it bears a striking resemblance to Hardin's (1968) "tragedy of the commons" (Aram, 1989) and might be dubbed the *team consumption* problem. Regardless of which perspective one takes on the team production/consumption problem, one conclusion is clear: someone must bear the costs of the divergence of individual and team goals. These costs may take the form of reduced team production (the logical limit being no production) or costs incurred to monitor the behavior of team members.

The contracting problems described here under the headings of agency theory, transaction cost economics, and team production theory have some common threads. Problems of agents pursuing their own interests at the expense of principals, sellers of resources misrepresenting their value to consumers, consumers of resources "holding-up" their producers, and team members "free riding" all involve manifestations of *opportunism* on the part of one party to a contract. The *opportunist*, defined by Williamson (1975) as one who pursues self-interest "with guile," takes advantage of a situation in which he or she has power, however temporary, over the other contracting party or parties. Costs are incurred either because the opportunist succeeds or because one or more parties to the contract spends resources to reduce opportunism. Further, because costs are involved, markets reward those who are able to contract efficiently by reducing these costs and penalize those who contract inefficiently. It follows that, all else being equal, efficient contracting will result in competitive advantage.

EFFICIENT CONTRACTING

Efficient contracting has been the subject of much theorizing and empirical testing in financial economics for several years and is increasingly becoming a focal point of research in organization theory (Eisenhardt, 1988, 1989). This theory and research, in which opportunism is a behavioral assumption, focuses on such devices as interest-aligning mechanisms, incentive structures, monitoring mechanisms, and governing structures that will reduce opportunism to an "efficient" level for which the costs of further reductions outweigh the benefits. In the agency relationship between shareholders (principals) and managers (agents), for example, it is efficient for shareholders to allow the managers certain on-the-job consumption (e.g., high salaries and perquisites) because it is costly for thousands of dispersed shareholders to monitor and discipline their behavior. The extent of this consumption will be limited by interest-aligning mechanisms such as stock options, monitoring mechanisms such as boards of directors, and incentive structures such as performance bonuses. In addition, external governing structures such as regulation of information disclosure also may be employed. These devices, which are costly, assume opportunistic behavior and attempt to reduce it or link it to desirable ends.

There is another way to reduce opportunistic behavior, however—the voluntary adoption of standards of behavior that limit or eliminate it. Economists and moral philosophers since Adam Smith have observed that competitive market economies operate far better where shared values of honesty and integrity prevail than where they do not. North argued that "the absence of some degree of individual restraint from maximizing behavior would render the political or economic institution nonviable" (1981: 19). In another context, he claimed that "[S]trong moral and ethical codes of a society are the cement of social stability which makes an economic system viable" (North, 1981: 47).

An excellent summary explanation of the relationship between morals and economic efficiency at the microlevel is provided by Noreen (1988). He recalled the "market for lemons" (Akerlof, 1970), wherein the absence of reliable information about individual used cars on the part of potential auto buyers can result in substantial inefficiencies. If defect-free used cars of a certain vintage are worth $5,000 and similar cars with an average number of defects are worth $3,000, and if potential buyers of such cars cannot tell which cars have below average (or above average) defects, two behaviors will result. First, owners of cars in better than average condition will not bring them to market because they will not receive full value for them, if the market price is $3,000. Second, if "good" used cars are not offered for sale, only "average" to "poor" cars will be sold. Soon buyers will discover that the average value of cars offered for sale is lower than $3,000 and the prices will drop, eliminating the potential sale of formerly average cars and dropping the price further. Soon only the worst cars ("lemons") will be offered for sale. If the cost to repair the lemons exceeds $5,000, the market collapses entirely. Note that both sellers and buyers are harmed by this "adverse selection" problem. Potential sellers cannot sell except by accepting less than their cars are worth; (potential) buyers either will pay more than the cars are worth or will not buy a car at all. Many transactions that would benefit both parties, thereby promoting efficiency, will not take place. Solutions to this problem, a thorough inspection by a mechanic, for example, are themselves costly (Noreen, 1988). In short, the absence of reliable information and the presence of opportunism result in the malfunctioning or collapse of markets, to everyone's detriment.

At the macrolevel, opportunism burdens the economy and society-at-large with substantial "dead-weight losses" (Noreen, 1988). Prominent among these costs are economic regulation, social regulation, legal services related to contracting and postcontracting litigation, and whatever social malaise attends a lack of trust in society. The costs of denying monopolists their monopoly profits, cartel members the fruits of their collusion, and of deterring potential price fixers, are considerable. Also significant are the costs of reducing environmental degradation, raising workplace safety standards, reducing discrimination in employment, protecting employee pensions, and safely disposing of toxic wastes. Further, the psychological toll of an opportunistic culture on individuals in society may be significant; lives are made more complicated, and thus more difficult, by opportunism. In addition, the sense of injustice that results from instances in which opportunists "get away with it" can also be corrosive. Thus, the macrolevel effects of opportunism and attempts to curb it are likely to be pervasive and expensive. It follows that reduced opportunism, through the voluntary adoption of such shared values as honesty and integrity, aids the development of smoothly functioning, efficient markets (Noreen, 1988). Contracting and transacting possibilities expand. Monitoring and policing costs decline, although the need for some monitoring will remain in order to control opportunism that persists in the system.

An important question remains, however: Is it possible to enhance the functioning of markets through "enlightened self-interest" as opposed to the voluntary adoption of ethical standards in economic dealings? Game theory, in the form of the prisoner's dilemma (Figure 1), sheds some light on this question.

In any single play of the prisoner's dilemma, both players have incentives to choose D, the noncooperative strategy. If both do so, both will end up with a payoff of -3. However, as Axelrod (1984) has shown, in situations in which the same players engage each other repeatedly, the optimal strategy is "tit for tat." The decision rule for tit for tat is that one cooperates on the first play and then duplicates his or her opponent's previous move on all subsequent plays. If one's opponent cooperates on play number 4, one cooperates on play number 5, and so on. Axelrod's (1984) computer simulation of tournament strategies (designed by prominent game theorists) showed tit for tat to produce higher payoffs than all other strategies. The tit for tat strategy tended to induce a regime of mutual cooperation, often quite quickly. Axelrod's evaluation of the simulation is that a winning (and therefore self-interested) strategy involves initial trust, provocability, and forgiveness (1984).

