

## STAKEHOLDER-AGENCY THEORY

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### ABSTRACT

Taking agency theory and stakeholder theory as points of departure, this article proposes a paradigm that helps explain the following: (1) certain aspects of a firm's strategic behaviour; (2) the structure of management-stakeholder contracts; (3) the form taken by the institutional structures that monitor and enforce contracts between managers and other stakeholders; and (4) the evolutionary process that shapes both management-stakeholder contracts and the institutional structures that police those contracts.

### INTRODUCTION

Over the last decade, agency theory has emerged as the dominant paradigm in the financial economics literature (Jensen and Meckling, 1976; Ross, 1973). As developed in that literature, agency theory has been primarily concerned with the relationship between managers and stockholders. However, recently authors in the management field have begun to explore the implications that agency theory might have for the disciplines of organizational behaviour, organizational theory, and strategic management (*e.g.*, Eisenhardt, 1985, 1988, 1989; Kosnik, 1987). One area that remains relatively unexplored concerns the ability of agency theory to explain the nature of the implicit and explicit contractual relationships that exist between a firm's stakeholders. In addition to managers and stockholders, stakeholders include employees, customers, suppliers, creditors, communities, and the general public. The agency theory view of the firm as a nexus of contracts between resource holders (stakeholders) suggests that this may be a promising avenue for investigation.

Taking agency theory and stakeholder theory as points of departure, the purpose of this article is to propose a paradigm that helps explain the following: (1) certain aspects of a firm's strategic behaviour; (2) the structure of management-stakeholder contracts; (3) the form taken by the institutional structures that monitor and enforce contracts between managers and other stakeholders; and (4) the evolutionary process that shapes both management-stakeholder contracts and the institutional structures that

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police those contracts. Like agency theory, this paradigm suggests that the firm can be seen as a nexus of contracts between resource holders. Unlike agency theory, the paradigm encompasses the implicit and explicit contractual relationships between *all* stakeholders. Stated simply, the resultant model is a generalized theory of agency: one of *stakeholder–agency*.

Although similar to agency theory in many respects, stakeholder–agency theory is based on assumptions concerning market processes that are substantially different from those underlying the finance version of agency theory. The result is a paradigm whose predictions are not always consistent with those of agency theory. While agency theory operates on the assumption that markets are efficient and adjust quickly to new circumstances, here the existence of short to medium-run market inefficiencies are admitted. The result is the introduction of power differentials into the stakeholder–agent equation. Although the idea of power differentials is at variance with the traditional agency approach, in our view the approach developed here increases the explanatory power of the paradigm.

#### AGENCY THEORY

An agency relationship is defined as one in which one or more persons (the principal(s)) engages another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent (Jensen and Meckling, 1976; Ross, 1973). The cornerstone of agency theory is the assumption that the interests of principals and agents diverge. According to agency theory, the principal can limit divergence from his/her interests by establishing appropriate incentives for the agent, and by incurring monitoring costs designed to limit opportunistic action by the agent. Further, it may pay the agent to spend resources (bonding costs) to guarantee that he/she will not take certain actions that would harm the principal, or to ensure that the principal will be appropriately compensated if he/she does take such action. That is, the agent may incur *ex-ante bonding costs* in order to win the right to manage the resources of the principal. Despite these devices, it is recognized that some divergence between the agent's actions and the principal's interests may remain. Insofar as this divergence reduces the principals's welfare, it can be viewed as a *residual loss*.

The sum of the principal's monitoring expenditures, the agent's bonding expenditures, and any remaining residual loss are defined as agency costs. Further, agency theory asserts that natural selection processes favour governance structures that economize on agency costs (Fama and Jensen, 1983; Jensen, 1983). By governance structures, agency theorists mean the mechanisms that police the explicit and implicit contracts between principals and agents (Demsetz, 1983; Fama, 1980; Fama and Jensen, 1983). These include the structure of law governing corporate behaviour and its attendant legal apparatus, monitoring mechanisms (such as the board of directors), and enforcement mechanisms (such as the market for corporate control and the managerial labour market).

Although applied primarily to the stockholder–manager relationship, Jen-

sen and Meckling (1976) argue that agency theory 'will lead to a rich theory of organizations which is now lacking in economics and the social sciences generally' (p. 309). Jensen and Meckling view the implicit contract between stockholders and managers as just one of the nexus of contracts that form the legal fiction known as the modern corporation. Other contracts that could be considered within an agency framework include those between managers and the various primary interest groups of the firm or stakeholders.

#### STAKEHOLDERS

The term stakeholders refers to groups of constituents who have a legitimate claim on the firm (Freeman, 1984; Pearce, 1982). This legitimacy is established through the existence of an exchange relationship. Stakeholders include stockholders, creditors, managers, employees, customers, suppliers, local communities, and the general public. Following March and Simon (1958), each of these groups can be seen as supplying the firm with critical resources (contributions) and in exchange each expects its interests to be satisfied (by inducements). Stockholders provide the firm with capital. In exchange, they expect the firm to maximize the risk-adjusted return on their investment. Creditors provide the firm with finance and in exchange expect their loans to be repaid on schedule. Managers and employees provide the firm with time, skills, and human capital commitments. In exchange, they expect fair income and adequate working conditions. Customers supply the firm with revenues and expect value for money in exchange. Suppliers provide the firm with inputs and seek fair prices and dependable buyers in exchange. Local communities provide the firm with locations, a local infrastructure, and perhaps favourable tax treatment. In exchange, they expect corporate citizens who enhance and/or do not damage the quality of life. The general public, as tax payers, provides the firm with a national infrastructure. In exchange, they expect corporate citizens who enhance and/or do not damage the quality of life and do not violate the rules of the game established by the public through their legislative agents.

##### *Specific Asset Investments*

Stakeholders differ with respect to the size of their stake in the firm. The magnitude of an individual actor's stake is a function of the extent to which that actor's exchange relationship with the firm is supported by investments in specific assets (Williamson, 1984). Following Williamson (1984, 1985), by specific assets we mean assets that cannot be redeployed to alternative use without a loss of value. For example, employees with general-purpose skills and knowledge can leave the firm and be replaced without productive loss to either the worker or the firm (assuming efficient labour markets). In such cases, their 'stake' in the firm is low. Alternatively, employees with skills that are uniquely tailored (specialized) to the requirements of the firm cannot leave without bearing substantial exit costs in the form of the lower rent stream that their skills can earn in the next best application. The 'stake' of such employees in the firm is high. This distinction is important: compared to

actors with a low stake in the firm, actors with a high stake will demand more comprehensive incentive mechanisms and governance structures in order to safeguard their asset-specific investments in the firm.

