TRANSACTION FREQUENCY, INSTITUTIONAL CONTEXT AND THE AGENT-STEWARD CONTINUUM

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ABSTRACT

We revisit the issues of corporate governance and conceptualize the agent-steward argument as a continuum rather than a dichotomous theoretical framework by incorporating a multi-period model and considering the efficiency of institutional environment in which the organization is located. We argue that in the context of recurrent transactions coupled with efficient legal institutions corporate governance issues will be mainly resolved. In contrast, weak institutional environment and occasional transactions represents the classic spot market like situation with high agency costs. Our argument shows that a generalized neoclassical model can illuminate the sociological perspective of managerial behaviour. We deduce that reputational concerns in recurrent transactions are of greater importance than strength of institutions to resolve governance issues.

Keywords: *Corporate Governance; Agency theory; Stewardship theory; Institutional context; Transaction Frequency*

INTRODUCTION

During 1980s and 1990s *corporate governance* became the favourite term of regulators, the press, financial institutions and shareholders in developed economies. The WCG and Enron scandals in advanced market economies with strong regulatory institutions or the accounting fraud of *Satyam* in India with weaker institutions emphasized the need to revisit issues of corporate governance beyond the boundary of the firm and consider the institutional context in which the organization is located.

The neoclassical economics literature conceptualizes corporate governance problems as conflicts between different stakeholders, such as owners-versus-managers, debt holders-versus-equity holders, and controlling-versus-minority shareholders. The focus was on how suppliers of finance to firms ensure getting full return on their investment (Shleifer and Vishny, 1997). The Principal-Agent paradigm was the dominant theoretical framework for this stream of research. Agency theory explores the conflicts of interest as well as differing predispositions toward risks of different stakeholders and attempts to resolve the issues by offering *static equilibrium models* (Lazonick and O'Sullivan, 2000) of efficient contracts and incentive alignment. The focus was on minimizing the costs associated with an agency relationship. Empirical evidence is mixed at the best.

The sociology stream of research challenged the negative connotation associated with agent autonomy. They emphasized the differences between the institutional contexts of Western and Japanese firms and proposed the role of managers as *steward*. Even within the institutional context of developed economies agency theory offers limited view of major issues such as conglomerate diversification, since it fails to explain why there was a surge in restructuring of conglomerates in the US during 1980s but not earlier. The institutional context of the US in 1980s marked by predominance of security analysts provides an answer to this (Zuckerman, 2000).

This paper analyzes the corporate governance problems in a multi period model as well as the institutional context in which the players are situated. We found in a generalized neoclassical model reputational concerns of actors in recurrent transactions are of greater importance than strength of institutions to resolve corporate governance issues. Most importantly we showed that agency-versus-stewardship argument is two extreme ends of corporate governance and this is more like a continuum rather than dichotomous theoretical perspectives.

CORPORATE GOVERNANCE: EXTANT LITERATURE AND LIMITATIONS

Agency theory is one of the most influential economic theories in corporate governance, in its simplest form discusses the relationship between two peoples, a principal and an agent who work or makes decision on behalf of the principal. Agency theory assumes if both principal and agent are utility maximizers, then it’s possible that the agent will not always act in the best interests of the principals. Agency theory explores corporate governance issues both within the firms (traditional manager and subordinate relational) and between firms (in the case of licensing or franchising). The main argument is welfare of the principal may not be maximized because the principal and the agent might have conflicts of interest as well as differing predispositions toward risk and the focus is to minimize the costs associated with an agency relationship. Agency theory considers the agent as an economic actor. They assume some agents might be opportunistic in behaviour, they may “…disguise, mislead, distort, or cheat as they partner in an exchange”. This stream of research focuses on “making rational choices toward maximization of utility”, “examine the efficacy of contracts so as to manage agents efficiently” and also “examine incentives that align the behavior of agents with those of principals" (Wright et al. 2001). In general the agency theory is apprehensive regarding individuals and their behaviours.

