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The Problem of Contract Enforcement in Economic Organization Theory

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Abstract

Recently, economists have directed attention to the phenomenon of organization. An important difference between the newly developed economic theories of organization, such as for example agency theory, and sociological theories of organization is the fact that economists explicitly employ an individual utility maximization assumption. In this paper, it is reasoned that this assumption, if used as in agency theory, entails logical inconsistencies if we try to explain the existence of the kind of agreements that purportedly form the basis of organizations. However, if the condition of uncertainty — to which agency theorists merely pay lip-service — is taken seriously, the observed inconsistencies can be reconciled. A classificatory scheme of four 'sources of obligation' is proposed for the analysis of the basis of agreements. Taking all four sources into consideration in the analysis of organizational agreements can help to avoid one-sided attention to, for example, formal, legally enforceable agreements. The findings of empirical research suggest that two basic dimensions lie at the root of the proposed classificatory scheme. Further research is needed to check this supposition and its implications.

Introduction

The phenomenon of organization has long been neglected by the economic discipline. In neoclassical theory, firms are traditionally treated like single loci of decision-making, indicating that even though these firms actually consist of up to hundreds of thousands of individual actors, this fact is considered to be irrelevant to the analysis. However, of late, new branches of the neoclassical tree have directed attention to the nature of organization. Transaction cost analysis (Williamson 1975, 1985) juxtaposes markets and hierarchies as alternative mechanisms for coordinating transactions. Agency theory (Alchian and Demsetz 1972; Jensen and Meckling 1976; Fama and Jensen 1983) focuses on decision structures in which one party acts for, or on behalf of, the other party, structures that may be considered to be the basic elements out of which organizations are built.

These newly developed theories are interesting because they constitute competitors to existing theories of organization, predominantly rooted in sociological paradigms. The economists' attitude to and evaluation of

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organizational problems seems to be radically different from those of most organization sociologists. Some economists do not hesitate to predict a revolution in the field of study, that is seen as still being in its infancy (Jensen 1983).

Of the two branches of economic organization theory mentioned above, transaction cost theory and agency theory, I will concentrate on the second in this paper. The reason for this concentration on agency theory is twofold. In the first place, transaction cost theory, although ostensibly discussing hierarchical organization, can perhaps be typified most adequately as a theory of internal and external markets and market failures, because the nature of hierarchy is scarcely explored in this literature (Granovetter 1985; Kay 1987). Agency theory, on the other hand, investigates the ways in which a principal can discipline the behaviour of an agent, and consequently the agency relation can be characterized as inherently hierarchical. Hierarchy, in turn, may be considered as the quintessence of organization.

The second reason to concentrate on agency theory here is that this school of thought is a major stumbling block to organization sociologists, many of whom object to the view on human behaviour that is displayed by its proponents. According to Perrow (1986: 232–236), agency theory is dangerous because it can be used to rationalize and encourage selfish behaviour and cheating. Perrow states that the central assumption of agency theory, the assumption of individual utility maximization can, at best, partially explain human behaviour, and that agency theory should make clear under which circumstances individual utility maximization may be assumed and under which circumstances other, possibly conflicting goals have to be considered. Etzioni (1988) postulates a dual human nature, with aspiration to individual utility and compliance with moral imperatives as constituent elements. Donaldson (1990) points at the narrow account of human motivation offered by economic organization theorists, and proposes an alternative view of organization members acting in the interest of the organization as a whole, rather than driven by self-interest.

Thus the individual utility assumption seems to form the crux of the controversy between agency theorists and organization sociologists. Therefore this assumption, and its ramifications, take an important place in this paper. Below, I will first sketch, very shortly, the rudiments of agency theory, indicate the importance of the individual utility assumption for this theory, and discuss the fundamental differences between agency theory and sociological organization theory that are related to this assumption. After that I will focus on the concept of 'contract', used in agency theory to refer to voluntary agreements between principal and agent and, by means of an impossibility argument, attempt to show that the existence of such contracts cannot be explained in an agency-theoretical analysis. Subsequently, I will consider the question of whether the existence of these voluntary agreements is completely irreconcilable with the basic assumptions employed in agency theory. In my opinion, this is

not the case, if the conditions of uncertainty and positive information costs are given appropriate weight. A classificatory scheme of four 'sources of obligation' is presented that can be used in the study of exchange between parties striving after individual utility under these conditions. It is shown that empirical research points at two basic dimensions underlying the four 'sources' discerned. Finally, some tentative conclusions are drawn.

