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POINT
COUNTERPOINT

Towards a Social Theory of Agency

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ABSTRACT We challenge critics of agency theory who suggest that agency theory's value does not extend outside a narrow context dominated by egocentric agents seeking only to maximize wealth at the expense of the principal. Instead, we argue that agency theory's flexibility allows for its application to a variety of non-traditional settings where the key elements of agency theory, such as self-interest, information asymmetry, and the mechanisms used to control agency costs can vary beyond the narrow assumptions implied in traditional agency-based research. We suggest that extending agency theory to diverse settings using a deductive approach can be accomplished by formally recognizing and incorporating the institutional context surrounding principal–agent (P–A) relations into agency-based models. Thus, criticisms that agency theory fails to acknowledge the social context in which P–A relations occur provides not a barrier but an opportunity for extending our understanding of P–A relations to a variety of diverse contexts.

Keywords: agency theory, corporate governance, principal-agent relations, social context

INTRODUCTION

In recent years, critics of agency theory have argued that social constraints outside the principal–agent (P–A) contract may limit agent opportunism or influence mechanisms used in controlling agent behaviour, and these are particularistic to the institutional environment in which the firm finds itself (Aguilera and Jackson, 2003; Bruce et al., 2005; Fligstein and Freeland, 1995; Lubatkin et al., 2005, 2007). In other words, these scholars argue that the nature and design of internal corporate governance is bounded by institutional context, both within and across countries. In support, these critics point to evidence indicating that in countries outside the USA, CEO pay is much less and closer to that of lower level employees (e.g. Kakabadse et al., 2004), suggesting that CEOs may be less inclined to use their position to extract more residuals from the firm, and thus the need for costly governance mechanisms is diminished. This observation has led to a call for alternative governance models that are idiosyncratic to the overarching institutional

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environment and the specific national setting being considered (Bruce et al., 2005) and acknowledge the influence of the broader social context in which P–A relations reside (Lubatkin et al., 2007).

In contrast to these critics, we make the point that agency theory does indeed have application to a variety of settings that previously have been considered infertile to an agency perspective. Thus, we challenge the critics of agency theory by suggesting that their criticisms have mistaken the largely US centred empirical applications of agency theory – which by design are context specific – with the underlying theory of agency. Distinguishing what agency theory is and is not helps reveal its adaptability to a broader set of contexts. Further, while we fully accept that applying agency theory to diverse contexts requires that we broaden our conceptions of key elements within agency theory, we argue that the underlying premises of the theory remain intact. In other words, we suggest that the limitations to the application of agency theory suggested by its critics are artificial and would be removed by incorporating an institutional perspective into agency theory, thereby giving explicit recognition to the social contexts surrounding P–A relations. Finally, we argue against an inductive approach to assessing the applicability of agency theory to diverse settings. We suggest that in trying to identify context-specific differences between P–A governance structures, inductive approaches fail to produce a theory of P–A relations that can be applied across institutional contexts. Instead we suggest a deductive approach that begins by using existing theory to build models of how institutional arrangements influence specific aspects of P–A relations within an agency framework.

CHALLENGING THE CRITICS OF AGENCY THEORY

Presuming shareholders to be the principal and managers the agent, corporate governance research has produced consistent support for the central prediction of agency theory that agents often pursue interests which depart in material ways from those of the principal (see, for example, Tosi et al., 1999, for a review). Data produced from literally hundreds of scholarly articles on agency theory and decades of governance research support the central contention of agency theory that if left unmonitored (for instance, when ownership is widely dispersed and control mechanisms are weak), agents are likely to pursue private objectives that deviate and even conflict with the goals of the principal (e.g. Devers et al., 2007; Harris and Bromiley, 2007; Tosi et al., 2000; Westphal and Khanna, 2003).

Despite the considerable evidence in support of agency predictions (see also reviews by Gomez-Mejia, 1984; Gomez-Mejia and Wiseman, 1997), critics of agency theory have argued that the theory lacks validity outside a specific social context. Specifically, they contend that agency theory relies on an assumption of self-interested agents who seek to maximize personal economic wealth while minimizing personal effort (Bruce et al., 2005; Davis et al., 1997; Lubatkin et al., 2007). Thus, their view of agency theory is that it applies only to settings in which agents (and possibly principals) hold little regard for others and have little compunction when it comes to shirking one's responsibilities (Davis et al., 1997). At the root of these criticisms is the view that simplistic assumptions about human nature preclude recognition of diverse social contexts where institutional conventions and social norms may encourage very different interests.

It is clear that some cultures encourage personal responsibility and a concern for others over self-interest. As Hofstede (1980, 1991) argued, managers are influenced not only by their jobs but also by the cultural values they bring to an organization. Among the dimensions used by Hofstede to classify the national culture is the individualism–collectivism dimension that distinguishes between people who take care of themselves (individualism) versus people who are cared for by the group (collectivism). His work has had a significant influence on the management literature with studies that range from marketing (Tse et al., 1988) to research projects (Kedia and Bhagat, 1988), accounting (Chow et al., 1997), or corporate social responsibility (Ringov and Zollo, 2007). Thus critics contend that by ignoring the social or institutional context surrounding P–A relations, agency theory lacks validity outside a very narrow setting.

