The stakeholder theories today economics essay

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Introduction

In the last 200 years, business corporations' influence on the society has grown rapidly and immensely. Two contending theories are eminent when discussing the purpose of the modern business firm. Both theories present a structure for assessing company's governance procedures, managerial compensation policies, and the economic and societal performance of a firm. The first, shareholder theory, originates from an economic viewpoint that, the company's should focus firmly on those who have a monetary share of the company and that a firm's only purpose is to serve the needs and interests of the company's owners. On the other hand, the stakeholder theory broadens the first view, identifying the relevance of wealth creation in addition to the business's interactions with its integral groups, shareholders, suppliers, creditors, employees, regulators, customers, and native communities and effect on society as a whole. These stakeholders are those without whose participation the corporation cannot survive (Clarkson, 1995). This paper discuss the foundations of these two theories, provide an overview of some current progress within the theories, and conclude with some suggestions on how the two theories might be used to create a better effective structure for the role of the modern business firm.

Shareholder Theory

The origins of the ideas shaping shareholder theory are more than 200 years old, with roots in Adam Smith's (1776), Wealth of Nations. In general, shareholder theory encompasses the idea that the main purpose of business lies in generating profits and increasing shareholder wealth. Shareholder theorists call for restricted government and supervisory interference in

business, believing that society will also benefit from markets been regulated through the mechanism of the invisible hand, that is, if all businesses work towards their own self-interest by trying to maximize profits.

Some advocates of the shareholder view also were of the view that the invisible hand checks unlawful activities, arguing that the market will discipline or punish firms that involve themselves in illegal or unethical behaviour. They were of the view that too much oversight and regulation of firms is needless.

They believe that the state should be responsible for solving social problems. Corporate generosity and other actions not directly connected to creating shareholder wealth are a waste of shareholders' investments and, possibly, depraved since it amounts to stealing from them. Though this statement seems strong, Friedman conceived that the " business of business" is business; and that firms are formed to make money, not run the social or moral growth of society. According to Friedman, social and moral development is best handled by the government or by a voluntary organization. Wealth is shifted to issues outside the core expertise of their executives if businesses become tangled in public or social policy issues. If wealth is used inefficiently this way, society will be affected negatively in the long run. The negative view of Friedman towards socially involved companies went so far as to announce that such activities seized the role of constitutionally chosen officials.

It should also be noted that, Friedman never advocated firms behaving unlawfully, dishonestly, or unethically. Whilst supporting the corporate aim of make best use of shareholder wealth, he argued that it should be done within the ethical, moral and legal confines of society.

Shareholder theories today.

Recent advocates of shareholder theory embrace three views from Smith, the significance of free markets, the invisible hand of self-regulation, and the importance of " enlightened self-interest."

Two influential and recent schools of thought fall under the broad umbrella of shareholder-based theories: " transaction cost economics" (TCE) and " agency theory." Like shareholder theory, each focuses on behaviours that can maximize firm efficiency: TCE focuses on the importance of corporate hierarchies and monitoring employee behaviour to minimize self-interested behaviour; agency theory focuses primarily on the principal vs. agent (shareowner vs. manager) relationship in publicly traded firms, and how to best align the competing interests of the two parties to maximize firm value.

Both TCE and agency theory have a " gloomy vision" of human self-interest. Both assume that human beings are opportunistic, and, thus, will put their own interests before the firm's.

TCE and agency theory grew out of scholarship in the early 1970s, and both form the foundations for much of the corporate governance behaviour we see today. Since both theories assume that humans are self-interested, both focus on mechanisms to monitor manager behaviour, and to provide incentives to align manager interests with those of the firm's owners

(primarily, to maximize shareholder wealth). Those mechanisms constitute the primary incentive systems currently in use today in most large corporations: Because opportunism, self-interest, and shirking are assumed, public corporations have instituted boards to both monitor managers and to incentivize them. Boards hire and fi re executives and set their compensation; they evaluate executive behaviour and use ownership plans (the granting of stock, stock options, and bonuses) to incentivize executives to work more toward the overall interests of the firm than to increase their own personal wealth. Although these incentive systems have come under increasing fire recently, it is difficult to argue against aligning owner and manager interests through monitoring and incentive systems.

Stakeholder Theory

The traditional definition of a stakeholder is " any group or individual who can affect or is affected by the achievement of the organization's objectives" (Freeman 1984). The definition of a stakeholder, the purpose and the character of the organization and the role of managers are very unclear and contested in literature and has changed over the years. Even the " father of the stakeholder concept" changed his definition over the time. In one of his latest definitions Freeman (2004) defines stakeholders as " those groups who are vital to the survival and success of the corporation". In one of his latest publications Freeman (2004) adds a new principle, which reflects a new trend in stakeholder theory. In this principle in his opinion the consideration of the perspective of the stakeholders themselves and their activities is also very important to be taken into the management of companies. He states " The principle of stakeholder recourse. Stakeholders

may bring an action against the directors for failure to perform the required duty of care” (Freeman 2004).