Agency Theory and the Individual Utility Assumption

In its most simple form, the agency relation can be modelled as follows. A principal contracts an agent to perform a certain task. The execution of this task involves decision-making by the agent. The agent chooses an action out of the set of options open to him. This action, together with a random state of nature comprising all the factors beyond the agent's range of influence, determines the outcome or pay-off of the task. As a reward for the execution of the task the agent receives a fee, depending on the realized pay-off of the task and/or the action performed according to some fee-scheme. This fee-scheme is considered to be the 'contract' between principal and agent. As the fee to be received by the agent in most contracts will be positively related to the level of the pay-off of the task in some way (as will be discussed below), the agent has an incentive to choose an action that leads to a high pay-off. However, the agent is also led by other considerations. Not all actions will yield the same utility to him, e.g. because he may value leisure higher than a hard day's work. In other words, the agent may want to 'shirk' — to exert less than optimal (from the point of view of the principal) efforts in the execution of the task. The agent's problem now is to choose an action that maximizes his net utility, taking the expected fee as well as the differential utility of possible actions into account.

The principal's income is formed by the residual, positive or negative, of the pay-off of the task minus the fee paid to the agent. Consequently the principal's problem is to maximize this residual, taking into account that the agent, in choosing his action, will consider the fee as well as the possibility to 'consume on the job'. In general, two strategies can be discerned. In the first place, the fee can be made variable with the pay-off of the task. This strategy is attractive, for the principal has no need for information about the action chosen by the agent, only some measure of the value of the pay-off acceptable to both parties has to be established. However, as the pay-off is determined not only by the action of the agent, but also by the 'state of nature', variability of the fee with the pay-off constitutes an imperfect incentive. The more important the influence of the 'state of nature', the less adequate the fee scheme will be. In the extreme case, the agent will consider the contract to be a kind of lottery, and will choose his action disregarding its uncertain relation to the pay-off. Furthermore, the contract now shifts a substantial degree of risk to

the agent. As the agent is generally assumed to be risk-averse, he will be asking a higher expected fee the more risk he is bearing. As the agent's cost of carrying risk is assumed to be higher most of the time than that of the principal (e.g. because the agent has fewer possibilities of diversifying his activities), the resulting contract will be sub-optimal.

Here is where the second strategy comes in. The principal can also directly observe the action of the agent, and make the fee variable with the choice of this action. For instance, if the nature of the task provides abundant opportunities for 'shirking', the principal can make the fee variable with the measured level of effort exerted by the agent. As information, or the transfer of information between parties, is considered to be costly in agency theory this strategy will entail costs too: monitoring costs. Of course, combinations of both strategies are also possible, and even likely in practical situations.

The rudimentary model sketched above can be formalized and expanded in a number of directions, e.g. by including more than one agent and/or more than one principal, by extending the number of periods studied, or by varying the assumptions concerning the availability of information. For the purpose of this article this simplified description will suffice, however. For overviews and discussions of agency theory in general see Baiman (1982), Pratt and Zeckhauser (1985), and Rees (1985); for a discussion of the applicability of agency theory to organizational analysis, and for an overview of empirical findings see Eisenhardt (1989).

The two central assumptions of agency theory are that of positive information costs and that of individual utility maximization. The information cost assumption is what differentiates agency theory from more traditional neoclassical economic analyses, and what makes the phenomenon of organization relevant to the economic discipline. The individual utility assumption, on the other hand, ensures the firm attachment of agency theory to the neoclassical trunk. This assumption is the basis of an impressive deductive edifice, the key-stone of which is formed by the conclusion that — under certain conditions — the contract between principal and agent will constitute a Pareto-optimal equilibrium (Ross 1973). The assumptions of positive information costs and individual utility maximization meet in the concept of 'opportunism', the notion that parties to an agency contract are prepared to use guile in their self-interest seeking behaviour.

In sociological organization theory positive information costs are hardly discussed, but rather taken for granted. The assumption of individual utility maximization on the other hand forms the crystallization nucleus of the animosity between agency theorists and sociologists. The acceptance or rejection of individual utility as the central principle of organizational analysis leads to two contrasting approaches. In organization theory, especially sociological organization theory, power rather than individual utility is the central concept in the analysis (Crozier and Friedberg 1977: 78; Mintzberg 1983: 1; Perrow 1986: 258; Clegg 1989: 17). In line with this difference in approach, organizational sociologists are inclined to see as

ruled and constrained by power relations behaviour that agency theorists conceptualize as voluntary exchange.