FIGURE 1
Prisoner's Dilemma Payoff Matrix

		Player A	
		C_A	D_A
Player B	C_B	A = 7 B = 7	A = 10 B = −7
	D_B	A = −7 B = 10	A = −3 B = −3

C = Cooperate
D = Don't Cooperate

Actual human beings, as subjects in behavioral experiments, also settle into a mutually cooperative mode in repeat plays of the prisoner's dilemma game, albeit often only after several instances of noncooperation on the part of one or both players. Eventually, the poor outcomes resulting from noncooperative strategies induce most subjects to cooperate (Pruitt & Kimmel, 1977). Thus, human beings can be induced to make choices that are efficient in the long term, even though short-term self-interest would seem to dictate inefficient solutions.

It should be noted that the phenomenon described above and represented by a prisoner's dilemma game can be applied in all three instances in which opportunism is a problem—principal/agent relationships, transaction cost relationships, and team production relationships. Noreen's (1988) argument that shared values help reduce agency costs, summarized previously, was intended to apply to agency relationships, but it applies equally well to transaction cost economizing and team production. Regarding transaction costs, two implications are apparent. First, such costs can be reduced through mutual cooperation. If the seller accurately represents the value of his or her resource and the buyer trusts the seller to do so, an efficient transaction will take place. No incentive-aligning mechanisms are required and no costs are incurred for searching, negotiating, monitoring, or enforcing. In addition, investments in specialization will be facilitated when a producer ("A" in the above example) cooperatively makes specialized investments in the production of a resource and the consumer of the resource ("B" above) cooperates by not "holding-up" producer A after A has made specialized investments. Mutual cooperation, therefore, reduces transaction costs.

The benefits of mutual cooperation to team production efforts are readily apparent. Teams produce more efficiently when none of their members "shirks" or "free rides." If team members can be induced to cooperate fully in team efforts without any need to monitor their behavior, monitoring costs are saved, and net team output will expand. Other costs of reducing opportunism also can be avoided by cooperative behavior on the part of team members.

Further, the benefits of cooperative strategies, when mutually adopted, obtain whether the prisoner's dilemma-like "game" is played once or many times. Indeed, in actual economic relationships in which opportunism on the part of one party is discovered, future relationships may be seriously jeopardized. For example, a producer who invests in specialized resources and is "held-up" by the consumer of those resources might be unwilling to contract with that consumer again.

ETHICS AND EFFICIENT CONTRACTING

Analogies to prisoner's dilemma games are instructive only up to a point, however. The rules of a prisoner's dilemma fit very few contracting relationships perfectly and some contracting relations quite imperfectly. In particular, parties to contracting relationships do not always have repeated, regular interactions. Some interactions are either unique or repeated on an intermittent or irregular basis. Further, contracting relationships, unlike the described game, need not always occur with the same partner or "opponent." In repeat play prisoner's dilemmas, one player can learn about the behavior of his or her opponent by experience; he or she need not face each round ignorant of the other player's prior behavior. If the identity of the other player changes, prior knowledge (of that player) is not available. (Of course, knowledge of prior players' behavior could, over time, induce optimism or pessimism about the focal player's behavior.) In addition, as Noreen (1988) pointed out, real-life agency situations are often characterized by considerable uncertainty regarding what the other player did on the prior round; learning about the opponent's behavior may be quite difficult at best. This lack of congruence between the game theoretic situation and real contracting relationships would, at minimum, suggest that stable, mutually cooperative, efficient solutions would be slow to evolve, even under conditions of enlightened self-interest. Impeding the development of such solutions is the specter of the opportunist deciding that the benefit of noncooperation outweighs the benefit of further cooperation. This problem becomes particularly acute when one or both players sense that the end of the sequence of plays is near.

Another solution to the opportunism problem is suggested by Robert Frank in his book *Passions Within Reason: The Strategic Role of the Emotions* (1988). Although his terminology is somewhat different than that used here (his "commitment problem" is similar to the opportunism problem), he argued that people who behave honestly, even when they could escape detection or at least get away with dishonest behavior, will often fare well in economic endeavors. His view, supported by ample evidence, is that narrow self-interest is often incompatible with productive and advantageous economic relationships. Conversely, "an honest person will benefit by being able to solve important commitment problems. He will be trustworthy in situations where the purely self-interested person would not, and will be much sought after as a partner in situations that require trust" (Frank, 1988: 18). A person's desirability as a contracting partner is based on his or her intrinsic trustworthiness, which is not dependent on a balance of interests and thus not subject to continuous reevaluation.

Frank's larger thesis, aptly reflected in the book's subtitle, is that emotions help solve the commitment problem by giving important clues about a person's true moral sentiments. Emotions help others to accurately judge a person's honesty and integrity and, hence, to engage (or refrain from engaging) in certain types of economic transactions in accordance with those judgments.

Essential to Frank's argument is the conclusion that moral sentiments are difficult to fake. He posits two "pathways" to judgments of the moral tendencies of other people: "sincere-manner" and reputation. Sincere-manner consists of an assessment of a number of physical cues. Facial blushing, perspiration, mouth dryness, certain eye movements, voice pitch, voice cadence, imprecise hand movements, and facial gestures are often associated with deceit (Frank, 1988). Human beings can significantly improve the accuracy of their judgments of the honesty and integrity of other people by careful attention to these cues, although no claim is made that these cues are always detectable or even that they always exist. DePaulo, Zuckerman, and Rosenthal (1980) provided empirical evidence that people can detect deception significantly better than chance would suggest.