For the first time Adam Smith identified the issue of 'separation of ownership and control'. Berle and Means (1932) argued that this separation produces a condition where the interests of owner(s) and managers can diverge and proposed that owner controlled companies should be much more profitable than manager controlled companies. But this proposition lacks empirical support. The reasons might be the market for corporate control or the market for managerial labor. Corporate control is the process by which society exerts some control on the corporation through markets or regulatory means and this mechanism of control under efficient market hypothesis. The market for managerial labor ensures control through the reputational concern of managers and negative reputation like pursuing personal interest can adversely affect the chance of obtaining few top positions in the firm. In other words, managerial labor market disciplines the firm management (Fama, 1980).

Jenson and Meckling (1976) defined an agency relationship as a contract under which the principals engage the agent to perform some service on their behalf and it also involves delegating some decision-making authority to the agent, which might resulted into conflict of interests especially when both principal and agent are utility maximizers. They further identified three types of agency costs: the monitoring costs by the principal, the economic bonding expenditures by the agent; and the residual loss and finally concluded that agency costs are unavoidable non-zero costs. Jenson and Meckling (1976) also explore the issues of imperfect capital market and showed how asymmetric information and conflict of interests between different participants in the organization. The conflicts of interests between different participants like equityholders (it can be further subdivided into majority equityholders & minority equityholders), managers, and debtholders influence the capital structure of the firm (Harris and Raviv, 1991). Debt ensures that firm has to pay out the cash which reduces the free cash available with managers as well as reduces opportunistic behaviour (Jensen, 1986) but there is a cost associated with the debt. Agency cost of debt, due to the informational asymmetry, may affect the investment decision (Harris and Raviv, 1990). A firm with a high debt might go for risky investments. Since the risk is shifted to debt holders, it can lead to over investment, or even it may forgo positive NPV projects. Asymmetric information between managers and investors in imperfect capital market leads a set of corporate governance issues (Diamond, 1989; Myers and Majluf, 1984; Myers, 1984).

Fama and Jensen (1983) argued for including outside members in corporate boards since outside directors have incentives to carry out tasks and do not collude with managers to expropriate residual claimants as they are motivated to develop reputations as experts in decision control. Fama and Jensen (1983) argued for the first time that institutions beyond the boundary of firm can reduce corporate governance problems. Previous research on corporate governance was heavily dominated by agency theory, whereas Hambrick et al. (2008) recommend to go beyond the formal structure and explore other aspects like institutional context. It is often argued that agency theory offers partial view of the corporate governance issues, since it fails to explain why there was a surge in restructuring activities in USA during 1980s but not earlier. The environmental explanations are mostly based on the tenets of institutional theory. Motivation assumptions of agency theory have also given rise to an enormous amount debate. Critiques argue that theory of the firm misinterprets the causal relation between motivation (e.g., the tendency to shirk) and the surrounding environment (the type of governance structure in place).

The sociology stream of research in corporate governance doesn't have any negative connotation with the agent autonomy and argued that autonomy can be used for numerous positive possibilities. Ouchi (1980) argued that organizational culture might be stronger than formal controls and the basis of cultural control is attachment to firm and not incentives.

Ouchi (1980) analysed the differences between Western and Japanese firms and introduces the idea of *clan control* i.e. control through a system of organizational norms and values. In reality most organizations use some elements of the *clan control* as described by Ouchi since this framework provides a set of ideal types. Donaldson and Davis (1991) extended this argument and raised the question whether it will be 'Stewardship Theory or Agency Theory'. Stewardship Theory proposed that there is no conflict of interest between managers and owners. Managers are benign in nature and their role is to coordinate efficiently (Donaldson, 1990, 2008). Managers have higher utility value of cooperative behaviors than pursuing self-serving opportunistic behaviors (Davis et al., 1997). This stream of research further argued that managers are motivated by intrinsic rewards by achieving the collective goal of the organization. Donaldson and Davis (1991; 1993) argued that *situational* and *psychological* factors can predict whether a manager will behave like an agent or a steward. Situational factors like involvement-oriented management system, collectivistic culture, small power distance encourages a steward like behavior. Psychological factors are specific to the executives. Peoples who are motivated by higher-order needs and intrinsic factors, have greater identification with the organization and are high in value commitment are more likely to behave like a steward. Davis et al. (1997) further argued that the behavior of the executive not only depends on situational and psychological factors but also mutual expectations of both the parties. The questions which remain unanswered are: what happens if there is mismatch of expectations? Or when does this mismatch of expectation happen?