According to agency theory, organization is the product of the rational action of parties seeking to maximize their individual utility by concluding agreements concerning the execution of a certain task. In this perspective a firm, or any other organization, is a device for accommodating certain forms of voluntary exchange, a 'nexus of contracts'. Sociologists, far from categorically dismissing the idea of self-interest as a driving force within organizations, stress the importance of power differentials for understanding the nature of organizations. In this view, organizations are not primarily products of voluntary association, but rather instruments of hegemony and domination. In short, sociologists consider the texture of organization to consist of 'status' rather than 'contract'.

On the other hand, the antithesis between agency theory and sociological organization theory is not absolute. The assumptions employed in agency theory do not necessarily imply that both parties to the agency relation have the same (market) position at the outset. For instance, there is no fundamental conflict between the notion that class differences in society are reflected in power differences within organizations and agency theoretical analysis. As illustrated in Solzhenizin's *Ivan Denisovitch* individuals exert choice even in extremely unfree situations. Agency theorists choose to concentrate on this exertion of choice rather than on contextual restrictions. As a consequence, the voluntarily concluded contracts acquire a ring of fairness, for if the deal would be unfair one of the parties would have backed out. However, seemingly fair exchanges may be underlain by prior structures of inequality that restrict the domain of choice of one party far more severely than that of the other (Clegg and Dunkerley 1980: 457). In a well-balanced analysis, attention should be paid to the constraints to choice as well as to the exertion of choice within these constraints and attempts to change them (Crozier and Friedberg 1977: 121–122). Williamson's suggestion to substitute the broader term of 'treaty' for that of 'contract' in economic organization theory, opening up the dialogue to sociology and political science, seems to hint in the same direction (Williamson 1990).

Agency theory, although concentrating on the choice aspect while generally neglecting restrictions to choice, cannot do without the notion of constraints to choice altogether. After all, the relationship between principal and agent is assumed to be governed by a contract, implying that after the initial decision to enter into the relationship, the parties are not completely free any longer. How do these constraints to action relate to the assumption of individual utility maximization in agency theory? This question will be explored in the next section.

Individual Utility Maximization and the Concept of 'Contract'

As we have seen, principal and agent enter into an agreement on the basis of considerations of maximization of the (expected) utility of both individual parties. Once the deal is struck, the parties are bound by the contract and, consequently, are no longer completely free in the pursuit of their individual utility. Thus, if the contract specifies that the agent is to be paid a certain fraction of the pay-off of the task, the principal cannot refuse to pay that fraction, even if the fee turns out to be much higher than he expected. At least, this is what the parties think when entering the agreement, for otherwise there would be no point in concluding a contract. Consequently, we must assume that the contract is enforced in some way, for individual utility maximizers, let alone opportunistic individual utility maximizers, may not be assumed to observe rules that cannot be enforced.

The question of the enforcement of contracts is largely neglected in agency theory. Most authors fail to define what is meant by a 'contract' or to specify how contractual obligations are assumed to be enforced. In some contributions enforcement by legal courts is alluded to (Jensen and Meckling 1976: 311f; Baiman 1982: 168), indicating a narrowly legalistic position. In other contributions, however, a broad but vague concept of 'contract' is used, and unwritten or even 'implicit' contracts are referred to (Jensen 1983: 326; Fama and Jensen 1983: 303; Faith et al. 1984: 661; Rees 1985: 3-4). The first group of authors seems to overstate the importance of the judicial system. Empirical research suggests that (the potentiality of) enforcement of contracts by legal courts plays only a minor or a very indirect role in the practice of business agreements (Macaulay 1963, 1966; Beale and Dugdale 1975). The second group begs the question of how the behaviour of individual utility maximizers can be disciplined by 'implicit' contractual conditions. One wonders whether the neglect of the definition of the concept of 'contract' in agency theory points at a serious problem.

Let us consider the question of contract enforcement systematically. Two kinds of contract enforcement can be discerned: internal, i.e. enforcement by the parties themselves; and external, i.e. by one or more third parties. Starting with internal enforcement, I will disregard the possibility of enforcement by means of physical threat or coercion. If this kind of power relation was to be considered seriously, there would be no reason to assume that any economic exchange would be taking place between the parties concerned, for the stronger party would simply take whatever it fancied. Instead, I will assume that internal enforcement of contracts is based on the prospect of doing business with the same party in the future, a prospect that presumably will be lost in the case of breach of the present contract. The temptation to breach (or to cheat, with the risk that the other will find out) will normally exist in the present contract, however, for every exchange entails situations in which one of the parties

is temporarily vulnerable to exploitation (e.g. because he has performed his part of the deal first).