Similarly, reputation is a fairly reliable indicator of a propensity toward opportunism, Frank argued, because "dishonest persons tend to cheat in situations where the odds militate against cheating" (1988: 76). Drawing evidence from experimental psychology, he shows that a person who is merely prudent (i.e., cooperative for self-interested reasons) will be caught cheating with sufficient frequency that a reputation for honesty will be difficult to maintain. Because the rewards of opportunism are often immediate and the rewards of cooperation temporally distant, and because the value of rewards is often discounted in an irrational manner, prudent (as opposed to intrinsically moral) persons will often mistakenly opt for the quick payoff of opportunistic behavior. This tendency makes their getting caught more likely and increases the probability that the prudent person will lose his or her reputation for honesty. "Knowing this, we can infer that a person who has not been caught is probably something more than a merely prudent person" (Frank, 1988: 88). Honest, trustworthy behavior is difficult to fake, even in the absence of face-to-face contact.

Much of this argument can be recast in ethical terms. The sentiments expressed by people who (a) are honest; (b) have personal integrity; (c) don't lie, cheat, or steal; and (d) honor their commitments are clearly moral in nature. People who have these sentiments are desirable partners for a large range of economic relationships. They will make good agents in principal/agent relationships because they will not require expensive monitoring by principals. They will make good sellers of resources in transaction cost situations because they will not opportunistically misrepresent the value of their resources, thereby reducing search and monitoring costs incurred by the buyer. Also, these persons, as buyers (consumers) of specialized resources in transaction cost situations, will not be inclined to "hold up" the sellers (producers) of such resources. Finally, people with the moral sentiments described above will make good team members in team production situations because they will not shirk or "free ride" on the work of others. Thus, Frank's argument can be adapted to reach a conclusion that good ethics, made manifest in the context of economic relationships with others, is also good business.

This conclusion, shortened to read "ethics pays," must be distinguished from the conclusion reached by Noreen (1988). Noreen argued that efficient contracting in agency relationships is best achieved through shared norms and ethical rules that reduce opportunism. His argument is utilitarian in nature; the economy (and hence society) will benefit from ethics in economic relationships. Frank (1988) took the argument a step further by concluding that not only is ethics good for us collectively, but it is also good for us individually. "[T]he modern presumption of a severe penalty for behaving morally is utterly without foundation" (Frank, 1988: xi); indeed, the ability to make credible commitments, "which springs from a failure to pursue self-interest, confers genuine advantage" (Frank, 1988: 5).

CORPORATE MORALITY

The benefits to individuals of good ethics in contracting relationships do not necessarily translate into similar benefits for corporations, however. To demonstrate that firms, like individuals, will benefit from moral behavior, it is necessary to show that the firm's behavior will, in general, reflect the moral sentiments of its top management and that stakeholders will be able to assess the moral sentiments of top management with reasonable accuracy. Because some stakeholders (employees and representatives of the company such as dealers, salespersons, purchasing agents, attorneys, and service personnel) are also agents of top management in their dealings with external stakeholders (e.g., customers, vendors, shareholders, and the neighboring community), these two arguments will be intertwined in the following paragraphs.

First, assume that the behavior of corporations with respect to moral issues ("corporate morality"), like individual morality, is detectable in two ways—through sincere manner and reputation—and further assume that corporate morality is reflected in the policies and decisions of the firm and in the nature of its direct dealings with corporate stakeholders. In addition, recall that company policies and decisions will be products of its top managers. Some of the firm's policies and decisions will be readily apparent to the stakeholders affected by them. For example, if a firm decides to lay off 10 percent of its salaried workforce in order to boost profits, the decision and its implications will be well known to salaried employees. If a company establishes a strict policy of "no returns" on merchandise, the policy will soon become known to dealers and certain customers. These decisions are "visible" to the affected stakeholders, and the company's reputation among its employees and customers, respectively, will be affected accordingly. Further, decisions and policies of this type are likely to influence the judgments of stakeholders other than those immediately affected. That is, the effect of these decisions and policies on the firm's reputation is likely to transcend the relationship between the firm and the immediately affected stakeholder group. For example, if the firm reneges on its pension obligations to company retirees, it will probably have difficulty maintaining the trust of its current (or potential) employees. Further, the firm's policies and decisions with respect to stakeholders are likely to have a cumulative effect on its reputation. If a single firm made all three of the decisions used as examples above, its reputation would reflect, in some measure, opportunistic policies toward employees, customers, and pensioners. Thus, the firm's reputation, and that of its top managers, will be partly a direct function of its policies and decisions.

Other facets of corporate morality will not be as readily detectable as will the policies and decisions described above. The effects of some managerial policies and decisions will be experienced by stakeholders only indirectly through the behavior of various company employees and representatives—dealers, salespersons, purchasing agents, service personnel, and so on. By what mechanism does the behavior of these individuals reflect the moral sentiments of top managers?

First, the morality of top managers will be reflected in the system of incentives and sanctions employed by the firm (i.e., the rewards and punishments that are given to or imposed on employees for various behaviors). These rules, both formal and informal, will reflect the values and, hence, the moral sentiments of top managers. Management's enforcement of these rules also will be a strong indicator of its values regarding moral issues. Top management also influences the corporate culture; the examples it sets through its behavior tend to be adopted by individuals at lower levels of the firm (Clinard, 1983).

Employees who are subordinates of the top executives will tend to adopt the "moral coloration" of the firm and its top managers (Jones &

Quinn, 1993) through a process of social learning (Bandura, 1986). Evidence that moral clues from the organization play a role in individual morality is provided by Treviño and Youngblood (1990), who found that vicarious reward positively influenced ethical decision making indirectly through outcome expectancies, as predicted by social learning theory. Jones (1989) argued that language also plays a role in individual morality. Because human beings "make sense" of their environment through the language that they have available to interpret it, the ready availability of moral (or opportunistic) language within the organization's lexicon will lead individuals to make decisions along moral (or opportunistic) lines. Firms with opportunistic vocabularies will enhance the opportunistic tendencies of employees; firms with moral vocabularies will nurture the moral tendencies of employees.

Further, through a process of self-selection, moral people will tend to leave (Lee & Mitchell, 1994) or avoid opportunistic firms. According to image theory (Beach, 1990), such individuals will find the values of the firm incompatible with their *value* images (Lee & Mitchell, 1994). Similarly, the value images of opportunists will be incompatible with the values of moral firms. In addition, opportunists will tend to leave moral firms because they may become frustrated with "irrational" (moral) decision making and because the norms and incentives of such firms will make it difficult to capture the benefits of their opportunistic behavior. Further, moral firms will tend either to avoid opportunistic individuals (Clinard, 1983) or to dismiss them because their superiors find the behavior of these individuals morally objectionable and because these individuals may damage the firm's reputation and, thus, harm it economically.