*The Unique Role of Management*

Whatever the magnitude of their stake, each stakeholder is a part of the nexus of implicit and explicit contracts that constitutes the firm. However, as a group, managers are unique in this respect because of their position at the centre of the nexus of contracts. Managers are the only group of stakeholders who enter into a contractual relationship with all other stakeholders. Managers are also the only group of stakeholders with *direct* control over the decision-making apparatus of the firm (although some stakeholders, and particularly the suppliers of capital, have indirect control). Therefore, it is incumbent upon managers to make strategic decisions and allocate resources in the manner most consistent with the claims of the other stakeholder groups.

The unique role of managers suggests that they can be seen as the agents of other stakeholders; hence the term stakeholder–agency theory. It would be incorrect, however, to suggest that all the other groups of stakeholders are therefore principals in the sense implied by agency theory. In agency theory, principals hire agents to perform some service on their behalf. Stockholders and some customers apart, few stakeholders can be said to hire managers (in the case of employees the reverse is clearly true). Nevertheless, there is a parallel between the general class of stakeholder–agent relationships and the principal–agent relationships articulated by agency theory. Both stakeholder–agent and principal–agent relationships involve an implicit or explicit contract, the purpose of which is to try and reconcile divergent interests. In addition, both relationships are policed by governance structures. Moreover, many of the concepts and much of the language of agency theory can be applied to stakeholder–agent relationships. All of this suggests that principal–agent relationships, as defined by agency theory, can be seen as a subset of the more general class of stakeholder–agent relationships.

UNDERLYING ASSUMPTIONS

Our main assumptions concern the efficiency of the market mechanism. These assumptions have implications for the existence of power differentials between the parties to a contract. By a power differential, we mean a condition of *unequal dependence* between the parties to an exchange (Emerson, 1962; Pfeffer, 1981). That is, for two entities, *A* and *B*, there is a power differential in *A*'s favour when *B* depends upon *A* more than *A* depends upon *B*. (While this definition is suitable for the purposes of this article, a fuller discussion of the definitions of power can be found in the work of Lukes (1974) and Wrong (1988).

Agency theorists see the firm as surrounded by efficient markets that adjust quickly to new circumstances (Barney and Ouchi, 1986). They make the rather heroic assumption that markets are in or near an efficient equilibrium

(Fama, 1980; Fama and Jensen, 1983; Jensen, 1983). The efficient markets assumption implies that principals and agents have freedom of *entry* into and *exit* from contractual relationships. According to mainstream agency theorists, if an agent (principal) does not like the terms of a contract offered by a principal (agent) and/or the governance structures that police that contract, he/she can always seek a better alternative. If a shortage of agents (principals) results, the principals (agents) will be compelled by market forces to adopt more acceptable incentive mechanisms and/or governance structures. Of course, this argument ignores the obvious fact that a better alternative might not always be available (for a discussion of the implications, see Burt, 1983). Putting this criticism aside for a moment, however, the mainstream agency theory argument suggests that contracts between principals and agents, along with the governance structures that police those contracts, are determined by market forces. Thus, within the framework of mainstream agency theory, they must be seen as having efficiency properties.

This tidy logic breaks down if the efficient market assumption is dropped (Perrow, 1986; Putterman, 1984). If the markets that surround the firm are inefficient, as occurs when alternative contracting opportunities are limited, the existence of power differentials between principals and agents must be admitted. If agents are unable to exit from a contractual relationship without taking a substantial loss (because 'better alternatives' are not available), or if the supply of agents exceeds the demand for agents by principals, power shifts towards the principal. Similarly, if principals are unable to dismiss agents, or if there is a shortage of agents, power shifts towards the agents. This is important, since power differentials can materially affect both the content of principal-agent contracts and the structure of governance mechanisms policing those contracts.

Given this, it is important to state our assumptions with regard to market efficiency and equilibrium. There are two points of disagreement between stakeholder-agency theory and agency theory. The first concerns the speed with which markets adjust to new circumstances, while the second concerns the assumption of equilibrium. In contrast to agency theory, we view market adjustment processes as being characterized by friction (Williamson (1985) makes a similar point and argues that this friction results in transaction costs). Due to friction, once created disequilibrium conditions may persist for a prolonged period of time before an efficient equilibrium is re-established. The resulting disequilibrium conditions imply the existence of power differentials between the parties to an exchange.

#### *Sources of Friction*

Barriers to entry and exit constitute one source of friction (Porter, 1980). Barriers to entry and exit impede adjustment processes and may allow power differentials arising from an initial disequilibrium to persist in a market for significant periods of time. Open systems theory suggests a further source of friction. Managers and other stakeholders can to a degree shape or enact their environment (Pfeffer and Salancik, 1978; Weick, 1979). If a disequilibrium situation is perceived as being to their advantage, managers may be able to slow down the adjustment process by appropriate strategic investments (*e.g.*,

investments designed to increase entry barriers, by collusion, by predatory pricing, etc.).

Organizational inertia may be a further source of friction (Hannan and Freeman, 1984). As a result of disequilibrium, one party to a contract may be disadvantaged. Correcting the disadvantage may require the innovation of new incentive structures and/or monitoring and enforcement mechanisms. However, the ability of the disadvantaged party to innovate may be hindered by strong inertia forces. Due to inertia, it may be difficult to alter established routines and procedures for monitoring and enforcing management-stakeholder contracts so as to reflect new realities. Pressures such as sunk costs, political coalitions, the tendency to consider precedents as normative standards, and a simple lack of imagination all limit the degree to which incentive, monitoring, and enforcement structures respond quickly to new circumstances.

Having said this, in *the long run* we believe that market processes work to select out the most inefficient organizational forms. Despite barriers to entry and exit, attempts by managers to shape the environment to their advantage, and inertia, in the long run there are grounds for believing that the market system does achieve a *rough* balance between the efficient and inefficient (Alchain, 1950; Nelson and Winter, 1982). Although the adjustment process can be slowed down, it cannot be halted altogether. While we certainly do not agree that only the most efficient survive, we think it is highly probable that the most inefficient organizational forms lose ground and are eventually selected out.

#### *Equilibrium and Market Processes*

If change was a rare event, the above arguments would imply that equilibrium situations in which the most inefficient organizational forms have been selected out are commonplace. However, one of the central features of the real world is that the only constant is change. Although market process work towards some kind of equilibrium, change constantly alters the direction in which that equilibrium is to be found. As argued by Schumpeter (1942), such change often occurs due to the process of creative destruction triggered by innovation. Moreover, Schumpeter suggested that innovation is itself a product of the competitive process. Thus, ongoing change may be a persistent endogenous feature of capitalism. Alternatively, change may be due to exogenous macro-environmental trends (demographics, social-political factors, macro-economic change, etc.). No matter how it arises, ongoing change creates a situation of permanent disequilibrium and hence, of persistent power differentials between stakeholders and managers. However, because of the random nature of change, power differentials are themselves unlikely to remain unidirectional. While change at one point in time may favour managers, change in a subsequent period may shift the balance of power towards other stakeholder groups.