In this context, a discussion of Telser's (1980) analysis of so-called 'self-enforcing agreements' may clarify the problem. A self-enforcing agreement in Telser's definition is an agreement in which the only penalty that can be imposed on a violator consists in blocking the prospect of future exchanges (consequently the argument bears no relevance to those agency contracts that must be considered as pure one-shot affairs, but in an organizational setting there will presumably always be a series of exchanges between principal and agent). Thus, an agreement is self-enforcing only as long as, for both parties, the expected utility of future dealings with the other party outweighs the utility of breaching the present contract. At any point in time, the parties are assumed to consider only the (uncertain) future, Telser explicitly dismisses the possibility that the parties take the past record of the relationship into account: 'The argument postulating a stock of goodwill based on past experience faces a fatal objection because it is inconsistent with rational behaviour' (1980: 35). The reason for this is that, to a party who knows that the other party is led by the record of past behaviour, the temptation to breach would become only stronger. 'It is the prospect of the loss of future gain that deters and the existence of past goodwill that invites cheating' (Telser 1980: 36).

However, there is a flaw in this argumentation. If rational behaviour of the parties implies that the decision to (continue to) do business with the other party depends only on the expected future gains, there is no reason whatsoever to assume that a breach of the agreement, or cheating by one of the parties, will end the sequence of transactions. Even if a party breaches time and again, it would remain just as attractive a partner for future transactions as any other party, for '[r]eliability [. . .] is not an inherent personality trait' (Telser 1980: 28). Consequently, the party that has just breached is supposedly as (un)reliable as any other potential exchange party, and the threat of discontinuing the series of transactions, made by a rational party as defined by Telser, is incredible.

The conclusion to be drawn is that, on the basis of the assumptions made in Telser (1980) — identical to the assumptions made in agency theory — self-enforcement of agreements cannot be explained. This means that under these same assumptions — including the absence of external enforcement mechanisms — only transactions with an immediate and simultaneous exchange of performance and *quid pro quo* can be explained, i.e. transactions without contract. Clearly, a relation of agency implies an exchange that is neither immediate nor simultaneous.

What about external enforcement? In the light of the discussion of self-enforcement above, it seems as if the legalistic position assumed in some contributions to agency theory is based on the understanding that under the assumptions employed these relations can only exist if governed by some effective external enforcement mechanism. However, then the question arises of how, in turn, the existence of such external enforce-

ment mechanisms can be explained in the purely individualistic analysis of agency theory. As demonstrated wittily by Lowry (1976), an approach that isolates the relationship or contract analyzed from all other contracts or relationships fails to appreciate that exchange can only take place within a social context. Thus, in the analysis of Lowry, a farmer who sees part of his crop demolished by the straying cattle of his stockbreeding neighbour will not negotiate a price for keeping the cattle off his land that equalizes the marginal production of crop-growing and stockbreeding activities — as the neoclassical economist would want us to believe — but rather will take his rifle and communicate to his neighbour that he has invested 25 cents in a rifle cartridge with which he intends to shoot one of the steers, thus setting up new criteria for bargaining. This, of course, is only the first step in the escalation of the conflict. Lowry concludes that 'bargain and contract are to be understood in the social context which is the *sine qua non* of their existence' (1976: 5).

The upshot of all this is that, apart from the fact that reference to the legal system for the enforcement of agency contracts seems inadequate in the light of empirical investigations, this external enforcement mechanism also has to be considered a *deus ex machina* under the assumptions employed in agency theory. From the point of view of the organization analyst this state of affairs is unsatisfactory, for it means that the nature of the contracts that purportedly form the texture of organizations remains completely in the dark.

A Typology of Sources of Obligations

To a Reconciliation

The question arises of whether the existence of exchange agreements such as agency contracts is entirely irreconcilable with the basic assumptions of agency theory. I believe this is not the case, only the conditions of uncertainty and positive information costs should be taken more seriously than in most of the agency analyses, and certainly more seriously than Telser (1980) does. If we do so, we have to assume that parties never know with certainty whether in the future it will be attractive to do business with one another again or not. Accordingly, the calculus of net individual utility is impeded, and the parties will have to find a way to deal with this fundamental uncertainty. Strategies will fall into two broadly defined classes: cooperation (observe the conditions of the contract, do not cheat, and renew the contract if the other party has also complied and if the next transaction seems profitable), or exploitation (breach as soon as the utility of breaching exceeds the utility of not-breaching, or cheat whenever cheating enhances the expected utility). The individual utility maximizer may be rechristened individual utility *enhancer*, at this point, as maximization — if uncertainty and information costs are taken seriously — refers to an imaginary end-state, while

enhancement refers to the actual process of trying to reach that elusive end-state.