In those cases in which opportunistic individuals remain in moral firms, they will be constrained from behaving opportunistically by the prospect of sanctions by the firm (unless, of course, the gains from opportunism outweigh the costs of sanctions). Further, it may not matter that the opportunist cleverly conceals his or her opportunism (self-interest with guile); as long as he or she intends to act in a moral manner (if only out of fear of corporate retribution), he or she need not be insincere, and, hence, need not reveal his or her opportunism through "insincere manner." That is, if insincerity can be thought of as the result of a person's intending to do something other than what he or she promises to do (real intent is not the same as declared intent), then sincerity consists of a match between real intent and declared intent. As long as the person truly intends to do what he or she says that he or she will do, it may not matter *why* he or she intends to do it. Morality "induced" by the firm's norms and rules may be functionally identical to intrinsic morality; an opportunistic person may appear sincere (and act morally) when acting as the agent of a moral firm.

In addition, in the relationships between internal stakeholders at adjacent levels of the firm's hierarchy, tests of sincere manner and reputation will be frequent due to the frequency of interaction. The moral sentiments of corporate employees will, therefore, be well known to those with whom they work closely. Similarly, employees who deal directly with external stakeholders (e.g., suppliers and customers) will be known for moral sentiments that are a function of external signals (e.g., complaints and litigation) in addition to signals from other employees. Thus, throughout the corporate hierarchy the moral sentiments of individual employees will be known to at least several of their co-workers.

Given the previous argument that individuals whose moral sentiments are incompatible with the values of the firm's top management will tend to avoid, leave, or be driven out of the company and the argument that the moral sentiments of firm employees will be fairly well known, it follows that a firm will tend to have a relatively homogeneous culture with respect to morality. Thus, even though the behavior of corporations regarding moral issues will not be simple extensions of the morality of their top managers, firms will tend to be populated by employees whose moral sentiments are compatible with the values of their top management.

It then follows that the behavior of lower level employees and representatives will have an effect on the company's reputation similar to that which is acquired directly through the decisions and policies of top management (as described previously). Further, in the frequent interactions between the corporation's employees and representatives and its external stakeholders, the firm's "morality" will be relatively accurately portrayed through the presence (or absence) of "sincere manner."

It should be noted that the cumulative reputation acquired by a firm may be ambiguous with respect to its moral behavior. Some firms may have relationships with some stakeholders (e.g., customers) based on high levels of trust and cooperation, but they may have wary, opportunistic relationships with other stakeholders (e.g., hourly workers). Additionally, a firm may hire a new CEO who is known for honesty and integrity in order to burnish a reputation for opportunistic dealings with some (or all) stakeholder groups. Further, it is likely that some firms, rather than having a single, unambiguous corporate morality, will have subcultures that have their own "subcorporate morality." Situations like these will be the result of inconsistent, changing, or ambiguous morality on the part of the company's top management.

Because the reputation of top managers is tested (a) periodically through policies and decisions that affect stakeholders directly and (b) frequently through indirect interactions with stakeholders through the behavior of their agents (employees and representatives), corporate morality should be well reflected in the company's reputation. Firm morality, like individual morality, is difficult to fake. It also follows that the benefits available to ethical individuals also should be available to ethical corporations. Such firms will be desirable, sought after partners in relationships in which opportunism is a problem. They will be in demand in situations that require agents who do not require expensive monitoring, sellers who do not misrepresent the value of their resources, buyers who do not "hold up" sellers of specialized resources, and team members who do not shirk on collective efforts. These firms will, in short, be offered opportunities unavailable to opportunistic firms; briefly stated, "corporate morality pays."

According to this formulation, firms do not signal their trustworthiness except by avoiding signals of opportunism. Recall that the relationships for which moral firms (and moral individuals) will be sought are those in which a high level of trustworthiness and cooperation is required. A firm that *usually* honors its contracts, *usually* cooperates in joint efforts, and *usually* delivers on time may not qualify as a desirable partner in such relationships. Thus, a reputation for trustworthiness is really a reputation for not being opportunistic. Although firms may attempt to enhance their reputations by advertising or by being visibly generous or altruistic, such acts do not form the foundation of a good reputation. A good reputation generally must be earned by avoiding behavior that discourages or dissipates trust. In contrast, the reputations of firms could be deliberately, even unfairly, tarnished by the acts or accusations of other firms, the media, or government agencies. Discussion of this latter set of possibilities is beyond the scope of this paper.

A THEORY OF COMPETITIVE ADVANTAGE

The explicit promise of this article was to develop an instrumental theory of stakeholder management. The instrumental theory presented here is simultaneously contingent, descriptive, and empirical. It is contingent on certain types of behavior. It describes the result (outcome) of the postulated behavior. It posits an empirically testable link between the behavior and the outcome. Recall that no behavioral assumption was made in the Assumptions section. I will now explain the reason for that omission. As Margolis (1984) and Etzioni (1988) demonstrated, human beings are capable of a wide range of behavior, particularly with respect to the extent that they are self-interested (or opportunistic) and rational. Etzioni's argument that people are rarely fully rational or totally unconcerned with the well-being of others underlies his call for a "socioeconomics" to replace or supplement neoclassical economic theory. The instrumental theory presented here is a partial response to Etzioni's challenge; it claims that the manifestations of certain types of ethical behavior will result in competitive advantage.