According to Shapiro (2005:271) "agency theory may not occupy a niche in sociology" but sociology has much more to offer in future. He argued that political scientists must go beyond the standard principal agent framework and consider multiple principals and multiple agents, since political system is analogous to a "complex network of principal-agent relationships composed of citizens, nation states, elected officials, lawmakers, members of the executive branch, administrative agencies, courts, international organizations, ambassadors, bureaucrats, soldiers, police officers, supervisory officials, civil servants, patronage appointees, and even those who monitor other agency relationships inside political institutions and in the market".

Both agency theory and stewardship theory assume that the behavior of the manager is a rational process. This paper is exploring the complex issues of corporate governance by relaxing the set of assumptions of both the stream, which may provide a complete and an accurate view. In an assessment of agency theory Eisenhardt (1989) recommends to look beyond the economics, expand it to richer theory-relevant contexts, and incorporate multiple theories. This paper makes an incremental effort in these directions.

COPORATE GOVERNANCE REVISISTED: FARMER, LANDOWNERW AND MONEYLENDER

We argue that confining ourselves to the definition provided by the neoclassical paradigm excludes important issues. We follow the view of corporate governance as "… the structures, processes, and institutions within and around organizations that allocate power and resource control among participants" (Davis, 2005:8.1). We analyze the agency relationship or the steward relationship in a multi period model. We consider both recurrent transactions between stakeholders as well as "spot market" like occasional transactions. Game theoretic analysis of reputational concerns reveals cooperative behaviour in case of repeated games and reduces agency problems. Secondly, we conceptualize the institutional context in terms of legal institutions which ensures the execution of property rights with nominal transaction costs in case of opportunistic behaviour. In general it is argued that weak institutions exacerbate opportunistic behaviour and subsequently agency costs. We develop a framework of 2X2 matrix (Refer Figure 1). The *quadrant I* represents the situation when institutional environment is weak and number of transaction between actors is occasional i.e. spot market like transactions. Similarly *quadrant IV* represents multiple transactions between actors in a strong (i.e. efficient) institutional environment and so on.