Building on this perspective, we follow modern 'Austrian' economists in arguing that the focus of theoretical attention should be on *market processes* rather than equilibrium conditions in efficient markets, since the latter is little more than a convenient fiction (Kirzner, 1979; Knight, 1921; Littlechild and

Owen, 1980; Nelson and Winter, 1982; Schumpeter, 1942). While a drive towards efficiency may characterize the business system, in the sense that the most inefficient producers ultimately get selected out, we view short- and medium-term inefficiencies arising out of disequilibrium conditions as commonplace.<sup>[1]</sup> This suggests that power differentials arising out of disequilibrium conditions between managers and other stakeholders are an essential determinant of the nature of many stakeholder-agent contracts and the structures that police those contracts.

In sum, our view of market dynamics is fundamentally different from that which characterizes most of the agent-principal literature. We do not assume equilibrium, although we do assume that *market processes* work in such a manner that, in the long run, inefficient incentive structures and monitoring and enforcement mechanisms are selected out, while more efficient structures and mechanisms evolve to replace them. However, due to barriers to entry and exit, the ability of stakeholders and managers to enact their environment, and inertia, the adjustment process is plagued by significant frictions. By forcing attention onto adjustment processes under disequilibrium conditions, this perspective adds richness to the discussion of stakeholder-agency theory.

#### DIVERGENT CLAIMS, UTILITY LOSS, AND CONTRACTING COSTS

The interests of principals and agents diverge primarily because these different groups have different utility functions. In turn, this can lead to direct conflict over the use to which resources are put (for example, see Jensen, 1986). Agency theory focuses on the divergence of interests between managers and stockholders. The argument can be traced back to the managerial discretion literature of the 1960s (Baumol, 1959; Marris, 1964; Williamson, 1964). This literature theorizes that stockholders are wealth maximizers, while managers maximize a utility function that includes remuneration, power, job security, and status as its central elements. The agency/managerial literature postulates that satisfying the claims of stockholders involves maximizing the efficiency of the firm (Fama, 1980), while satisfying the claims of management requires increasing the size of the firm (remuneration, power, job security and status are argued to be a function of firm size). In turn, it has been argued that the desire to increase firm size results in a managerial preference for maximizing the growth rate of the firm, principally through diversification (Amihud and Lev, 1981; Aoki, 1984; Marris, 1964). Further, the discretion literature postulates a trade-off between growth maximization and efficiency maximization. Beyond a certain point, the greater investments in growth, the lower investments in maximizing efficiency. Thus, divergent claims give rise to an agency conflict between managers and stockholders.

Stakeholder-agency theory postulates that other stakeholder groups also place claims on the firm that, if satisfied, reduce the amount of resources that management can channel towards the pursuit of growth through diversification. Satisfying employee claims for higher wages, consumer claims for greater quality and/or lower prices, supplier claims for higher prices and

more stable ordering patterns, and the claims of local communities and the general public for lower pollution and an enhanced quality of life, all involve the use of resources that might otherwise be invested by managers in maximizing the growth rate of the firm. Thus, an agency conflict is inherent in the relationship between management and all other stockholders (for a transaction cost interpretation of this phenomenon see Williamson, 1985).

This is not to deny that to a degree the claims of stakeholders and managers also converge. For example, satisfying employee claims for higher wages and better working conditions may improve employee productivity and thus provide management with greater resources. Similarly, devoting resources to controlling pollution may result in local communities being more receptive to future proposals by management for expanding its operations. However, our contention is that beyond a certain point, this convergence of interest is replaced by divergence.

If uncorrected, the divergence between management and stakeholder preferences with regard to the way in which a firm allocates its resources will result in a failure of stakeholders to maximize their utility. The difference between the utility that stakeholders could achieve if management acted in stakeholders' best interests, and the utility that is achieved if management acts in its best interest, can be referred to as a *utility loss*. In the absence of incentive, monitoring, and enforcement structures that serve to align the interests of managers and stakeholders, utility loss may be substantial. The function of incentive, monitoring, and enforcement structures is to minimize utility loss by correcting for the divergence of interests between management and stakeholders.

The concept of utility loss leads to a somewhat broader definition of agency costs than that typically given in the agency literature. To distinguish this from the agency definition, from now on we shall talk in terms of *contracting costs*. These are defined as the reduction in utility that stakeholders bear by channelling resources to support incentive, monitoring, and enforcement structures, as opposed to using those resources directly to satisfy their utility function, plus any remaining or residual utility loss. For example, imagine that the maximum amount of utility that stakeholders can derive from a given relationship is 100 units, but that management preferences result in stakeholders only getting 60 units, resulting in a total utility loss of 40 units. If stakeholders devote resources equal to 10 units of utility to establishing incentive, monitoring, and enforcement mechanisms, they may increase the utility they derive from the relationship to 90 units, resulting in a net gain of 20 units. The remaining residual utility loss is 10 units. Thus, contracting costs are equal to the 10 units of utility that are sacrificed to support incentive, monitoring, and enforcement mechanisms, plus the residual utility loss of 10 units.

#### INTEREST ALIGNMENT MECHANISMS

One way of minimizing the utility loss that arises from a divergence of interests involves introducing *ex-ante* interest alignment mechanisms into the

contracting scheme. In the agency literature, management and employee stock option plans are the most widely discussed of these mechanisms (Demsetz, 1983). Stock option plans serve to induce managers and employees to pay more attention to maximizing stockholder wealth, since that will simultaneously maximize their own wealth. On a more general level, offering tax breaks for investments in pollution containment equipment is an example of how local communities and the general public (through their legislative agents) use incentives to try and align management interests with their own.

In addition, to gain access to their resources, stakeholders may demand that managers absorb *ex-ante bonding costs* in order to demonstrate their commitment to satisfying stakeholder interests. For example, consider the consumer contemplating entering an exchange relationship with a manufacturer of consumer durables. The purchase of durables presents consumers with a difficult agency problem. Consumer durables are purchased infrequently and involve large expenditure. In such circumstances, the consumer is vulnerable to opportunistic action on the part of management. Management may misrepresent the quality or durability of the product in an attempt to close the sale. The agency problem is solved by the *ex-ante* introduction of a warranty into the contracting scheme. This specifies management's obligation to correct defects or provide suitable compensation in the event of substandard quality. The warranty is a bonding mechanism that communicates to consumers a commitment on the part of management to a certain standard of quality.