The theory of competitive advantage, developed here, can be summarized as follows. Recall that (a) the firm is characterized by relationships with many stakeholders; (b) the contract metaphor applies to these relationships; (c) the firm, therefore, can be seen as a "nexus of contracts"; (d) corporate managers are the contracting agents for the firm; and (e) markets tend toward equilibrium and, in turn, produce a tendency toward efficient contracting. Given that the contracting process gives rise to agency problems, transaction cost problems, and team production problems (in general, commitment problems), efficient contracting will be profoundly affected by the costs of solving these commitment problems. Because these commitment problems (opportunism) abound, firms that solve commitment problems efficiently will have a competitive advantage over those that do not. Further, because ethical solutions to commitment problems are more efficient than mechanisms designed to curb opportunism, it follows that *firms that contract (through their managers) with their stakeholders on the basis of mutual trust and cooperation will have a competitive advantage over firms that do not.*

This source of competitive advantage does not, of course, mean that firms employing ethical contracting frameworks will always outperform firms in which contracting mechanisms are based on the assumption of opportunism. However, all else being equal, firms in the former group will have an advantage over firms in the latter group. They will experience reduced agency costs, transaction costs, and costs associated with team production. More specifically, monitoring costs, bonding costs, search costs, warranty costs, and residual losses will be reduced. The resources saved will benefit not only the firm employing ethical contracting but also the stakeholders with whom it contracts. In such cases, overall contracting costs are reduced, and the benefits are shared among the firm and its stakeholders.

It must be stressed that the emphasis in this summary statement of the theory is on *mutual* trust and cooperation. Nothing in the theory suggests that trustworthy, cooperative firms must also be trusting dupes. No assumption is made that a moral firm will always have (or will be able to attract) equally trustworthy and cooperative stakeholders. A trustworthy, cooperative firm must (like all firms) reject relationships with prospective partners whose potential or revealed opportunism is not within limits that it can manage. For these moral companies, the threshold of manageable opportunism is likely to be quite low, however. Because the benefits of mutually trusting and cooperative economic relationships are realized through reduced contracting costs, the moral corporation must choose its partners carefully in order to ensure that the desired benefits are obtained. The competitive advantage that accrues to moral firms takes the form of substantially increased *eligibility* to take part in certain types of economic relationships and transactions that will be unavailable to opportunistic firms. It, like all firms, must be discriminating in its choice of contracting partners. Further, careful discrimination in the choice of contracting partners applies to terminating contracts with existing stakeholders who prove to be opportunistic, and rejecting contracts with prospective stakeholders who are potentially opportunistic. These addenda to the theory are analogous to Axelrod's (1984) "provocability" criterion in prisoner's dilemma situations and do not detract from the conclusion that trustworthy, cooperative firms will have a competitive advantage.

I should also note that the role of trust and cooperation in organizations has been addressed by other authors in organization theory and related fields. In addition to economists Adam Smith and Douglas North, organization scholars including Barnard (1938/1968), Simon (1945), Etzioni (1965), and Weick (1969) have focused on these issues. Ouchi also emphasized the importance of trust and cooperation in his discussion of clans (1980) and his development of "Theory Z" (1981). Hill, in a recent game theory analysis of transaction cost economics, argued that market forces favor "actors whose behaviors are biased toward cooperation" (1990: 501).

RESEARCH PROPOSITIONS AND INSTRUMENTAL IMPLICATIONS

The focus of this instrumental theory of stakeholder management is the *contract* (i.e., a metaphor for the relationships between the firm and its various stakeholder groups). The firm will gain competitive advantage if it is able to develop relationships with its stakeholders based on mutual trust and cooperation. Implicit in this theory is the notion that the problems of opportunism and a lack of trust and cooperation are real problems in firm/stakeholder relations such that instrumental conclusions are appropriate. Thus, in addition to the formal research propositions that follow, all of which have instrumental implications, this section contains some examples of problems of potential opportunism for which formal propositions are inappropriate at present. The development of these examples into theoretically compelling empirical propositions is left to future researchers.

Shareholders are among the firm's important stakeholders. Several features of the law of corporations govern the relative power of managers and shareholders. Some of the legal options available to firms serve primarily to make hostile takeovers more difficult. Examples of such options are "poison pills," "shark repellents," dual-class stock, and incorporation in states (such as Delaware) in which corporation law favors broad management discretion. Researchers have used two theories to explain the emergence of such phenomena—the shareholder interest hypothesis and the management entrenchment hypothesis. According to the shareholder interest hypothesis (e.g., Grossman & Hart, 1980; Linn & McConnell, 1983), managers undertake such actions in order to protect and enhance the interests of shareholders. The management entrenchment hypothesis (DeAngelo & Rice, 1983) posits that such actions as these are motivated by the desire of managers to retain their employment and its associated perquisites. The difference between these two theories, in terms relevant to the theory developed in this article, is that the shareholder interest hypothesis assumes trustworthy behavior on the part of management, whereas the management entrenchment hypothesis assumes opportunistic behavior. Thus, empirical tests of these theories are relevant to instrumental stakeholder theory.

That managers are threatened by takeovers is an accepted fact. Furtado and Karan (1990), Martin and McConnell (1991), and Walsh and Ellwood (1991) found that incumbent managers are frequently fired soon after a change in control. That takeovers tend to benefit shareholders of target firms is also beyond question. Bid premiums in takeovers average 30 percent over pre-bid share prices (Jarrell, Brickley, & Netter, 1988). In addition, shareholders received $86 billion through takeovers and share repurchases, amounting to 68 percent of their total cash returns, between 1981 and 1986 (Bergsma, 1988). In order for antitakeover actions to benefit shareholders, they must either result in more bid offers being made or result in higher bid premiums overall. What does the evidence suggest?

Pound (1987) found that certain types of shark repellents (antitakeover charter amendments) substantially reduced the probability of a takeover bid. Frankforter (1991) also found shark repellents to have a deterrent effect on takeover bids. Neither author found significantly higher bid premiums for firms with shark repellents than for "defenseless" firms, leading both to conclude that shark repellents serve managerial, not shareholder, interests.