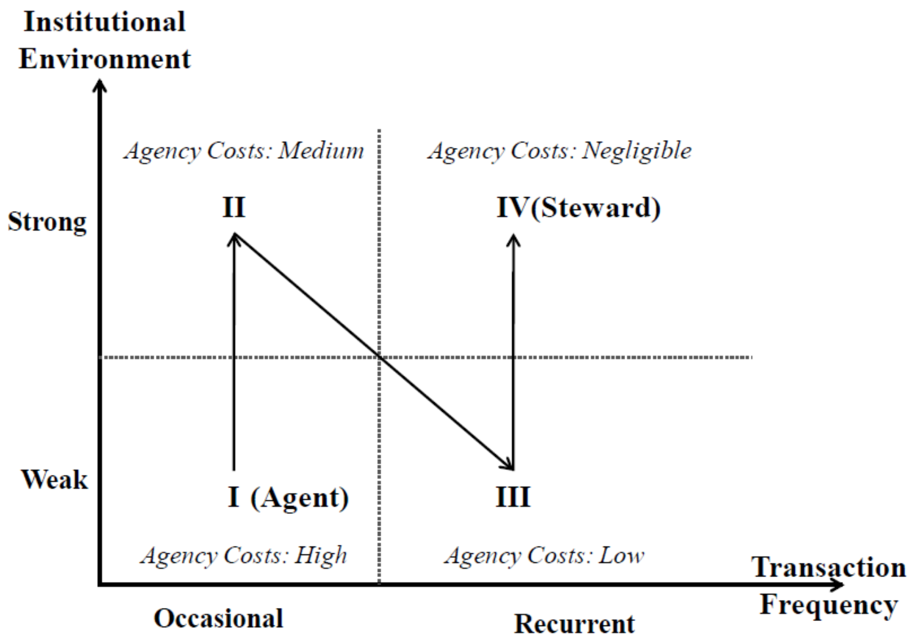

Figure 1: Agent-Steward Continuum

This section explores the question: When Agents Become Stewards? In other words we are trying to analyse when some players will have the incentive to behave in an opportunistic way and corporate governance issues will accentuate and when these issues will be sorted out. We explored this question through three cases. Different players in traditional harvesting scenario: farmers (managers), landowners (equity-holders) and moneylenders (debt-holders) are a simplified representation of the problems under discussion. We explored three different scenarios among these players which illuminates the nuances of three different types of corporate governance issues as follows:

a) Conflicts between Equityholders (landowners) and Mangers (farmers)

b) Conflicts between Equityholders (landowners) and Debtholders (moneylenders)

c) Conflicts between Controlling (landowners) and Minority (landowners) shareholders

Case A: Landowner-Farmer Contract

Let us assume a situation of landlord-farmer contract where the landlord doesn't require any money from the moneylender (this represents all equity financing). The landlord (principal – equityholders) and the farmer (agent) have different predispositions toward risk and hence the contract has a fixed as well as a variable (depending upon production) component. One portion of the fixed component will be given beforehand or at the time of signing of the contract. The remaining portion of the fixed component and the variable component will be given at the end of the harvesting year. Hence there is an incentive for *ex post* opportunistic behaviour for the farmer. This opportunistic behaviour can be twofold: outright *contract dishonouring* and/or *shirking.*

We assume two scenarios to capture the occasional and recurrent transactions of our argument. In the first scenario, there are multiple landlords and multiple farmers in the economy. Here both the landlord and the farmer have alternative options and the contract is like a spot market one off transaction. In the second scenario, there is one landlord and multiple farmers, so there are no alternative options for the farmers therefore he has to get into recurrent transactions with the landlord. In contrast the landlord has alternative options (i.e. there are many farmers), so the landlord need not enter into future contracts in case of opportunistic behaviour of either type.

We also assume in strong institutional environments, there are legal institutions which can effectively penalize (i.e. with nominal transaction costs) the farmers in case of contract dishonouring; whereas in weak institutional environments these legal institutions are either absent or ineffective. And we further assume that there is a cost associated in observing employee's efforts and that the litigation costs (i.e. transaction costs) is high in case of shirking. Though the landlord as a residual claimant has the incentive to observe employee efforts, there is no incentive for the landlord (due to high litigation costs) to go the court in case of shirking.

Weak institutional environment and occasional transactions (quadrant I) represents the classic principal agent contracts in a spot market like situation where the agent has incentive for opportunistic behaviour like contract dishonouring and shirking. The landlord can only refuse to pay further in case of contract dishonouring and agency costs will be high. In case of occasional transactions in strong institutional environment (quadrant II) the farmer has no incentive to dishonour the contract, since the legal institutions will penalize him. The likely penalty will be greater than the gain from dishonouring the contract. But the farmer could prefer to shirk in a one-period game since as a rational player the farmer is aware that the cost of litigation is high for shirking issues and there are no reputational concerns. The agency cost will be lower than the first scenario but still significant.

In the case of recurrent transactions even in a weak institutional environment (quadrant III) the contract dishonouring problem will be mostly resolved, since in the case of contract dishonouring the landlord will not only refuse to pay the remaining amount of the contract but also has the option of not entering into future contracts with the farmer. Considering that the farmer has no alternative options, the gain from one time contract dishonouring will be much lower than the gain from multi-period cooperation. We argue that the landlord as a residual claimant has the incentive to observe famer's effort and furthermore can avoid high litigation costs by not entering into future contracts in case of shirking. Hence in recurrent transactions the reputational concerns of the farmer reduce agency costs. In quadrant III there is a theoretical possibility of contract dishonouring in the $(N\text{-}x)^{th}$ game in a N-period game. Assuming the gain from cooperation in $(N\text{-}x\text{-}1)$ games and contract dishonouring in the $(N\text{-}x)^{th}$ game is higher than the cooperation in all the periods i.e. all N periods. Generally in quadrant 3 the agency cost will be low and farmers will mostly behave like stewards.