More generally, a bonding mechanism is an example of the use of *credible commitments* (Williamson, 1985). Establishing a credible commitment requires that managers post a 'hostage' or bond forfeitable upon malperformance (Alchain and Woodward, 1988). The concept has been used to explain certain characteristics of a firm's relationships with its suppliers and consumers (although it is hardly limited to this context). For example, when a supplier has to make substantial investments in specialized assets in order to enter into trade with the firm, it is also exposing itself to the possibility of opportunistic abuse by management (Williamson, 1985). Once the supplier has made the investment, it is effectively 'locked in' to the relationship and cannot exit without reducing the value of those assets. Management may use this fact to go back on any *ex-ante* agreement and drive down the prices charged by the supplier. As insurance against this possibility, the supplier may demand a similar *ex-ante* investment in dedicated assets on the part of the firm. This locks both parties into a mutually dependent relationship in which power is symmetrically distributed. Examples include reciprocal trade agreements, most-favoured-buyer clauses, inflexible prices, posted prices, exclusive territories, franchise-specific investments, patent pools, and union shop agreements (Williamson, 1985). In all these cases, the underlying objective is to establish mutual dependency between managers and other stakeholder groups so that interests are more closely aligned. As a general rule, the use of credible commitments to bond managers and stakeholders will be greater the greater the investments in specialized assets required of either stakeholders or managers to support a given exchange relationship.

## MONITORING AND ENFORCEMENT MECHANISMS AND STRUCTURES

Interest alignment mechanisms apart, the contracts between stakeholders and managers are primarily implicit (Mitroff, 1983). Stakeholders supply the firm with resources on the implicit (tacit) understanding that their claims on the organization will be recognized. To ensure that this occurs, a number of institutional structures have evolved that serve the function of monitoring and enforcing the terms of implicit contracts. Agency theory generally refers to such institutions as governance structures. Our change of terminology reflects a broadening of emphasis. Specifically, we are concerned with more than just quasi-independent or third party governance (such as the board of directors, the market for corporate control, or the legal superstructure of society). We are also concerned with institutions that have evolved to represent and further the interests of a given set of stakeholders (such as labour unions and consumer unions) precisely because such institutions have utility loss-minimizing properties. Thus, the term institutional structures subsumes the term governance structures.

*Monitoring Structures*

An information asymmetry exists between managers and stakeholders. As insiders, managers are in a position to filter or distort the information that they release to other stakeholders. Management control over critical information complicates the agency problem. It makes it difficult for stakeholders to identify if management is acting in their interests. The obvious response is for stakeholders to gather more information about management activities. However, while individual stakeholders can and do undertake their own monitoring of management performance, the costs of gathering and analysing additional information may be prohibitive.

This is particularly likely when stakeholders are diffused. Diffusion refers to a situation where a stakeholder group contains many individuals or entities, no one of which has command over a significant proportion of the group's total resources. In such circumstances, *ceteris paribus*, no one individual or entity may be able to finance the extensive information-gathering and analysis necessary to reduce significantly the information asymmetry between managers and stakeholders. In turn, this gives managers greater discretionary control over the use to which the firm's resources are put, increasing the residual loss that stakeholders have to bear.

The response to the monitoring problem has been the evolution of a wide range of institutional structures that serve to economize upon the costs of information-gathering and analysis. Some of these structures are enshrined in legislation (*e.g.*, the requirement that public companies publish consolidated annual accounts). Other institutions have evolved in an attempt to exploit the profit opportunities of gathering, analysing, and then selling information to stakeholders (*e.g.*, stock analysts' services, consumer reports, *etc.*). Still others have arisen as non-profit organizations that exist in part to monitor the degree to which managers act in the best interests of certain stakeholder groups (*e.g.*, Consumer Watch, Infact, labour unions). The common theme found in all of these structures is their ability to achieve economies of scale in information-

gathering and analysis, primarily through the employment of specialists. The consequence of such devices is a reduction in utility loss.

*Enforcement Mechanisms and Structures*

The function of enforcement is one of deterrence. Enforcement mechanisms are articulated by stakeholders prior to any resource exchange in an attempt to deter management from maximizing its utility at the expense of stakeholders. The success of enforcement mechanisms depends upon their credibility (Schelling, 1960), and those lacking credibility will be ignored by management. In such circumstances, any attempt to put enforcement mechanisms into effect will involve costs that outweigh the benefits of reducing the utility loss from management opportunism. In short, mechanisms that are not effective deterrents will fail (as do laws that are commonly ignored by the general population).

*Law as a deterrent.* Establishing credible deterrents in the context of stakeholder-management relationships requires enforcement mechanisms that are supported by a broad consensus of stakeholders, and which are effectively communicated to management *ex-ante*. Certain legal penalties have this character (laws against insider trading, antitrust regulations, pollution regulations, *etc.*). Indeed, it can be argued that much of the structure of law relating to business activity in society reflects critical points of conflict in stakeholder-agent relationships. That is, legislators, as representatives of certain stakeholder interests, have enacted into law enforcement mechanisms that, because they are credible deterrents, serve to economize on utility loss.

*Exit as a deterrent.* The legal approach to resolving principal-agent conflicts constitutes only one way of establishing a credible threat. A more general approach involves the establishment of a credible threat to withhold resources from the firm if management fails to serve stakeholder interests. That is, to threaten exit from the exchange relationship (Hirschman, 1970). Such threats may be more effective than legal penalties. Only in rare situations are legal penalties likely to jeopardize the survival of the firm. Indeed, many firms view such penalties as a 'normal cost of doing business'. In contrast, by denying the firm access to critical resources, stakeholders can threaten its very survival (Pfeffer and Salancik, 1978).

In a sense, the threat of exit is an underlying theme of many stakeholder-management relationships. For example, if dissatisfied with product quality, consumers can always take their business elsewhere. Similarly, if dissatisfied with a firm's performance, stockholders can always sell their stock. Thus, credible threats to exit can be enacted through the market mechanism. However, market action suffers from a number of weaknesses. First, there is a co-ordination problem among diffused stakeholders that in certain circumstances makes collective action problematic. Exit may not be a very effective deterrent if members of a stakeholder group are unable to act in unison to impose demands on management. For example, while employees may be unhappy about working conditions, individual complaints or threats of exit may do little to persuade management to improve conditions, particularly if

there is a ready supply of replacement labour. Similarly, while consumers as individuals may disapprove of the pollution implications of a given product (*e.g.* auto exhaust, plastic containers, air conditioning fluid) the threat of individual exit may be futile, particularly if no cost-effective alternative exists. Thus, consumers may continue to purchase the products, even though as individuals they are unhappy about the implications of doing so, and would prefer the firm to devote resources to developing less harmful alternatives.