While the premise of unmitigated self-interest leading to agent opportunistic behaviours reflects one tradition within agency-based research, specifically that of neo-classical economists who impose simplifying assumptions in order to satisfy computational efficiency (e.g. Holmstrom and Milgrom, 1987; Lambert, 1986; Shavell, 1979), we suggest that this heroic assumption is unnecessary for cross-institutional governance research. By abandoning this extreme characterization, agency theory provides an important analytical tool to analyse any situation that involves delegation independent of the particularistic institutional context. All that is needed is to replace this restrictive assumption by a broader and more flexible one, namely that conflict of interest between agent and principal is always a possibility because these parties may hold contrasting views about desired objectives and means–ends relations, potentially leading to actions on the part of the agent that are inconsistent with the principal's desires (cf. Mitnick, 1975). From this perspective, convergence and divergence of interests is a dynamic process since both parties may agree or disagree on key issues at different points in their relationship.

Consistent with the intellectual tradition of management scholars examining delegation issues (e.g. Eisenhardt, 1985, 1989; Gomez-Mejia and Balkin, 1992), we conceptualize agency problems in terms of limited information availability, idiosyncratic goals independently held by the principal and agent that, in combination, produces the potential for opportunistic agent behaviours including moral hazard and adverse selection. Thus, we relax the egoist notion of self-interest found in economic models and simply proclaim that individuals, both agents and principals, have socially derived interests that may or may not coincide, nor must they automatically reflect wealth maximization. That is, some agents may genuinely desire to serve the principal, while others may seek to serve a *principle* even when it conflicts with the wishes of *the principal* (e.g. military officers who, at the risk their careers, refuse to torture prisoners in direct conflict to the directives of senior leaders). Thus, agency theory only requires that there be the potential for differences between the principal's and agent's interests. More importantly, because information asymmetry exists between the principal and agent, and given the long term and dynamic nature of the relationship, it may be difficult for principals to know when an agent's interests differ from their own. Hence, some form of governance mechanisms is necessary, not because agents are universally selfish, but because it is difficult for principals to know when this occurs and when it does not, and agents may interpret what is best for the organization in a manner that differs from that of principal.

We suspect that the reason so many scholars have become critical of agency theory is that much of the agency scholarship itself has lent to these criticisms by implicitly taking a *discretism* view of exchanges between principals and agents that ignores the relational aspects of this interaction. Building on game theory and rational choice theory (cf. Bromiley, 2005; MacNeil, 2000), economists and financial economists in particular have focused almost exclusively on the design of the explicit contract between the agent and principal and how specific elements of the contract constrain or encourage certain agent behaviours. This has led to a concern with the efficient designs of private governance mechanisms to the exclusion of publicly available mechanisms (such as social norms) that could also play a role in controlling agency costs. That is, by focusing on the contract's design, much of the agency-based research has given minimal attention to the broader social fabric that defines the nature of that contract as well as how agents may respond to it.[1] We contend that because of this orientation, most applications of agency theory have taken a calculative view of transactions between principals and agents and therefore have focused on how quantifiable elements of the contract impact performance outcomes or governance costs[2] (MacNeil, 2000). Although this focus on the contract does contribute to our understanding of P–A relations, it also fails to consider the role of the broader social matrix or context surrounding that contract. For example, it is this social context that may lead transacting parties to give greater weight to factors that do not have directly quantifiable aspects, such as reputation, personal satisfaction, guilt, shame, honour, trust, and so forth (Lubatkin et al., 2007).

Thus, we agree with the critics in one sense, which is that much of the agency-based research has focused on the efficiency of specific contractual designs for controlling moral hazard within P–A relations, and thus have largely overlooked institutional influences on the nature and incidence of moral hazard. This has left a critical disparity in our understanding of how institutional arrangements and social context may affect governance design and efficiency. That is, P–A models based on Jensen and Meckling's (1976) view of agency theory have neglected the fact that transactions are socially embedded and thus have ignored the implications derived from formal recognition that these transactions reside within broader institutional contexts. However, the failure of prior research to fully embrace an institutional or social perspective should not be viewed as a restriction on the applicability of theory, but an opportunity to extend the theory by formally incorporating these perspectives into the theory. Doing so, we contend, will generate new P–A models and predictions that apply to diverse contexts previously thought to be inhospitable to an agency point of view.

TOWARDS A SOCIAL THEORY OF AGENCY

Although the relation between the nature of P–A relations and the development of and investment in governance mechanisms such as board monitoring or incentive alignment has been extensively discussed in the agency literature (for a review, see Gomez-Mejia and Wiseman, 1997), the contextual antecedents to P–A relations have received inconsistent attention.[3] Yet it would seem important to understand how these contextual antecedents influence the specific manifestations of agency problems as a way of enhancing our explanations for why governance structures appear to vary across social contexts (Aguilera and Jackson, 2003, 2010; Fligstein and Freeland, 1995). One model that shows promise in leading towards a more socialized agency theory is provided by Doney et al. (1998, p. 601), who propose linking cultural dimensions (e.g. power distance, individualism/collectivism, and risk orientation) to the development of interpersonal trust. Hence, improving our understanding of how P–A relations are embedded in a particular social context should enhance the explanatory power of agency theory outside of the traditional contexts in which it has been applied.