And finally the agency problem will not exist in case of recurrent transactions in a strong institutional environment (quadrant IV). There is no incentive for contract dishonouring at any stage of the game and the reputational concerns of the farmers will reduce opportunism. Hence the farmers will behave like a steward and agency costs will be negligible. In quadrant IV there is a remote theoretical possibility of shirking in the N^{th} game in an N-period game, since the reputational concern will not matter for the farmer after the N^{th} game.

Case B: Landowner-Moneylenders Contract

We assume to achieve the economy of scale the landowner requires some debt from the moneylender(s) and they approach the moneylender(s) after the seeding of crops. In accord with Diamond (1989) we further assume that landowners have two options of cropping: a safe crop (which is a positive NPV project) and risky crop which is completely dependent on monsoon (which is a negative NPV project). Moneylender(s) don't have the technical expertise to judge whether landowners are harvesting the safe or risky crops, hence moneylender(s) will incorporate the cost of risky crop in their lending rates which will be same for all landowners.

Similar to the earlier case we assume in one scenario there are multiple landowners and multiple moneylenders in the economy. Here both the landowners and the moneylenders have alternative options and the contract is like a spot market transaction. In the second scenario, there are multiple landowners and single moneylenders, so there are no alternative options for landowners therefore he has to get into recurrent transactions with the moneylenders. Whereas the moneylender has alternative options, so the moneylender need not enter into future contracts in case of opportunistic behaviour by the landowner.

We also assume in strong institutional environments, there are institutions (similar to credit rating agency) which are experts in harvesting and give a certification regarding the nature of harvesting crops efficiently; whereas in weak institutional environments these institutions are either inefficient in predicting the nature of crops or absent. The cost incurred for this certification is significant. So both landowners and moneylenders have the option of taking the service of these institutions. In addition to this the cost of liquidation is low in strong institutional environments.

In the case of weak institutional environment and occasional transactions (quadrant I), the moneylender will not be interested to incur the high cost of certification (monitoring costs) and moreover the prediction from the certification can be wrong. Hence the landowner has the incentive for opportunistic behaviour and he will always go for the risky crops. Incorporating this (opportunistic behaviour of the landowners) in their costs moneylenders will charge higher lending rates. And finally bad landowners (risky crops) will drive out the good ones (safe crops). In case of occasional transactions in strong institutional environment (quadrant II) the landowner harvesting safe crops has the incentive to go for certification, since this will ensure a lower lending rate for him. This will resolve the information asymmetry but farmer has to incur the cost of certification (bonding costs), which will resulted into an overall residual loss (which is the agency costs). The opportunistic behaviour will be lower than the first scenario but still significant.

In the case of recurrent transactions both in weak as well as strong institutional environment (quadrant III and IV) the harvesting of risky crops will be mostly resolved, since in the case of harvesting risky crops the moneylender has the option of not entering into future contracts with the landowners. Considering that the landowner has no alternative options, the gain from one time harvesting risky crops will be much lower than the gain from multi-period harvesting of safe crops. Hence in recurrent transactions the reputational concerns of the landowners reduce agency costs and landowners have no incentive for opportunistic behaviour.