The institutional response to the problem of achieving collective action among diffused stakeholders has been the evolution of a number of structures that perform the co-ordination function. Examples include labour unions, consumer unions, and special-interest groups. By providing centralized direction, these structures economize upon the costs of co-ordination and establish the credibility of the exit mechanism. Thus, labour unions may initiate a strike if management fails to meet their demands for better working conditions. Similarly, special-interest groups may initiate a consumer boycott if the firm continues to produce products that they consider to be harmful (*e.g.*, Infact's consumer-led boycott of Nestle's was designed to halt the company's questionable infant formula marketing practices in Third World countries).

A more intractable weakness of market action is that it may lack effectiveness in those situations where stakeholders are 'locked in' to an exchange relationship by specific asset investments. Suppliers, customers, employees, or communities who have invested in specialized assets in order to enter into an exchange relationship with the firm may not be able to exit without incurring substantial exit costs. The exit costs consist of the reduced rents from specialized assets that can be earned in their next best application. Other things being equal, such barriers to exit reduce the credibility of any threat to exit as a contract enforcement mechanism. This is serious given that actors who make specific asset investments in the firm are by definition among the most important of its stakeholders (their future is most closely aligned to that of the firm).

However, certain bonding mechanisms have the additional character of increasing the credibility of the threat to exit among stakeholders who have invested in firm-specific assets. For example, a union shop agreement can be viewed as a bonding mechanism by which management agrees to hire only union labour as a means of safeguarding employees' investments in firm-specific human capital. This bonding mechanism limits management's ability to abrogate any previously agreed labour contract. If they do, they face the possibility of a strike (exit), the threat of which is made credible by the inability to hire non-union labour. Notwithstanding such examples, however, the threat of exit may be limited in such circumstances, in which case stakeholders may have to resort to voice as an enforcement mechanism (Hirschman, 1970).

*Voice as a deterrent.* In certain circumstances voice may be the most effective enforcement mechanism. Voice is often the least costly mechanism to adopt. Newsworthy publicity comes cheap, yet it can severely damage managerial reputations and the intrinsic value of a manager's human capital. To be effective, however, voice must be articulated by interest groups that have a

legitimate claim to represent stakeholder interests. Again, certain institutional structures such as labour unions, consumer unions, and special-interest groups arguably have this characteristic. This reinforces our earlier conclusion that interest groups can be viewed as institutional structures that have evolved to economize on contracting costs.

#### STATIC EQUILIBRIUM

In our view, due to the pervasive nature of change, much of the business system is in a state of almost permanent disequilibrium. Despite this, there is value in discussing what we would expect to find if the business system were ever to achieve equilibrium. Although this is something of an abstract and teleological exercise, such a discussion tells us something about the end towards which dynamic processes propel the system. Here we discuss the factors determining the complexity of the institutional structures that we would expect to find in an equilibrium situation; later we focus on disequilibrium.

##### *A Static Model*

If equilibrium were ever reached, institutional structures would display efficiency properties. Specifically, stakeholders would increase the complexity of institutional structures up to that point where the marginal benefits of doing so (in terms of a reduction in utility loss) were equivalent to the marginal costs of maintaining those structures (in terms of the utility that has to be sacrificed to support them). Given this, it is probable that in equilibrium managers still retain some (diminished) discretionary control over the use to which the firm's resources are put. The argument is explained with reference to figure 1.

The horizontal axis of figure 1 measures the complexity of *existing* institutional structures. The least complex structure is that of the market mechanism. More complex structures involve increasingly extensive monitoring and enforcement mechanisms. Thus, consumer watchdogs such as Ralph Nader's Consumer Watch, or the development of labour unions, can be seen as adding complexity to the institutional structures that police the management-stakeholder interface. The vertical axis measures units of utility.

A positive relationship between the complexity of available institutional structures and the costs of those structures (in terms of the utility that has to be sacrificed to support them) can be postulated. If working efficiently, the market system, because it is a decentralized mechanism, imposes the lowest costs on stakeholders. More complex structures impose additional costs. For example, ultimately consumers underwrite Consumer Watch through donations. Employees underwrite labour unions through subscriptions. Similarly, if stakeholder pressures result in certain regulations being enacted into law, ultimately stakeholders, as taxpayers, underwrite the commensurate increase in legal apparatus.

However, due to the benefits of specialization it seems likely that economies of scale in information-gathering and analysis exist. Thus, initially the costs

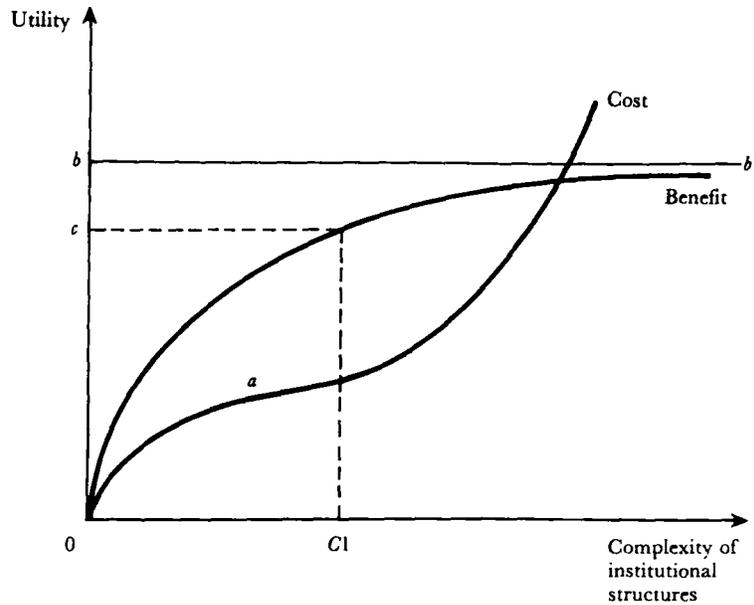


Figure 1

(in terms of utility) of maintaining institutional structures will increase at a decreasing rate with increasing complexity. This is illustrated in figure 1 where the cost function increases at a decreasing rate up to the point of inflection *a*. Past *a* diminishing returns to specialization are likely to set in and costs will increase at an increasing rate.

The benefits to stakeholders of maintaining institutional structures can be measured in terms of the *reduction in utility loss* that such structures achieve. The benefit function in figure 1 is shown to increase at a decreasing rate, symbolizing decreasing returns to increasingly complex structures; that is, increasing management resistance to reductions in their discretionary control over the use to which resources are put. Eventually, the function will approach the line *bb'*, where  $0-b$  symbolizes the total utility loss arising from an *ex-ante* divergence of interests.