As a first step towards creating a social theory of agency, we begin by accepting the core insight of sociologists that economic behaviour is shaped by social mechanisms not just at the margin, but also at the core. That is, social mechanisms influence the conventions defining the various roles we inhabit (including that of agent and principal), as well as how we interact with one another. These mechanisms entered the lexicon, according to Dobbin (2004), under the terms *institution*, *cognition*, *network*, and *power* (see Figure 1). Within each of these mechanisms we can identify a variety of aspects of society that appear to play a role in how agents and principals see themselves, their interests, the nature of the problems that are likely to arise from their interactions, as well as the

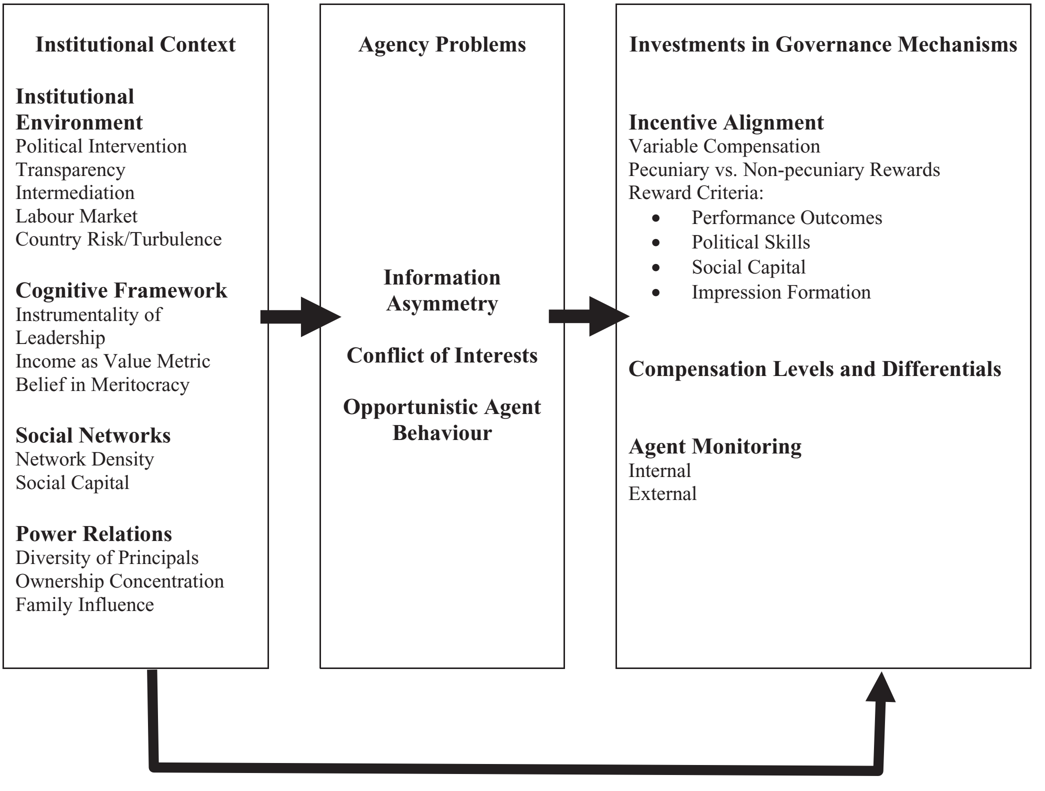

Figure 1. Institutional contexts and their effect on agency problems and investments in governance mechanisms

mechanisms devised to control these problems. Unlike sociologists, however, who have approached the interplay of society and economics from an inductive perspective, we adopt a deductive approach more common to economists. We favour the deductive approach because it provides the best opportunity for building a generalizable theory of governance that is not simply a reflection of characteristics idiosyncratic to one social–political context. Thus, we argue for the development of a social theory of agency as a first step towards understanding how P–A relations may vary across social contexts, which in turn can vary both across and within national boundaries.

The basic idea summarized in Figure 1 is that as long as delegation is involved, agency problems (information asymmetry, conflict of interests, and opportunistic agent behaviour) are universal, even though the explicit manifestation of these problems and ways to deal with these problems may vary depending on institutional context. Thus, for instance, information asymmetry in a highly centralized economic system (such as the old Soviet Union) may mean that plant managers would produce low quality goods in order to meet the established quota for their respective plants. Conflict of interests in a society ruled by a religious minority may translate into agents making choices for their units that differ from established dogma. And opportunistic agent behaviour may not involve personal financial gains at all, but rather the desire to acquire more power or to pursue a particularistic agenda (such as investing in social projects because of moral convictions that this is the right thing to do). Given that most of the agency literature has emanated from the United States, these agency problems have generally been portrayed in terms of CEO entrenchment, excessive CEO pay, risk minimization by top management and the like when executives enjoy substantial discretion (Gomez-Mejia et al., 2011a). But clearly issues of information asymmetry, conflict of interests, and opportunistic agent behaviours are universal concerns in any delegation situation, even though their specific manifestations may take a multitude of forms. The same can be said for the control systems to deal with these agency problems. Thus, for instance, incentive alignment in some contexts may not involve financial rewards at all but rather the provision of such non-pecuniary rewards to agents as greater political visibility, the ability to place relatives and friends in key positions, and affect-related utilities (or 'socioemotional wealth'; Berrone et al., 2010). We now turn our attention to the role of institutional environments in shaping the nature of agency problems and control systems to deal with them.

Institutions (Institutional Environment)

For sociologists, institutions reflect the conventions of a society, often defined by law (Dobbin, 2004). Thus, government represents an institution that prescribes certain practices while circumscribing others. Recognizing this, we suggest a theory of government that could be used to explain differences in P–A relations by focusing on government's role in promoting and controlling economic exchanges. Clearly economic and political institutions are inextricably intertwined (e.g. North, 1982), although from the perspective of theory development it may be important to disentangle them in order to derive more precise and generalizable predictions about how political and economic institutions may individually and separately influence the nature of agency relations.