Shareholders also seem to be aware of the divergence of their interests and managerial interests with respect to shark repellents. Institutional investors, likely to be among the most sophisticated shareholders, were far more likely than individual holders to vote against shark repellents in corporate proxy votes (Brickley, Lease, & Smith, 1988). In addition, DeAngelo and Rice (1983) and Jarrell and Poulsen (1987) found that shark repellents have a negative effect on shareholder wealth. Thus, in the case of shark repellents, the evidence offers support for the management entrenchment hypothesis and, hence, for the conclusion that management opportunism is at work. Thus, if the adoption of shark repellents signals managerial opportunism, instrumental stakeholder theory predicts that:

> *Proposition 1: Firms that do not adopt shark repellents will outperform firms that adopt these devices.*

Poison pills (contingent securities that burden an acquiring firm with various obligations after takeovers) are also devices intended to deter hostile takeovers. Ryngaert (1988) and the SEC (1986) found that poison pills were effective in helping firms defeat unsolicited tender offers. "Event studies" of stock prices showed significant negative effects of the adoption of poison pills (Malatesta & Walkling, 1988; Ryngaert, 1988; SEC, 1986) and significant price increases when they were abandoned (Malatesta & Walkling, 1988) or declared by a court to be invalid (Ryngaert, 1988; SEC, 1986). Thus, poison pills, like shark repellents, signal managerial opportunism because they tend to protect managerial employment at the expense of shareholders, who are denied the potential windfall benefits of tender offers. Instrumental stakeholder theory predicts that:

> *Proposition 2: Firms that do not adopt poison pills will outperform firms that adopt these devices.*

Research on (a) the effects of the issuance of dual-class stock, which places a disproportionate share of voting power in "management friendly" hands, or (b) the movement of the corporate charter to a state that allows management substantial discretion in its dealings with shareholders has been limited. (See Jarrell & Poulsen, 1988, and Karpoff & Malatesta, 1989, for exceptions.) Therefore, formal propositions relating these events to corporate performance are inappropriate at present. However, because these changes in corporate governance, undertaken under the law of corporations, seem to promote management entrenchment and not shareholder interest, they also seem to signal managerial opportunism and, hence, be relevant events in the application of instrumental stakeholder theory.

Control repurchases ("greenmail" in less formal parlance) are purchases of blocks of stock from potential "raiders" who pose a threat to the control of top management of a firm (Kosnik, 1990). Although raiders are usually paid a premium for their shares (often a substantial premium) (Bradley & Wakeman, 1983), other shareholders cannot take advantage of the offer (Kosnik, 1990). Although theory has been advanced to the effect that greenmail benefits nonparticipating shareholders (Macey & McChesney, 1985; Shleifer & Vishny, 1986), empirical evidence supports the conclusion that greenmail substantially harms shareholders (Bradley & Wakeman, 1983; Dann & DeAngelo, 1983; SEC, 1984). Thus, the payment of greenmail appears to be another manifestation of managerial opportunism and, hence, an event of relevance to instrumental stakeholder theory, which predicts that:

> *Proposition 3: Firms that do not pay greenmail will outperform firms that do pay greenmail.*

The relationship between executive compensation and corporate financial performance has been the subject of substantial empirical scrutiny. Some researchers have found a positive link between CEO pay and stock returns (Coughlan & Schmidt, 1985; Deckop, 1988; Jensen & Murphy, 1990; Murphy, 1985, 1986). These authors are quick to praise the pay-for-performance plans implemented by many firms, because they tend to align the interests of managers with those of shareholders. Other authors, including Kerr and Bettis (1987), Benston (1985), and Boyd (1994), found no links between CEO pay and stock returns, leading them to conclude that managerial dominance of corporate boards (Berle & Means, 1932; Herman, 1981; Mace, 1971) alters the pay-performance relationship. The mixed nature of these results has led other authors to seek additional explanations for these disparate findings. Gomez-Mejia, Tosi, and Hinken (1987) and Tosi and Gomez-Mejia (1989), for example, explored the effect of ownership structure on the pay-performance link, whereas Hill and Phan (1991) examined the impact that CEO tenure had on the strength of the pay-performance relationship.

Instrumental stakeholder theory turns the (assumed) causal relationship between pay and performance around. This theory would predict a negative relationship, positing that disproportionately high executive pay is an example of inefficient contracting between the firm and its managers. Because top managers contract with stakeholders (including themselves, as previously argued) on behalf of the firm, excessive executive compensation can be seen as an abuse of trust and a symbol of a lack of trustworthiness on the part of top managers. The reputation earned by this type of behavior could cause inefficient contracting with other stakeholders and a decline in relative performance. Thus, rather than the theory postulated in prior studies that *high (low) performance causes high (low) pay*, instrumental stakeholder theory leads to the prediction that:

> *Proposition 4: Firms with disproportionately high levels of executive compensation will perform less well than firms without high levels of executive compensation.*

Suppliers also are important corporate stakeholders and the level of mutual trust and cooperation between a firm and its suppliers can affect the firm's cost structure significantly. Hill (In press) has explored the differences between Japanese and American auto firms in terms of their dealings with subcontractors. American firms, seeking to economize by inducing component part suppliers to invest in specific assets, settled on vertical integration, a relatively expensive solution because the costs of bureaucracy are high relative to those of the market (Monteverde & Teece, 1982). Japanese firms, in sharp contrast, entered into long-term "relational contracts" with their important (first-tier) suppliers. Aoki (1988) reported that Toyota and Nissan manufacture less than 30 percent of their components in house, whereas Ford and General Motors manufacture 50 percent and 70 percent of their components in house, respectively. The ability of Japanese firms to successfully employ such relationships is a function of the cultural institution of mutual trust and mutual obligation (Dore, 1987). The focal firm's long-term commitment to the subcontractor is matched by the subcontractor's obligation to conscientiously meet the focal firm's component manufacturing needs. Because such relationships facilitate investment in efficient specific assets, cost savings can be substantial (Hill, In press). If these arguments are expressed in terms of instrumental stakeholder theory, it appears that long-term relationships with a relatively small number of suppliers are indicative of cooperative, mutually trusting relationships.