The equilibrium condition in figure 1 involves the stakeholders devoting resources to increasingly complex institutional structures up to that point where the marginal benefits of such expenditures are equivalent to the marginal costs. It is worthwhile for stakeholders to bear the costs of establishing and running institutional structures of  $0-C1$  complexity.<sup>[2]</sup> Note, this equilibrium point involves a reduction in total utility loss of  $0-c$ . The remaining utility loss is equivalent to  $c-b$ . Thus,  $c-b$  represents the resources still under the discretionary control of management once the claims of stakeholders have been satisfied. The logic of our earlier arguments suggests that these resources will be devoted to investments in maximizing the growth rate of the firm.

Another way of viewing  $c-b$  is as a measure of the incentive stakeholders have to develop more efficient institutional mechanisms. More precisely, the

gross returns to innovation are equivalent to the discounted present value of  $\sum c_t - b_{t,e}$  where the subscript  $t$  refers to successive time periods. For C1 to represent a true equilibrium, the perceived returns to innovation must be equivalent to the perceived costs of innovation. The costs of innovation refer to the costs of overcoming resistance to change (in terms of the utility that must be sacrificed) and imposing new institutional structures upon the implicit or explicit contract. An example of these costs might be the costs in terms of both money and emotion to employees of supporting a strike to get their labour contract with management renegotiated. If the perceived returns to innovation are greater than the foreseeable costs, it will pay stakeholders to devote resources to the development of more efficient institutional structures. The implications of this point are developed later.

#### *Extensions*

A shortcoming of this model is that it glosses over the problems created by the conflicting claims of different stakeholder groups. Obviously, the claims of different groups may conflict (*e.g.*, stockholder demands for greater dividends conflict with employee demands for higher wages). However, on a more general level, each group can be seen as having a stake in the continued existence of the firm.<sup>[3]</sup> Where opinions differ between stakeholder groups is on how the firm's resources should be allocated between investments, and the most desirable time pattern of organizational rent streams. If the different stakeholder groups engage in open conflict over this issue, the net effect may well be to damage the firm and all involved with it (as when employees go on strike or consumers boycott its products). Thus, different stakeholder groups have an incentive to *co-operate*, rather than incur the costs of open conflict (for a theoretical discussion of this see Aoki, 1984).

An equilibrium solution to this type of problem can be found in the literature on co-operative game theory. Although beyond the scope of this article, it should be noted that it is possible to model what has been referred to as an 'organizational equilibrium' (Aoki, 1984). This is a state in which no one group of stakeholders can increase its utility without risking a higher expected loss of utility owing to the possible withdrawal of co-operation by the other stakeholders. A rational stakeholder would not disturb such a state by making a demand for greater control over how the firm's resources are invested (for a theoretical proof of this argument see Aoki, 1984).

With reference to institutional structures, the implication of such an organizational equilibrium is that each stakeholder group will adopt increasingly complex structures up to the point that is consistent with the co-operative solution. That is, no one group will attempt to establish additional institutional structures if doing so would upset the organizational equilibrium and precipitate open conflict between stakeholders.

Management's role in this process is one of an interest mediator. Management is assigned the difficult task of balancing conflicting demand so as to achieve a co-operative solution. Management is hardly a passive player, however. Management can be viewed as trying to expand its bargaining position with respect to different stakeholder groups. Under the restrictive conditions of neoclassical equilibrium, such an exercise would be fruitless.

However, an Austrian perspective of the market process leads to a very different conclusion.

#### POWER DIFFERENTIALS AND MARKET PROCESS

It was argued earlier that due to the pervasiveness of change, extensive disequilibrium is the norm. Moreover, although we view markets as being ultimately efficient, we theorized that the adjustment process is characterized by considerable friction due to inertia, the ability of managers and stakeholders to slow down adjustment by their strategic investments, and entry and exit barriers. The implication of prolonged disequilibrium is that in practice, power differentials arising from a condition of dependency between principals and agents are commonplace and may persist for some time. The advantaged party may use such differentials to further entrench its position and modify institutional structures to its advantage.

Of course, power differentials do not always work to management's advantage. For example, labour shortages arising from unanticipated macro-environmental change will increase the bargaining power of employees relative to managers, enabling them to impose tighter constraints on managers (*e.g.*, to demand higher wages, better working conditions, more extensive grievance procedures, and employee directors). Often, however, power differentials will be in management's favour. Moreover, by virtue of their position at the nexus of the implicit and explicit contracts that constitute the firm, and because of their control over the decision-making apparatus of the firm, managers may be better positioned to exploit power differentials than individual groups of stakeholders. Thus, in the remainder of this section we will focus on management strategies for establishing and/or exploiting power differentials, the implications of power differentials for institutional structures, and stakeholder responses to management actions.

##### *Establishing and Exploiting Power Differentials*

Starting with the convenient fiction that in the 'beginning there was an efficient equilibrium', disequilibrium can be seen as either the product of a firm's own innovative efforts, or the result of an exogenous shock. However created, management may try to take advantage of the resulting turbulence and uncertainty to engineer a situation in which the firm's stakeholders are more dependent on management than management is upon them. This involves undertaking strategic actions that reduce the concentration of stakeholder power and/or increase the concentration of management power.

The concentration of stakeholder power can be reduced by strategies designed to *diffuse* the control over critical resources exercised by stakeholder groups. For example, with reference to stockholders, *targeted* stock buybacks along with new stock issues may be used to reduce ownership concentration and increase shareholder dispersion. Dispersion makes it more difficult for stockholders to monitor and enforce their implicit contract with management (Berle and Means, 1932). In a similar vein, management may diffuse supplier power by developing alternative sources of supply (assuming that alternatives

are available). Management may reduce customer power by building a more diverse customer base through product and market diversification. Management may limit the power of local communities and the general public by both national and multinational diversification. And finally, it has been argued that the way in which management has organized production in the workplace and has exercised control through bureaucratic mechanisms has significantly reduced the power of employees to oppose management policies (Braverman, 1974; Clawson, 1980; Edwards, 1979).

Increasing the concentration of management power requires strategies that increase the amount of resources under management control. These include horizontal mergers and acquisitions to increase concentration within an industry, vertical integration to gain power over suppliers and customers, and co-operative agreements between the managers of different firms including joint ventures, interlocking directorates, purchasing alliances, and price leadership agreements (Pfeffer and Salancik, 1978). The common theme underlying these strategies is that they restrict the choice set of stakeholders, thereby altering the configuration of resource dependencies. For example, horizontal acquisitions increase the buying power of the firm by limiting the number of independent customers to whom suppliers can sell.