Although several studies on agency relations have considered the role of political institutions, few have recognized that political institutions play distinguishable and to some extent opposing roles in an economy. On the one hand, political institutions promote economic exchanges by supporting an infrastructure of intermediation that increases the transparency of economic transactions and reduces the risk to transacting partners. Political institutions support intermediation and thus transparency by (a) providing the third party enforcement of contracts through an impartial judicial system, (b) collecting and disseminating financial information about transacting parties, and (c) setting and enforcing standards on independent institutional players providing and sanctifying such information including auditors, stock analysts, brokers, and so forth. The resulting transparency reduces information asymmetry between transacting partners, thus lowering transaction costs of economic exchanges and making them more likely to occur. For example, Marshall and Weetman (2002) find that the regulation of financial reporting reduces information asymmetry and thus the monitoring burden born by principals, because in this fishbowl-like environment agents are less tempted to act opportunistically lest they damage their reputation and thus their career value. Building on this argument, we speculate that increased transparency should foster more stewardship behaviours among agents. In turn principals, sensing lower risk of agent opportunism, may provide the agent with greater freedom of action and larger rewards for effort. Further, agents may respond to the relaxation of governance with greater commitment to fulfilling their responsibilities (Davis et al., 1997). That is, transparency can engender reciprocity between principals and agents, thus reducing the risk of moral hazard (cf. Irlenbusch and Sliwka, 2005).

On the other hand, political institutions simultaneously regulate economic exchanges by circumscribing and even preventing certain types of economic transactions from occurring. That is, political institutions also limit exchanges deemed socially undesirable (e.g. insider trading, loan sharking, tontines). This form of political intervention constrains managerial autonomy; the agent is faced with a powerful stakeholder having a political/social agenda that may hamper the agent's ability to satisfy other stakeholders, including the principal (Finkelstein and Boyd, 1998). These constraints could come not only by government regulation but also by government involvement in the corporate governance of individual firms through ownership and board ties (Okhmatovskiy, 2010). In looking at Italian utilities, Rienzner and Testa (2003) found that rapidly changing government regulation and policy severely burdened managerial decision making. Similarly, Finkelstein and Hambrick (1990) and Hambrick and Finkelstein (1987) suggest that in highly regulated industries (which are more subject to political meddling), managerial discretion is lower than in less regulated industries. For example, banking regulation in the USA long limited savings and loan financial institutions to home mortgages and pass-book deposits, and prevented retail banks from engaging in investment banking operations. Following the removal of these regulations, agency costs rose considerably in the Savings and Loan industry during the 1980s (Kane, 1989; White, 1991; Wiseman and Catanach, 1997) and in the retail and investment banking industry during the early 2000s (Demyanyk and Hemert, 2008). During a highly regulated environment, lower managerial discretion translates into less use of variable compensation, with executives receiving fixed salaries that are not linked to profitability. These executives can be easily dismissed, for actual or alleged incompetence, in response to pressures from regulatory commissions. In a study of the US thrift industry, Wiseman and Catanach (1997) found that principals relied on government regulatory authorities to monitor agents, and that deregulation left a void in agent monitoring that principals often failed to fill.

Beginning with a theory of government's role in private economic exchanges, one can then develop generalizable models of agency that examine how the different forms of political intervention vary and ultimately influence economic exchanges such as those between principals and agents (for an exception, see Bushman et al., 2004). It is our view that taking this deductive approach allows for the development of finer grained and more generalizable models of agency than can be derived from comparative inductive approaches. That is, simply comparing the average governance structure under one government system (often simply characterized by its philosophical or historical foundation) with the average structure under a different government system obscures the subtle differences within each setting. Beginning with a theory of institutions should also open new directions for research by providing new questions about the sources of moral hazard and its likely resolution.

Cognition (Cognitive Framework)

Cognition refers to the psychological process by which societal members make sense of the world. Thus it captures the beliefs that society uses to understand, interpret, and even generate experiences (e.g. false memories). So, the belief that leadership matters (what Meindl et al., 1985, dubbed the romance of leadership and others have called a heroic view of leadership) implies an assertion that individual executives can provoke large differences in how organizations perform. That is, some cultures strongly believe that top executives can and do have a major impact. This is especially true of the United States (for examples, see Jacobson and House, 2001; Shamir et al., 1993). This heroic view of leaders may correspond to higher absolute pay. In this line, Khurana (2002) and Tosi et al. (2004) find that perceived charisma is often used by boards in the United States to gauge and reward CEO success.

Similarly, in cultures where pecuniary rewards are important, CEOs make social comparisons of their achievements by devoting close attention to how their pay stacks up against that of other CEOs (Crystal, 1991). There is substantial evidence in the United States and England supporting this view (e.g. Eriksson, 1999; Ezzamel and Watson, 2002; Henderson and Fredrickson, 2001). In other cultural contexts, metrics other than money (such as official titles, wide media exposure, honorary appointments to prestigious universities, participation in key national committees on industrial policy, being portrayed as the embodiment of a set of moral or ethical values, and the like) may be used to determine one's value. In many Latin and Asian societies, high executive compensation packages may be seen not as symbols of personal success but as signs of avarice and hidden corruption (see Ibanez, 2005). In France, high compensation differentials between top and lower organizational levels of the order often seen in the United States would be regarded as shameful (Cala, 2005). These social values may explain why CEO compensation in most other countries (even after controlling for firm size, performance, industry, and per capita income) is only a fraction of what is paid to CEOs in the United States and England (Gomez-Mejia and Wiseman, 1997).