All the mentioned thoughts and principles of the stakeholder concept are known as normative stakeholder theory in literature. Normative Stakeholder theory contains theories of how managers or stakeholders should act and should view the purpose of organization, based on some ethical principle (Friedman 2006). Another approach to the stakeholder concept is the so called descriptive stakeholder theory.

This theory is concerned with how managers and stakeholders actually behave and how they view their actions and roles. The instrumental stakeholder theory deals with how managers should act if they want to favour and work for their own interests. In some literature the own interest is conceived as the interests of the organization, which is usually to maximize profit or to maximize shareholder value. This means if managers treat stakeholders in line with the stakeholder concept the organization will be more successful in the long run.

In particular, Carroll A 1979 and Ed Freeman 1984, theorized that by taking the interests of all the firm’s stakeholders into account, the firm could do “ better” (achieve greater performance) than by simply focusing on shareholder interests.

Carroll noted that corporations have four major responsibilities: economic (to generate shareholder wealth), legal (to obey laws and regulations), ethical (to recognize that the firm is part of a community, and thus has obligations to and an impact on, others), and discretionary (to engage in philanthropy).

Nonetheless, economic responsibility is still primaryâ€•that is, “ the business of business is business.” Similarly, Freeman espouses that profit generation should be the outcome of a well-managed company (much like Carroll and Friedman). Unlike Friedman, however, both Carroll and Freeman believe that that if a firm creates value for its stakeholders; it will create value for its shareholders, as well. Thus, unlike the assumptions of classical economics and shareholder theory (that a firm can only maximize value on one dimension), stakeholder theorists believe that taking all constituent groups into account is the better way to maximize overall firm performance.

Stakeholder theories today.

Indeed, as stakeholder theory has evolved in this century scholars are recognizing the importance for firms to understand “ who counts” under what particular circumstances, as well as how this “ hierarchy of salience” can change depending on the relative power of stakeholders, the legitimacy of their claims, and the urgency of their claims on the company. Hence, a firm must learn to deal with trade-offs among its stakeholders, since those groups inevitably will make competing claims in which it is likely that the firm will prefer the interests of one group over another.

For example, in the wake of child labor and sweatshop allegations against its factories in Asia, Nike considered the claims of NGO, regulatory, and activist stakeholders to be most salient. During other non-crisis periods, however, shareholders, employees, and customers most likely will be treated as higher in Nike’s stakeholder hierarchy.

Stakeholder theory also is influencing scholars from the communications and public relations domains who are interested in how firms interact with their environments. For example, a new theory of “ symmetric” communications emphasizes the interdependence of organizations with their customers, clients, suppliers, competitors, the media, and even activists. As a result, firms are encouraged to be two-way communicators, balancing their self-interest with altruism, advocacy with accommodation, and by creating symmetry between their own interests and those of their stakeholders, even if those interests are opposed. This symmetric approach calls for compromise from both sides in order to reach a win-win zone in which the firm and its stakeholders both can benefit. Significantly, the symmetric communications perspective does not call for an end to enlightened self-interest from any side; instead, the perspective looks for a process in which firms and their stakeholders both seek their own advantage while, at the same time, respecting the needs of others.

Two other recent theories that reinforce and relate to stakeholder theory are “ stewardship theory” and “ social capital theory.” Stewardship theory, an alternative to agency theory, assumes that human beings, in fact, may put the interests of others, including the organization, above their own self-interest. Scholars such as Donaldson L. and Davis J, 1997 have promoted stewardship theory as a positive approach to organizational dynamics and corporate governance, in contrast to the traditional gloomy vision of agency theory and similar economics-based perspectives.

A final branch of stakeholder-related theory is the now near-ubiquitous field known as corporate social responsibility (CSR). As befitting a stakeholder

view of the role of business in society, the study of CSR includes the actions a firm takes as it relates to other institutions and constituencies. For example, CSR can mean promoting environmental integrity, economic development, and social justice as part of the firm's overall strategy to gain competitive advantage. CSR advocates have been trying fervently to show that a positive link exists between more inclusive stakeholder management and increased financial performance (CFP). Unfortunately, only limited progress has been made in this regard because of the intrinsic difficulty of measuring the impact of corporate actions on stakeholders other than shareholders. One clear advantage of shareholder theory is its emphasis on metrics (stock price and the bottom line) that are readily available and easily quantified. Measuring a firm's effectiveness in its interactions with stakeholders outside the capital markets is far more difficult. Indeed, several meta-analyses of the link between CSR and CFP have proved inconclusive. Some studies show a positive relationship, some negative, and some show none at all.