All of these strategies are undertaken to increase management power rather than maximize efficiency. Their ultimate objective is to loosen the constraints imposed by stakeholders and give management greater discretionary control over the firm's resources. Without a commensurate increase in productive efficiency, the additional bureaucratic costs of running an expanded organization or of achieving intra-organizational co-ordination imply that declining efficiency will be one result of such strategies. Thus, in an efficient market, firms that pursue such strategies will be selected out by the competitive mechanism. However, the view of competitive dynamics advocated here suggests that disequilibrium gives managers the opportunity to build such power differentials.

Of course, it is possible that the ability of managers to pursue strategies that increase management power over one group of stakeholders may be limited by the constraints imposed by other stakeholder groups. Most significantly, the board of directors (as the representative of stockholders), is in theory well positioned to limit managerial actions that it perceives as being contrary to stockholder interests (Fama and Jensen, 1983). Thus, for example, management attempts to reduce customer power by building a more diverse customer base through diversification may be blocked by the board, precisely because the board might regard such diversification as being an inefficient use of stockholders' funds.

Whether the board can impose such constraints in practice is the subject of some debate. Contrary to the argument made by Mace (1971) and others that most boards do little more than rubber-stamp management decisions, Mizruchi (1983) has presented strong arguments in support of the proposition that board control of management actions in public corporations is still possible. More recently, Lorsch and MacIver (1989) present case study evidence which suggests that among selected United States corporations, boards are increasingly exercising their control over top management teams.

On the other hand, there is also evidence which suggests that board control over top management is still relatively weak. For example, Jensen and Murphy (1990), after finding only a very weak relationship between CEO pay and firm performance, concluded that most boards may lack the power to impose stockholder objectives on management. Similarly, Burrough and Helyar (1990) have described in detail how one CEO, Ross Johnson of RJR Nabisco, handed out lucrative consulting contracts to outside directors in a successful attempt to keep them from criticizing management policies that were clearly inconsistent with stockholders' best interests. The issue of how strong boards actually are, therefore, remains an open one.

However, one factor which suggests that tighter control over management actions may become the rule rather than the exception has been the dramatic rise of financial institutions as major providers of capital. On both sides of the Atlantic pension funds, insurance companies, mutual funds, and investment banks have rapidly been replacing individuals as the main stockholders in public corporations. For example, in the United States, Hanson and Hill (1991) present evidence which suggests that among Fortune 500 companies the percentage of common stock held by institutions increased from 24 percent to 50 percent between 1977 and 1986. The growing concentration of stockholding in the hands of a relatively few institutions is resulting in the evolution of a stock market that bears little resemblance to the fragmented and dispersed market described by Berle and Means (1932). Instead, the resulting concentration of stockholdings means that financial institutions are increasingly able to exert direct influence over management actions, either through (a) the threat to sell their holdings; (b) the threat to fight proxy votes more aggressively; or (c) by using their voting power to elect their own nominees to the board of directors.

For example, in 1987 a group of financial institutions with major holdings in General Motors was able to pressure GM management into adopting a bonus pay system for GM executives that was based upon stock price performance (prior to that time, bonuses had been awarded automatically, irrespective of the company's performance). The institutions did this by threatening to introduce a resolution at the next stockholders' meeting that would be critical of management unless the company changed its bonus pay policies (Nussbaum and Dobrzynski, 1987). More generally, Mintz and Schwartz (1985) argue for and present evidence which supports the view that financial institutions play a key role in the control of large firms. Similarly, Scott (1979) concludes that large firms and major banks 'confront one another as equals, each being constrained by its controlling constellation of interests' and that 'banks are able to exercise considerable influence over the policies of major industrial corporations and so can affect what happens in companies where they have no direct power' (p. 175).

It should be pointed out, however, that to a large degree management and major financial institutions share the same agenda. Although there will undoubtedly be conflict between them, it is reasonable to suppose that in many cases management actions designed to weaken the power of certain stakeholder groups (*e.g.*, employees, suppliers, or customers), will be congruent with the interests of major financial institutions so long as they

increase the profitability of the corporation. Thus, while important, the potential for conflict between managers and financial institutions should not be overstated.

#### *The Implications of Power Differentials*

Power differentials created by the strategies detailed above limit the ability of stakeholders to enforce implicit or explicit contracts. Diffusion of stakeholder power makes co-ordination between individual stakeholders more problematic and costly, thereby reducing the ability of stakeholders to act collectively. In turn, this limits the effectiveness of voice and exit as enforcement mechanisms. It is more difficult for stakeholders to establish a credible threat when power is diffused among many individuals and collective action is difficult to achieve. Similarly, the concentration of management power reduces the choice set of stakeholders, again limiting the effectiveness of exit and voice as enforcement mechanisms.

Stakeholder diffusion also makes monitoring more difficult. Less powerful stakeholders are less able to demand that management make itself accountable. They are less able to use the implied threat to exit or exercise voice as a means of gaining access to insider information or demanding that management regularly provides them with information concerning its activities. Moreover, the pursuit of diversification strategies by the firm obscures data relating to the efficiency of individual divisions (firms only have to publish consolidated accounts). This exacerbates the information asymmetry between management and stakeholders, making monitoring more problematic.

Managers may also take advantage of power differentials unilaterally to rewrite the terms of the implicit or explicit contract between managers and stakeholders. Thus, managers may take advantage of power differentials to revoke warranties, retract hostages posted as bonds, or retract other credible commitments such reciprocal purchasing agreements, posted prices, or union shops. Similarly, management may take advantage of a temporary power differential over its employees to rewrite employment contracts. In all of these cases, the effect of power differentials is to reduce the effectiveness of existing institutional structures and to increase the residual loss that must be born by stakeholders.

#### *Stakeholder Responses*

Stakeholder responses to the creation of power differentials can be analysed by way of figure 2. This shows the marginal benefit and marginal cost curves underlying figure 1. We start the analysis by accepting the convenient fiction of an initial equilibrium solution involving institutional structures of  $C1$  complexity, a reduction in utility loss of  $0-c$ , and a remaining utility loss of  $c-b$ . The effect of a successful attempt by management to create a power differential will be to reduce the gradient of the benefit function, and hence shift the marginal benefit function down from  $MB_1$  to  $MB_2$ . In other words, power differentials limit the effectiveness of existing institutional structures and result in a reduction in the utility loss that can be achieved by stakeholders at each level of institutional complexity. The new equilibrium solution implied by this shift is to be found at  $C2$ . Thus, comparative statics suggest