While there are valid reasons for comparing beliefs and values at the national level, such as those regarding the importance of leadership, pecuniary rewards, and social capital, at the national level (e.g. Spence et al., 2003; Sporer, 2004; Thompson and Yurkutat, 1999), there are also reasons for looking more deeply and considering within-country differences in these dimensions (cf. Brockner, 2003). For example, Parsons (1951) found that people living on the west coast of the USA preferred affective oriented people, while those living on the east coast preferred people who are more neutral in their disposition towards others. Mueller and Clarke (1998) provide another example in suggesting that difficulties in adopting US-style incentive systems in Central and Eastern European countries are based not only on differences in national cultures (characterized as more collectivistic in Central and Eastern Europe vs. individualistic in the USA) but also on differences in the social context within the countries. Although managers in former socialist countries have been instilled with a spirit of cooperation and benevolence towards the enterprises for which they work, younger citizens, particularly university students, have developed a sense of entitlement that leads them to favour their own interests, even at the expense of others in an organization. Brodbeck et al. (2000) describe similar cultural differences in leadership across Europe. Liberman (2001) also found that individuals' role expectations in a multinational enterprise differ not only across European country-units (suggesting influences of local cultures and other societal forces) but also between managers and employees (independent of country-office).

Building on a theory of culture that recognizes within country differences can only improve the predictive validity of comparative governance models by reducing the measurement noise created when social beliefs are measured using country-wide averages without regard to the degree of variance in beliefs within each country. To do so, however, begins with a theory of culture that provides a means for examining the cultural orientation of individual agents and principals. Although cultural differences between nations may be significant when measured in the aggregate, within nation variance tends to be large enough to undermine generalizations that link specific P–A relations to national culture (e.g. Mueller and Clarke, 1998).

Other directions for the elaboration of agency theory are found in research examining the unionization of labour, property rights of capital, managerial ideology, and consumption versus production cultures, to name but a few (Aguilera and Jackson, 2003; Dobbin, 2004; Rubach and Sebora, 1998; Smart, 2003). All of these provide interesting avenues for examining the potential for moral hazard risk. Rigorously examining these influences can not only provide insights into how P–A relations may vary, but also may help answer questions about how to design contracts that minimize the costs of governance while encouraging greater cooperation between principals and agents to maximize their joint utility. That is, recognizing how moral hazard risk varies across contexts may provide an additional explanation for why governance practices appear to vary across these contexts. In pursuing these lines of research, we may find that governance design is as much a response to the nature of the moral hazard problem as it is a consequence of cultural and legal constraints on P–A contract design. Indeed an analysis of moral hazard as reflective of institutional arrangements outside the P–A relation opens a new path of investigation into the efficacy of governance design.

Social Networks

Networks are institutions from which we learn and shape our identity (Durkheim, 1978). Networks occur at multiple levels of analysis that may or may not span firm and industry boundaries. At the organizational level, firm performance can benefit from the network ties of organizational members through their access to information and resources. For example, interlocking board memberships provide access to knowledge from multiple sources that can aid in addressing organizational contingencies (Galaskiewicz and Wasserman, 1989), or specific experiences and beliefs about strategic or structural changes (Betthenhausen and Murninghan, 1985; Haunschild, 1993; Palmer et al., 1993; Westphal et al., 2001).

A network's density, measured as the number of ties between actors in a network (Coleman, 1988), may influence the nature and potential for moral hazard. Network density removes roadblocks to the flow of information, thus making information widely and easily available to all members. Also, it encourages greater cooperation among network members. Since interactions among members in dense networks are likely to be observed by all other members, dense networks encourage reciprocity (Coleman, 1990) and increase the costs of defection and opportunism. Okamura and Vonortas (2006) note differences in the networking behaviour across industrial sectors, such that knowledge networks predominate in pharmaceutical sectors and alliance networks predominate in computers, electronics, and instruments. In this context, Gopalakrishnan et al. (2008) also found that the extent of financial capital that biotech firms acquire upon alliance formation was positively related to the level of familiarity across the allying partners. Thus, the degree of social network density would seem to play a role in reducing information asymmetry (Fjeldstad and Sasson, 2010) as well as increasing social pressures on agents and principals to limit opportunistic behaviours (Nielsen and Nielsen, 2009). As a result, principals do not need to invest as much in incentive alignment systems and internal monitoring mechanisms, but instead can rely on less costly and more efficient mutual monitoring by network members.

Exploring the social networks surrounding principals and agents using theories of network density, structural holes, and the creation of social capital (Burt, 2004) may open new avenues for gauging the likelihood of moral hazard and the necessity of establishing governance mechanisms to control agency costs.

Power Relations

Power represents our ability to shape our world. Focusing on the power of principals, we can examine how differences in governance structures are related to ownership concentration, or the nature of the principal (cf. Dixit, 1997). Ownership concentration and the power of particular stakeholders grow in tandem, since those with high ownership interests may impose their goals on the firm and agents are likely to be rewarded and/or dismissed according to the achievement of those goals. Even if we were to assume that agents are uniformly risk averse, as many agency models do (for an exception, see Wiseman and Gomez-Mejia, 1998), executives would be disciplined by principals if they pursued low risk/low return strategies (Hill and Phan, 1991).