A firm that keeps several suppliers "on line" competing for its business or that changes suppliers regularly is not indicating an interest in contracts built on mutual trust. Accordingly, its suppliers will not be able to achieve economies of scale in their operations and will not be willing to invest in assets specific to the production of the firm's needs. Therefore,

> *Proposition 5: Firms that have relatively few suppliers will outperform firms that have many suppliers.*

> *Proposition 6: Firms that have long-term relationships with their suppliers will outperform firms that have relatively brief relationships with their suppliers.*

Employees also are important stakeholders, and mutually trusting, cooperative relationships between a firm and its employees should provide a competitive advantage. Pfeffer, in his book entitled *Competitive Advantage Through People* (1994), made this point well. He argued that employment relationships built on the assumptions about human behavior implicit (and explicit) in neoclassical economic models (i.e., agency theory and transaction cost economics) are antithetical to the kinds of relationships that firms need to create in order to compete effectively in the long run. The assumption of opportunism (self-interest with guile) leads to expensive control mechanisms that are ultimately dysfunctional because they substantially reduce the level of trust in the organization. He noted that the five top-performing firms (in terms of percentage return on stock price) from 1972 to 1992 differentiated themselves by the way they managed their workforces (Pfeffer, 1994). These firms emphasized the value of their human assets rather than the economic factors that have been commonly believed (largely as a result of the work of Michael Porter, 1985) to be decisive in achieving competitive advantage. More generally, empirical evidence regarding the favorable effect of good industrial relations on economic performance has been provided by Katz, Kochan, and Gobeille (1983).

These general conclusions can be used to derive some specific research propositions that link evidence of managerial opportunism to corporate performance. In recent years, many firms have begun to "contract out" work formerly done by employees (in some cases to the former employees themselves). According to Pfeffer (1994), these firms do so (a) to increase employment flexibility, (b) to save money, (c) to increase staff quickly, and (d) to inflate statistical measures of productivity (e.g., sales per employee). Such practices are hardly conducive to the trusting and cooperative relationships advocated by instrumental stakeholder theory, suggesting instead managerial opportunism. It follows that:

> *Proposition 7: Firms that contract out work formerly done by employees will perform less well than those that do not follow this practice.*

Firms that hire only at the entry level and promote from within (internal labor markets) will enhance trusting relationships with their employees in contrast with those that rely heavily on labor markets external to the firm. Pfeffer touts the advantages of "promotion from within" (1994: 53), because such practices (a) bind workers to the firm and, thus, encourage training and skill development; (b) promote internal trust and, hence, facilitate delegation, participation, and decentralization; (c) promote informal relationships that make formal hierarchy less important; (d) provide a sense of justice and fairness, because loyal employees will not be passed over in favor of outside candidates for job openings; (e) offer better incentives for good performance; and (f) ensure that employees in key positions actually understand the business. Further, the firm will be able to count on the loyalty of internally developed employees, as opposed to "opportunists" who hop from job to job. Because internal labor markets promote trusting and cooperative relations between the firm and its employees, it can be predicted that:

Proposition 8: Firms with internal labor markets will outperform firms that rely on external labor markets.

Close monitoring and surveillance of employees is indicative of a lack of trust on the part of management. Such practices tend to (a) increase stress and physical ailments, (b) undermine intrinsic interest in work, and (c) produce distrust and alienation among employees (Pfeffer, 1994). Instrumental stakeholder theory predicts that:

Proposition 9: Firms that provide close monitoring of employees (perhaps including surveillance) will perform less well than firms that do not engage in such monitoring.

The relationships between firms and their employees are affected by other factors that are indicative of managerial opportunism or low levels of mutual trust and cooperation but for which theory and empirical work is as yet insufficient to warrant formal propositions. For example, firms that have undertaken major efforts to decertify unions might have trouble maintaining trusting and cooperative relations with their stakeholders and, hence, perform less well than those that have not taken such steps. Similarly, firms that undertake major downsizing efforts might perform less well than those that have not taken such actions, according to instrumental stakeholder theory. Of the current trend toward downsizing and similar activities in which people are viewed as short-term costs to be reduced, Noer says that "it represents a fundamental shift in the psychological covenant between the individual and the organization" (1993: 16). Such "covenants" (contracts) are central elements in instrumental stakeholder theory.

Other firm-stakeholder relationships also may be characterized by evidence of opportunism or a lack of trust and cooperation. For example, firms with pension plans may not fully fund the plans, thereby jeopardizing the retirement security of employees. Firms may have "caveat emptor" policies with regard to the satisfaction and safety of those who buy and use their products. In view of the high cost of losing existing customers and the high sensitivity of profits to the retention of customers (Reichheld & Sasser, 1990), product return, warranty, and recall policies that are sensitive to customer satisfaction and safety would seem to confer competitive advantage on firms that adopt them. Management-led leveraged buyouts, common in the 1980s, often led to the enrichment of participating managers (and gains for shareholders) at the expense of bondholders, whose bonds dropped in value as firms took on new debt. Further, employees often lost their jobs as a result of these buyouts. The "contracts" between firms and local communities also are subject to opportunism. Firms can bargain for costly infrastructure or low tax rates in areas in which they want to locate a facility and then renege on their commitments once the infrastructure has been provided and/or the community has grown dependent on the jobs the firms provide. Likewise, communities can renege on promises to keep taxes low.

These specific relationships, about which research propositions could be developed, might be supplemented by a prospective relationship between the extent of a firm's legal activities and its economic performance. A firm's legal department handles (either directly or indirectly) much of its formal contracting with shareholders, suppliers, customers, employees, bondholders, and dealers. Attorneys also are involved in the negotiation and litigation that attend after-the-fact contracting disagreements. Thus, the extent of legal activity that a firm engages in reflects the general level of trust across the full spectrum of manager/stakeholder relations. In summary, opportunism can be a factor in the relationships between the firm and many of its stakeholders. Instrumental stakeholder theory implies that managers should eschew policies and decisions that reveal opportunism and avoid relationships with stakeholders (existing or potential) thought to be opportunistic.

Clearly, some of these formal propositions and suggested relationships will seem counterintuitive to some readers because they run counter to conventional economic wisdom. However, the point of instrumental stakeholder theory is exactly this: manifestations of opportunism *may not* lead to optimal economic performance. The theory is intended to explain why certain behaviors heretofore thought to be irrational or altruistic are, in fact, quite compatible with economic success. It is also intended to explain why these behaviors persist in economic relationships despite their presumed irrational or altruistic nature.