Case C: Landlord-Landlord Contract

We assume that there is a cost associated with hiring farmers, harvesting equipments etc. and this requires an economy of scale in terms of total harvesting land. Hence landowners form a consortium before the harvesting season and share these costs as well as profits proportional to their land. This consortium can be for a single year or for N number of years. There are some big landowners who own more than half the total harvesting land and others are numerous small landowners with a small piece of land. We define these big landowners as the *controlling landowners* in terms of decision making and others are *minority landowners* who can't influence the decision made by the big landowner. We further assume to minimise the risk associated with the harvesting-uncertainty of specific crops they unanimously agreed to pursue mixed cropping i.e. two different types of crops simultaneously; but harvesting of one crop among these two leads to the deterioration of agricultural land (for e.g. takes the nitrogen from the soil and reduces the fertility/productivity of the land in the long term. To revive the fertility of the soil the landowner has to incur the cost of artificial fertilizer). We define this as a *harmful crop* and other crop as a *beneficial crop* (for e.g. these are leguminous crop where nitrogen is fixed in the root nodules and improves the soil fertility). The controlling landowners can behave in an opportunistic way as a decision maker by using the lands of minority shareholders for harmful crop.

We also assume in strong institutional environments, there are legal institutions which can look into the sharing of land and nature of crops (i.e. harmful and beneficial crop) and ensures a damage charge for the lands in which harmful crop was harvested at a nominal cost; whereas in weak institutional environments these institutions are either inefficient or absent. In case of opportunistic behaviour by the controlling landowner minority landowners should approach these legal institutions, but it is quite possible that since there is a cost associated with this there might be a free riding problem among minority landowners.

The dominant strategy for controlling shareholders, in weak institutional environment and occasional transactions (quadrant I), is to behave in an opportunistic way i.e. using the land owned by minority landowners for harmful crop. This leads to the exploitation of minority landowners. In case of occasional transactions in strong institutional environment (quadrant II) the controlling shareholders might either continue to exploit like the former case anticipating a free-riding problem among minority shareholders or a better strategy for the controlling landowners would be to reduce the extent of exploitation. The later strategy would reduce the incentive of minority landowners to go for the legal process and increases the chance of free riding problem among them. The chance of exploitation will be lower than the first scenario but still significant.

Exploiting the minority landowners in recurrent transactions will either reduce the overall productivity of the consortium in the long run or incur a recurrent cost of artificial fertilizer. This will uniformly affect the controlling as well as minority landowners. Hence in the case of recurrent transactions both in weak and strong institutional environment (quadrant III and quadrant IV) the dominant strategy for the controlling landowners will be to adopt a crop rotation which avoids a decrease in soil fertility. A non-leguminous crop will be followed by a leguminous crop to return the nutrient to the soil and reduce the need for artificial fertilizers. In other words the principal-principal problem will not exist in case of recurrent transactions irrespective of the institutional environment.

CONCLUSIONS

In all three situations we found that in the context of recurrent transactions coupled with efficient legal institutions managers will behave like stewards and corporate governance issues will be mainly resolved. In contrast, corporate governance problems and therefore agency costs will be accentuated in weak institutional environments especially with ‘spot market’ like occasional transactions in all three cases. Both these findings are in accord with the extant literature.

But most importantly we developed a framework of 2X2 matrix and conceptualized the agent-steward argument as a continuum rather than a dichotomous theoretical framework (Refer Figure 1). We deduce that reputational concerns in recurrent transactions are of greater importance than strength of institutions to resolve governance issues. We attempt to close the theoretical gap between two contrasting view of corporate governance by incorporating a multi-period model and considering the efficiency of institutional environment in which the organization is located. Our argument shows that a generalized neoclassical model can illuminate the sociological perspective of managerial behaviour.

It is worth to mention that another important corporate governance issue which we didn’t explore in this paper is the concentrated shareholding structure in family-owned business, which is the prevalent organizational structure in all emerging economies. Unlike the western economies, where the corporate governance problem is mainly characterized by divorce between ownership and control, in the context of the family owned business groups the conflict between controlling family owners and minority shareholders is more important than the standard shareholder versus manager conflict. This *principal-principal problem* in concentrated ownership structure especially in emerging economies is unique in nature (Dharwadkar, George, and Brandes, 2000). Morck and Yeung (2003) argued that when a family owns, manages and controls a group of publicly traded and private firms, it gives rise to a set of unique agency problems called tunneling (Johnson et al., 2000). This is the expropriation of minority shareholders by controlling shareholders especially in pyramidal forms of business group structure. It would be interesting to explore the tunneling problem in our framework of institutional context and multi-period model.

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