Furthermore, as ownership concentration increases, principals are less likely to share residuals with agents, since such payments would occur largely at the expense of particular shareholders. In accord with these arguments, studies by Tosi and colleagues (Gomez-Mejia et al., 1987; Tosi and Gomez-Mejia, 1989, 1994; Tosi et al., 1999, 2004; Werner and Tosi, 1995) as well as others (David et al., 1998; Hambrick and Finkelstein, 1995; Khan et al., 2005; McEachern, 1975) find that high ownership concentration tends to be associated with lower agent compensation, a closer linkage between agent pay and firm performance, and more vigilant monitoring of the agent's decisions. In other words, as ownership concentration increases, incentive alignment and monitoring serve as complementary (rather than alternative) mechanisms of agent control (Tosi and Gomez-Mejia, 1989).

Regarding the nature of principals, Dixit (1997) pointed out the problem of heterogeneous principals, arguing that in many countries managers are supposed to be responsible not merely to shareholders, but to a more varied collection of stakeholders (such as workers, creditors, the local community, and so forth), provoking a politicization of corporate governance. In Germany, for example, labour unions and bankers have been granted formal authority over management that rivals the control by shareholders (Bruce et al., 2005). In many Arab countries, religious figures often sit on bank boards to ensure compliance with Muslim law, which proscribes certain lending practices (Abdulrahman et al., 2002; Rice, 2003). Although this situation may have its roots in legal requirements for governance, there is reason to believe that the presence and involvement of multiple principals with divergent interests should not be restricted to countries that require this involvement. Instead, we should look individually at firm practices and how different ownership structures influence governance designs. Accordingly, Young et al. (2008) suggest that although each emerging economy has a corporate governance system and creates informal mechanisms to deal with the specific 'weak governance' environment, all of them are characterized by conflicts between the controlling and minority shareholders in the firm. Known as the 'principal–principal model', recognizing the potential conflict among principals requires remedies different from those that assume unified interests among principals where shareholder wealth maximization is the most important, if not the only relevant, objective. Examples of firms that have involved non-traditional stakeholders in their internal governance structures (e.g. the Milwaukee Journal, Chrysler, Eastern Airlines, and Pan American each had union members sitting on their boards at one time) can be found in the USA as well, though this practice runs contrary to typical governance practice in the USA. Even within what are often considered a uniform investment group such as block-holders, the US government's Securities and Exchange Commission distinguishes between active (SEC code 13D) and passive (13G) investors.

This brief review of the literature on the role of principals suggests two things about governance mechanisms when the primacy of a single stakeholder is in question. When agents must satisfy multiple and diverse, often conflicting demands, performance criteria will be more ambiguous. In addition, the provision of managerial incentives and the design of a control structure require consideration of the utilities of all stakeholders, not only those who have ownership rights over the firm (cf. Tirole, 2001). Hence we would expect less use of contingent or variable pay, since it is difficult to find a common performance denominator that meets the need of all principals. Second, given that the reporting relation is not clear in the presence of several different principals, we suspect that the monitoring process is likely to be politicized.

This would encourage a more internal monitoring process using supervisory bodies that reflect the composition of external stakeholders. Under such circumstances, a key task for the agent will be to engineer compromises among principals, and the agent's evaluation is likely to hinge on convincing various parties that his/her choices best optimize the interests of all. Thus it would be advisable to develop a theory of principals, possibly built on a stakeholder view (Donaldson and Preston, 1995) in order to capture the nature of principal involvement at the firm level if we are to improve the explanatory power of models of P–A relations (e.g. Tribo et al., 2007).

In addition, family ownership itself can be further defined to reflect the dispersion of ownership among family members, and this dispersion has been argued to influence the nature of governance and risk of moral hazard (e.g. Miller and Le Breton-Miller, 2006; Schulze et al., 2003). Given that family ownership and influence over the firm's affairs varies widely (La Porta et al., 1999), it seems reasonable that the nature of the agency contracts and forms of moral hazard should vary accordingly. Several studies have pursued this line of thought and have provided several new directions for understanding the role of family ownership on moral hazard and governance design. For example, Gomez-Mejia and colleagues (Cruz et al., 2010; Gomez-Mejia et al., 2001, 2003, 2007) found that concentrated family ownership is associated with higher dismissal of non-family executives when performance drops, greater tie of non-family executives' pay to firm performance, less trust in non-family executives, stronger emphasis on the non-family executive's fit with family values as an evaluation criterion, and lower pay for family than non-family executives. Other studies find that, in such firms, families fill the void of board control (Lubatkin et al., 2005; Schulze et al., 2001), and performance criteria applied to the agent include not only a fiduciary role, but also the ability to satisfy family needs (e.g. hire family members over better qualified applicants, work effectively with family members, act altruistically towards family members, and the like) (Casson, 1999; Lubatkin et al., 2005; Schulze et al., 2001). As Gomez-Mejia et al. (2007) suggest, owner-managers willingly sacrificed firm performance in order to protect what they called 'socioemotional' wealth or what others have referred to as 'familiness' (Habbershon et al., 2003). Likewise, Gomez-Mejia and colleagues (Berrone et al., 2010; Gomez-Mejia et al., 2010, 2011b; Jones et al., 2008) find strong evidence that family principals are often driven by non-economic objectives, and this is reflected in such strategic choices as lower diversification, less pollution, culturally-related international expansion, and lower research and development expenditures. Until very recently the agency literature has neglected the special role of family principals in the pursuit of non-economic objectives, even though the vast majority of firms around the world are controlled by families (La Porta et al., 1999).