Further, a few empirical caveats are in order. First, these research propositions are intended to be illustrative of the relationships indicated by the theory. However, researchers may find that no single proposition is empirically "true"; it may be the case that a threshold of trusting and cooperative relationships between the firm and its stakeholders must be met before empirically significant differences in performance are found. Second, as in all empirical work, the assumption of "all else being equal" must be made; trusting relationships with its stakeholders may be irrelevant to the success of a firm that has obsolete products, inefficient production processes, or uninspired marketing plans.

IMPLICATIONS AND EXTENSIONS OF THE THEORY

The most important academic implication of this theory may be its impact on transaction cost economics. Transaction cost economists, most notably Williamson (1975), posited that reduction of transaction costs is a critical element in the choice between markets and hierarchies as coordinating mechanisms in the production process. Markets have been alleged to reduce certain types of opportunism, whereas hierarchies (corporate bureaucracies) have been alleged to reduce other types of opportunism. Hill (In press) suggests that cultural patterns in Japan (trust, obligation, cooperation) reduce transaction costs and result in a competitive advantage for Japanese firms. Similarly, moral sentiments that resemble cultural traits such as those found in Japan may render the debate over markets versus hierarchies less relevant with regard to international competition: Moral firms, like Japanese firms, may solve problems of opportunism in markets and in hierarchies better than do their less moral counterparts. Efficiency within organizations, often best described in agency theory or team production theory terms, and efficiency at organizational boundaries, well described by transaction cost economic theory, may both be better achieved through trust and cooperation than through mechanisms purporting to efficiently curb opportunism. Moral sentiments may transcend both markets and hierarchies as efficient contracting mechanisms.

Another area of academic interest that can be illuminated through applications of instrumental stakeholder theory is the relationship between corporate social performance and financial performance. Although several studies have examined this relationship (e.g., Alexander & Buchholz, 1978; Cochran & Wood, 1984; Sturdivant & Ginter, 1977), none has been based on credible theory, prompting Ullmann (1985) to call them "data in search of a theory." In view of the ideas advanced in this article, the theory under examination could be simply stated: Certain types of corporate social performance are manifestations of attempts to establish trusting, cooperative firm/stakeholder relationships and should be positively linked to a company's financial performance. Corporate social performance would then be defined in terms of the contracting relationship rather than particular behavior. Researchers would be compelled to correctly describe and categorize the nature of the contract involved and to link it to the form of social performance under examination, of course, but theory-based research would be possible under the proposed framework. The research propositions I have included suggest some of these relationships as well as some of the means of operationalizing the characteristics of contracts.

An interesting extension of this theory is related to predicted changes in the global economy of the future. According to Robert Reich, in his book *The Work of Nations: Preparing for 20th Century Capitalism* (1991), economic wealth in the future will not accrue to "national firms" but rather to "national people," whose skills will be part of large and fluid global "enterprise webs." Business tasks will be performed by those who can carry them out most efficiently, and most of the repetitive production tasks will be performed abroad where wage rates are low. The wealth of nations will be a function of the number of "symbolic analysts"—problem identifiers, problem solvers, and strategic brokers—the nation supplies to these enterprise webs. The United States has, according to Reich, a substantial head start on other nations in terms of the number and skills of its symbolic analysts, who should do quite well at performing the tasks of conceiving, brokering, and implementing the specialized, high-value, market-niche-oriented production of the future. What Reich overlooks, in view of instrumental stakeholder theory, is the competitive disadvantage that results from a cultural tradition of opportunism or of expensively constrained opportunism. If the economy of the future depends on the success of countless "deals," those who can consummate and deliver on those deals efficiently should be more successful than those who cannot or will not honor their commitments. American symbolic analysts, with their penchant for opportunism, and the American legal system, with its penchant for expensive before-the-fact legal contracting and after-the-fact litigation, may be unattractive elements in a system that would seem to rely heavily on trust and cooperation. America's head start in education and critical skills may be dissipated by its cultural tradition of self-interest.

Because public policy often affects firm/stakeholder relationships, the theory has implications for government policy as well. Frank (1988) suggested one such implication: the questionable value of "mobile" resources. Economists stress the virtue of resources (e.g., capital, labor) being moved to their most efficient use. Plant closings, job hopping, takeovers, and leveraged buyouts are manifestations of this credo. The theory I present suggests that the opposite might be true. The instability and insecurity resulting from mobile resources can seriously impair the development of the trusting, cooperative relationships upon which efficient contracting depends. Firms that move part of their production overseas can hardly expect trust and cooperation (beyond what they can command) on the part of their remaining employees. Companies that are constantly acquiring and/or "spinning off" subsidiaries or divisions cannot expect commitment from their stakeholders. In short, mobile resources may not be efficient because they signal opportunism and promote further opportunism. It follows that the economy and the larger society might be well served by government policies designed to stabilize the economic environment rather than by letting market forces prevail unhindered. Specific policies worthy of consideration in this context are trade protection and takeover protection for domestic corporations. Hostile takeovers in particular, thought by economists to promote efficiency (the "market for corporate control" at work), can be enormously destructive to the trust and cooperation needed for efficient contracting. The long-term benefits of stable corporate ownership and control may outweigh the benefits of active markets for corporate control. Public policy promoting such stability may be superior to that promoting mobile resources. Again, conventional economic wisdom is questioned by the new theory.

CONCLUSIONS

At this point, a brief overview of the article and a summary of its main points are in order. The theory advanced here is intended to strengthen the case for using the stakeholder model as a central paradigm for the business and society field. The theory is built on an integration of the stakeholder concept, economic concepts (agency theory, transaction cost economics, and team production theory), insights from behavioral science, and ethics. It focuses on the contracts (relationships) between the firm and its stakeholders and posits that trusting and cooperative relationships help solve problems related to opportunism. Because the costs of opportunism and of preventing or reducing opportunism are significant, firms that contract on the basis of trust and cooperation will have a competitive advantage over those that do not use such criteria. This instrumental theory of stakeholder management essentially turns the neoclassical theory of the firm upside down. It implies that behavior that is trusting, trustworthy, and cooperative, not opportunistic, will give the firm a competitive advantage. In the process, it may help explain why certain "irrational" or altruistic behaviors turn out to be productive and why firms that engage in these behaviors survive and often thrive.

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