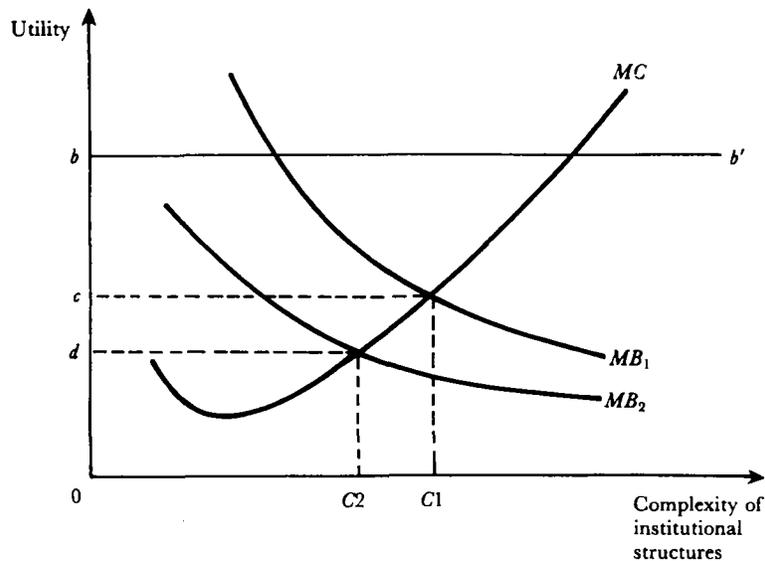


Figure 2

that when faced with an adverse power differential it pays stakeholders to reduce institutional complexity to  $C_2$  and accept an increased residual loss of  $d-b$ .

However, in a dynamic sense the existence of  $d-b$  can be seen as providing an incentive to stakeholders to find new ways of economizing on contracting costs (to develop new institutional structures). As noted earlier, for  $C_1$  to be an equilibrium position, the perceived gross return gained from the innovation of more efficient structures must be equivalent to the perceived costs of such innovation. Given this, the power shift has created an incentive to innovate equivalent to the discounted present value of  $\sum c_t - d_t$ . Our thesis is that the existence of such an incentive following the emergence of a power differential has driven much of the historical evolution of institutional structures. The evolution of labour unions, consumer unions, special-interest groups, incentive mechanisms and credible commitments, corporate regulation, and so on, can be traced back to such incentives.

For example, the development of the factory system in nineteenth-century England led to the decline of the 'putting-out' system of subcontracting and upset the balance of power that existed between those who made products to those who managed the production process, with management benefiting (Landes, 1966). Those who made products now became 'employees' and were at a power disadvantage *vis-à-vis* those who managed the process. Traditionally, craft guilds had governed the implicit contract between 'managers' and 'subcontractors'. One consequence of the shift to a factory system was that craft guilds lost their effectiveness as institutional structures, and declined dramatically in influence (Landes, 1966). Thus, the decline in the marginal benefit curve from  $MB_1$  to  $MB_2$  (*i.e.*, existing institutional structures were no longer effective). However, this shift increased the incentive that those who

made products (employees) had to develop new and more effective governance mechanisms. The response was the development of labour unions with the objective of re-establishing a condition of mutual dependence between those who made products and those who managed the manufacturing process. The effectiveness of unions was based on their ability to economize on co-ordination costs between diffused stakeholders and re-establish exit as a credible threat.

Of course, such adjustments are anything but smooth and will be resisted by the advantaged party. Indeed, there is a long history of management resistance to the development of union power following the introduction of the factory system. Moreover, the conflict between management and stakeholders following the development of a power differential can be expected to spill over into the explicitly political arena. That is, both parties can be expected to try to use the power of law to further their interests. This is hardly surprising given that many institutional structures either have a legal component or are supported by the law, but it does give us a way of explaining the selective use of Political Action Committee (PAC) money, along with more general lobbying by corporate trade associations and public interest groups. Specifically, at any point in time such monies and lobbying will be devoted to ongoing management-stakeholder conflicts, the amount of activity and money being roughly proportional to the size of the perceived power differential and the anticipated gains from either changing the system or maintaining the *status quo*.

Finally, it is important to remember that power differentials work both ways. Although we have concentrated on the benefits enjoyed by management from their control over the decision-making apparatus of the firm, and although this control probably does give management an inbuilt advantage, management may be put on the defensive by increases in stakeholder power (as may be occurring *vis-à-vis* stockholders due to the increase in the amount of stock held by financial institutions). As with management power, increases in stakeholder power have their genesis in disequilibrium conditions created either by exogenous shocks, or by innovations in the way that stakeholders do business.

#### CONCLUSION

The objectives of this article were ambitious. Taking agency and stakeholder perspectives of the firm as our starting point, we have attempted to construct a paradigm that explains certain aspects of the strategic behaviour of the firm, the structure of incentive alignment mechanisms, and the institutional forms that have evolved to police the implicit and explicit contracts between managers and stakeholders. In doing so, we have drawn on the literatures of business and society, economics, finance, and organizational theory.

The resultant paradigm, stakeholder-agency theory, can be viewed as a modification of agency theory to accommodate theories of power including resource dependence theories of organizations. Hitherto, these theories have been seen as offering mutually exclusive interpretations of organizational

phenomena (Perrow, 1986). While agency theory assumes efficient markets and rejects the idea of power differentials between managers and stakeholders, resource dependency theory (*e.g.*, Pfeffer and Salancik, 1978) implicitly assumed inefficient markets which allow for the existence of unequal resource dependencies (power differentials) between managers and stakeholders. The adoption of an 'Austrian' perspective on market processes allows us to treat notions of power and efficiency within the framework of the same model.

Following the theme of Austrian economics, we accept that markets are efficient. However, the existence of short-run disequilibrium arising from exogenous and endogenous change has been argued to give rise to temporary power differentials between managers and stakeholders. Some of the strategies pursued by managers with respect to stakeholders can be seen as an attempt to exploit and entrench these power differentials. In turn, the evolution of new incentive structures and institutional mechanisms for monitoring and enforcing the contractual relationships between managers and stakeholders can be seen as long-run market-generated responses to disequilibrium conditions and unequal resource dependencies.

Our contention is that joining together notions of power and efficiency within the same framework substantially increases the predictive power of the paradigm when compared to earlier 'theories of the firm'. Unlike earlier theories, the paradigm explicitly focuses on the causes of conflict between managers and stakeholders following the emergence of disequilibrium conditions. Stakeholder-agency theory also points the way towards a theory of the adjustment mechanisms that realign management and stakeholder interests following disruption.

#### NOTES

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- [1] There is in fact a large body of empirical evidence suggesting this is indeed the case. See Branch (1980), Bronzen (1970) and Jacobsen (1988).
- [2]  $C1$  is where the gradients of the two curves are equivalent: *i.e.* where  $d(\text{benefits})/d(\text{complexity}) = d(\text{costs})/d(\text{complexity})$ .
- [3] There are exceptions to this, however. For example, stockholders often stand to gain large profits if they sell out to corporate raiders. At this juncture, the continued fate of the firm is of little interest to them.

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