What this brief review suggests is that family ownership represents a unique context in which to view P–A relations. Thus developing a generalizable theory of principals in which family ownership is given prominence (e.g. Lim et al., 2010) could provide a first step towards understanding P–A relations across various institutional contexts in which ownership is held by founding family members.

IN SUPPORT OF A DEDUCTIVE APPROACH

As our review of these various institutional influences suggests, our perspective differs from some comparative governance research that contrasts governance practices between nations and then develops arguments linking unique political or economic characteristics of each nation to the governance mechanisms typically found in that nation. For example, Aguilera and Jackson (2003) compared typical governance mechanisms in the USA with those of other countries and suggested that differences in political and economic systems may account for the differences in these mechanisms. Elaborating on their findings, they argued that agency problems may be constrained by idiosyncratic political institutions (e.g. Germany's requirements regarding board of director membership) or the idiosyncratic nature of the local economy (e.g. Japan's patient capital markets) such that agency problems may be constrained under certain economic and political regimes. However, their arguments reflect an inductive approach that attempts to match different forms of corporate governance to idiosyncratic elements of political or economic institutions unique to each country. Indeed, in a subsequent review, they continue to advocate a case-based historical orientation that adopts, in their words, an 'actor-centred view of institutions' in order to understand the integrated nature of institutional arrangements unique to different social settings (Aguilera and Jackson, 2010, p. 529). It is our view that this approach to understanding P–A relations fails to yield a useful theory of agency. Instead, we advocate a more deductive approach in which we develop theory a priori to explain how specific institutional dimensions may influence the nature and incidence of moral hazard through their roles in reducing or increasing information asymmetry and by directly encouraging or discouraging cooperation between principals and agents. Thus, the intellectual challenge we face is to specify how the presence of certain institutional dimensions, theoretically derived, predict observed agency problems across various settings.

Towards this end, we extrapolate from this review of institutional factors to suggest possible predictions about how P–A relations may vary across different institutional arrangements (see Table I). These predictions are meant to suggest avenues for future theory development. It is our intention to encourage scholars in the development of a socially embedded theory of agency as a precursor to examining the nature and variety of P–A relations found across global contexts.

Socially Embedded Nature of Principal–Agent Contracts

Clearly, P–A contracts are socially embedded such that differences in the institutional social contexts surrounding the P–A relation can affect the nature of moral hazard, the form of governance that is used, and even the goals that agents and principals seek. Thus, we agree with Aguilera and Jackson (2010, p. 532) who argue that actors differ across different institutional contexts and that to fully understand how institutions shape

Table I. How P–A relations may vary within different institutional arrangements

Institutional context		*Agency behaviour and investments in governance mechanisms*
Institutional environment	Transparency intermediation	The higher the level of intermediation and transparency: (a) the less likely agents will act opportunistically; (b) the more likely agents' appraisal and rewards will be tied to performance information provided by external markets; (c) the lower the resources devoted to internal monitoring systems and the greater the role of independent observers or intermediaries in appraising and rewarding agents' performance.
	Political intervention	The higher the political intervention: (a) the lower the variable pay mix and pay-for-performance sensitivity; (b) the lower the use of performance criteria based on financial outcomes – on the contrary, the emphasis will be on the agent's political skills; (c) the greater the role of external monitors with strong political connections in rewarding or disciplining executives.
Cognitive framework	Instrumentality of leadership Income as value metric	The higher the romance of leadership and the importance attached to pecuniary rewards: (a) the greater the proportion of residuals an agent will extract from a firm in the form of larger pay packages; (b) the greater the compensation differential between CEOs and people at other organizational levels; (c) the more likely that agent pay will be associated with impression formation criteria such as perceived charisma, and individual's reputation.
Social networks	Network density	The higher the density of social networks surrounding P–A relations: (a) the lower the information asymmetry between principals and agents; (b) the less likely that agents will act opportunistically; (c) the more likely that principals will defer to the social network to monitor the agent's behaviours and deemphasize formal controls.
Power relations	Ownership concentration	The higher the ownership concentration: (a) the lower overall agent compensation in relative terms; (b) the more likely incentive alignment and monitoring will be used in a complementary fashion; (c) the more agents will be held accountable for observed firm performance outcomes; (d) the higher the use of internal monitoring because benefits to principal outweigh costs, and the principal has both the interest and the ability to monitor the agent's behaviour.
	Diversity of principals	The greater the number of different principals: (a) the lower the use of variable pay linked to performance criteria, since there is less agreement among principals on which performance criteria to use; (b) the more likely that agent monitoring will be conducted internally through formal bodies that represent multiple stakeholders; (c) the more likely that agents will be rewarded according to their ability to identify and enforce political compromises among principals with conflicting objectives.
	Family influence	The greater the role of family ownership in controlling business interests: (a) the lower the family agent's compensation in relative terms; (b) the higher the non-family agent's pay-for-performance sensitivity; (c) the more likely that non-financial criteria will be used to evaluate agent performance; (d) the higher the use of internal monitoring.

identities, interests, organization, and strategies we must recognize 'the socially embedded nature of actors, actor constellations, interests, and power relationships'. However, taking social 'embeddedness' too far is as problematic as ignoring it altogether. As Granovetter (1985) argues, were we to assume that individual behaviour is simply a reflection of social norms and values, we would simply be replacing wholly idiosyncratic utility functions with functions that are wholly socially imposed.