Nevertheless, perhaps the best proof is in the pudding: that is, the ever increasing number of companies recognizing the importance of bringing more stakeholder groups to the table, and believing that doing so can benefit their bottom line. For example, the 2009 release of the Global Corporations reads like a Who's Who of the world's most recognizable and profitable companies, and includes Adidas, Coca-Cola, Ericsson, Danone, and Honda. This demonstrates that stakeholder theory, and the theories like CSR that draw on it, are management theories intrinsically concerned with the performance of the firm.

Critics of the stakeholder theory

The political philosopher Charles Blattberg has criticized stakeholder theory for assuming that the interests of the various stakeholders can be, at best, compromised or balanced against each other. Blattberg argues that this is a product of its emphasis on negotiation as the chief mode of dialogue for dealing with conflicts between stakeholder interests. He recommends conversation instead and this leads him to defend what he calls a ‘ patriotic’ conception of the corporation as an alternative to that associated with stakeholder theory (Blattberg, Charles 2004).

Debates on Shareholder-Stakeholder theory and how to bridge the gap

A key tenet of stakeholder theory unfortunately often gets lost in the debates about its merits: taking all a firm’s constituencies into account (on some level) in the process of strategy formulation can be financially beneficial for the firm. Too often, however, advocates of stakeholder theory have gotten away from this core intention, focusing instead on the importance of non-financial market stakeholders (employees, NGOs, local communities, and environmentalists) at the expense of the firm’s owners. We must remember that both shareholder and stakeholder theories recognize the importance of the firm’s financial successâ€• they just advocate different approaches to that end. Both are theories of value creation, and both are predicated on the assumption that firms should create as much value as possible within the boundaries of the law. Stakeholder theories differ from shareholder theories, however, in recognizing that a firm can maximize value by understanding how it affects, and is affected by, all

its numerous constituencies. Shareholder theory is seemingly hostile toward actions not directly impacting the firm's bottom line, whereas stakeholder theory revolves around human decision-making and, thus, ethics. Advocates of stakeholder theory believe that it does not make sense to talk about business without ethics, and vice versa, and it doesn't make sense to talk about either without talking about humans making choices. They thus reject the commonly held separation thesis (that economic and ethical matters in business are distinct), and provide justification for using more inclusive frameworks to think about the role of business in society. Key questions stakeholder theorists encourage managers to ask are: For whom is value created or destroyed if this decision is made? Whose rights will be enabled or not? What kind of person will I be if I make this decision? None of this should be seen as anti-Friedman. After all, Milton Friedman wanted firms to maximize profits within the rulesâ€•and that may, or may not, include CSR-type activitiesâ€•depending on the outcomes generated. The trick here is that economists traditionally have had trouble measuring value outside of the bottom-line; hence they tend to ignore what they can't (precisely) measure. In the end, they are unable to create tight mathematical models that represent the loose, real world we live in.

Generating stable and growing profits should be the outcome of a well-managed company, and stakeholder theory can help the firm get thereâ€•perhaps more effectively than shareholder theoryâ€•by measuring such soft variables as firm reputation, the quality of products and services, trustworthy suppliers, good employees, supportive communities, and cooperative financiers. In short, stakeholder theory recognizes the firm has a

potential for profit in generating a strong, lasting reputation among stakeholders and through addressing real needs and interests of such groups.

It can be said that stakeholder theory is an extension of shareholder theory and that its broader framework and understanding of the firm's interaction with society can actually generate better performance for the firm and thus, create more benefits for society-at-large? That is a bold assertion to be sure, but it seems to make sense in the 21st century, when greater numbers of firms are accepting the legitimacy of notions such as the triple bottom line (economic, social, and ecological), sustainability, accountability, transparency, and other soft measures of performance. It also seems sensible to assume that people can be both self-interested and self-enlightened, thus creating potential for the melding of shareholder and stakeholder approaches into one useful theory.

Conclusion

Business firms face an increasingly competitive environment. The development of a world market for investment capital, in particular, increases the importance of competing for investment capital. Such increased competition, we believe, encourages firms to search for sources of organizational advantage that cannot be easily or quickly duplicated in order to continue to attract investment capital. Sustainable organizational advantage may be built with tacit assets that derive from developing relationships with key stakeholders: customers, employees, suppliers and communities where businesses operate. Stakeholder management may be complementary to shareholder value creation and may indeed provide a

basis for competitive advantage as important resources and capabilities may be created that differentiate a firm from competitors. On the other hand, participating in social issues may be seen at best as a transactional investment easily copied by competitors. These are problems faced by managers when called upon to serve an expanded role in society. If an activity is directly tied to stakeholders, then investments may benefit not only stakeholders but also result in increased shareholder wealth.

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