In between these extremes is, in our view, a more fruitful approach that we contend will enhance rather than obstruct the application of institutional perspectives to elucidate relations involving delegation, particularly at the top executive level. There is no need to assume, as economists usually do (see Jensen, 1998, for an exception), that agents are driven to maximize their pecuniary benefits and reduce their employment risk at the expense of principals so that in the absence of tight controls opportunistic behaviours are a given. Nor should we assume that the offering of incentives to agents is automatically insulting. A more meaningful position is some middle ground in which social context imperfectly intercedes in P–A relations. This point suggests that utility is dynamic and contrasts with many agency theorists and their critics who debate the nature of agent utility. If agent utility is dynamic then divergence of interests, though not assured, is always possible. That is, institutional contexts irregularly penetrate economic relations; hence their influence on P–A relations is incomplete. While descriptions of the various contexts that surround a P–A relation provide us with important clues about how specific features of the P–A relation might differ across these contexts, they should not be viewed as deterministic. By formally viewing P–A relations through a theory-driven institutional lens, we can explore the various manifestations of agency problems that might arise as well as the mechanisms that might be used to control them. This goes beyond simply classifying governments by the origins of their legal system (e.g. Common Law versus Napoleonic Code), and instead takes a fresh and more precise look at how different governmental roles and actions influence the nature and even the necessity of private governance mechanisms.

In sum, our view is decidedly deductive in that it begins with established theories and then blends these theories into an agency framework. As noted by Bacharach (1989, p. 498), the primary goal of a theory is to answer the questions of how, when, and why; unlike the goal of description, which is to answer the question of what. In pursuit of this last goal as it regards P–A relations we combine an institutional perspective with agency theory to develop a social theory of agency. The danger that we must consider, however, is that an over reliance on characterizing different institutions as a general background to explaining observed differences in P–A relations is that one might end up with particularistic descriptions that do not allow other researchers to predict how, when, and why such relations occur. Such an approach also lacks other important aspects of a good theory, namely universality (specification of the substantive relationship among the construct across a wide variety of settings), abstraction (positing broad constructs lacking in observational detail, but that may be manifested in different ways depending on the specific context in which the theory is being applied), and parsimony (the ability to simplify reality in order to better understand the phenomenon in question and allow for testable hypotheses with greater overall explanatory power) (Hage and Meeker, 1987; Nagel, 1961; Van De Ven, 1989). The coupling of agency theory with complementary theories, as others have done previously (cf. Wiseman and Gomez-Mejia, 1998), sets the stage for a richer understanding of the genesis and nature of P–A dynamics.

CONCLUSION

Much of the criticism of agency theory in the management field and related social sciences reflects a long-standing disagreement with economists' reductionist view of individual behaviour as atomistic and utilitarian, a view in which all individuals are assumed to exhibit unique self-interest (Durkheim, 1978). This oversimplification of reality has served financial economists well, allowing them to develop elegant mathematical models that specify maximization conditions for the parties involved subject to some constraints. But this modelling convenience is not isomorphic with agency theory. We contend that this narrow interpretation of agency theory focuses on the most pejorative view of human nature, which many management scholars find as repugnant and some see as promoting a self-fulfilling egotistical economic logic in business school training that is detrimental to organizational citizenship and incompatible with the values of collectivist societies (see, for instance, Ferraro et al., 2005). Instead, we accept that individuals could differ in their goals but that these differences may or may not result in agency costs for principals. Granted this, however, the principal may never know the full extent to which interest divergence, convergence, and opportunism are present at a particular moment in a dynamic principal–agent relationship. This is a neutral, amoral universal statement applicable to delegation in any institutional context and which holds true even if both parties firmly believe that they act appropriately, honourably, and in good faith. Further, even when there is strong social pressure to conform and general agreement on values, individual differences are still likely to manifest, resulting in the need to enact some forms of governance, even in the most uniform of societies.

Thus we suggest that agency theory predictions are not as restrictive as some critics contend. On the contrary, it is because agency theory abstracts from specific social factors that the theory can be generalized to a variety of settings. Agency theory builds from two axioms: (1) individuals have idiosyncratic goals; and (2) principals and agents have imperfect information about each other. Defining these goals and understanding the nature of information asymmetry can only be understood through the social context surrounding the P–A relation. By formally recognizing the broader social environment, we can improve our understanding of agency problems, by recognizing that the nature of agency problems may vary from those initially envisaged by modern agency scholars. The nature of moral hazard and how it is mitigated may change, but the potential for this risk to arise within a P–A relation remains. Because agency theory is independent of any institutional context, it is possible to incorporate an institutional perspective into agency theory, thus giving it greater generalizability than suggested by some scholars. By viewing agency within an institutional context, we suggest it has sufficient universality, abstraction, and parsimony to help us better understand how, when, and why moral hazard arises.

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NOTES

[1] We acknowledge that attempts have been made to recast contracts as learning mechanisms (e.g. Mayer and Argyres, 2004) and recognize the role of other stakeholders (e.g. Freeman et al., 2004), but these efforts have yet to penetrate the core governance literature.

[2] Two exceptions are the social network examinations of boards of directors, and the studies focusing on the social dynamics between agent and principal (e.g. work by James Westphall and Edward Zajac). But this work is atomistic in that it fails to spring from an overarching theory of principal–agent contracts that explicitly incorporate relational aspects.

[3] Aguilera and Jackson (2010) provide an excellent review of how the comparative corporate governance literature has examined the association between international contexts and various aspects of corporate governance.

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