Let us further assume that an individual utility-enhancing party may come to the conclusion that, in view of future transactions, it is wise to 'invest' in a relationship — meaning to forego individual utility temporarily — if he can reasonably expect that the 'investment' will pay in the end. This will be the case if either of the following two conditions applies: (1) reliability — contrary to Telser's (1980) assumption — is a trait inherent to the 'personality' of a party or to a relationship, and 'investing' in a relationship is a way to establish or enhance this reliability; or (2) 'investing' in the relationship renders applicable external enforcement mechanisms, such as contract law administered by the legal courts, or norms sanctioned by business communities.

If the first condition — related to internal enforcement — applies, the information about the other party gathered in a series of previous transactions has a non-trivial positive value. If the other party has been shown to be reliable, it will be rational in many cases to (continue to) follow a strategy of cooperation, even if occasional opportunities for exploitation arise, thus building up a 'stock of goodwill'. This view concurs with Blau's (1964) explanation of the emergence of trust in a series of (social) exchanges. Breaching or cheating may nullify a basis for transacting that has a positive value, since the costs connected to transactions that lack such a basis will presumably be higher (see also the experiments with, and empirical examples of, repeated Prisoners' Dilemma games described by Axelrod 1984).

For the second condition to apply, we will have to shed the purely individualist view maintained until now. It is difficult to understand how, in a universe of individual utility maximizers, laws and norms that occasionally go against individual utility can come about and be enforced. For instance, Ullmann-Margalit (1977), notwithstanding the title of her study (*The Emergence of Norms*), in the final analysis, fails to give an explanation of this phenomenon. She explains why some situations 'are prone to generate norms', but not how exactly these norms become established and are enforced. One thing she does make clear, however, is that a formal analysis of only the isolated structure of choice and pay-off is insufficient, 'the non-formal, contextual features of the situations [...] play a decisive role in explaining the generation of social norms' (Ullmann-Margalit 1977: 14).

The problem is mainly one of the cost of sanctions, I believe. Environmental pressure to enforce obedience to norms implies that third parties who have no direct interest in the case incur costs to punish a violator (cf. Heath 1976: 156). This enforcement mechanism will only be effective if the cost to individual parties is very low. For example, in case the sanction is a boycott, the cost consists in renouncing one potential exchange partner. The cost of institutionalized enforcement mechanisms such as legal courts, spread over the entire community of justiciable parties, will also be infinitesimal. The (historical) development of legal

institutions, however, remains a problematic point for a theory based on individual utility maximization (although perhaps less so for a theory of individual utility *enhancers*). Actually this is the problem of explaining social phenomena in an individualistic approach once again.

Four Sources of Obligation

If we assume that internal as well as external enforcement mechanisms exist in a world of individual utility enhancers, the next step is to consider *which* internal and external enforcement mechanisms can usefully be distinguished. Below, I will discuss four distinct motivational bases for not breaching an agreement. These motivational bases I will call 'sources of obligation'. 'Obligation', for these motivational bases cause a party to stick to the agreement even if breaching promises to enhance its short-run individual utility; and 'sources', for the factors identified do not themselves build an obligation, but they influence the individual utility considerations of a party, and via these considerations lead to 'obligations', i.e. perceived incentives to forsake direct individual utility enhancement.

As discussed above, internal enforcement of contracts is possible only if reliability is a trait inherent to a party or a relationship, and if it is possible to establish this reliability. However, in a universe of individual utility enhancers, reliability will never be absolute. One hopes and expects that the other party will not breach, but one can never be sure, i.e. one acts on the basis of *trust*. This trust can be placed in the other party as a person (as a private individual or as a decision-maker within an organization), in the motivation attributed to his behaviour. In this case, the other party is not necessarily assumed to be particularly benign, but it is believed that he values highly the informational advantage built up in the present relationship and consequently will continue to cooperate. Adoption of an attitude of trust may thus, under certain circumstances, be rational for an individual utility-enhancing actor (Barney 1990).

Trust can also be founded on the belief that a system is functioning in a certain way and will continue to do so in the future. This kind of trust is based on the existence of 'safety valves': the institution (in the sense of a particular identified organization) to be trusted is believed to be checked by forces internal or external to it. As an example, one can think of trust in the efficient functioning of a private firm, a trust that, in the last resort, is based on trust in the disciplining force of the market. This kind of trust (to be called 'institutional trust' in the remainder of this article) is independent of the personal motivations ascribed to the individuals who constitute the other party (cf. Luhmann 1979). The difference with external sources of obligation to be discussed below is that, in the case of institutional trust, no deliberate enforcement by third parties is assumed. Of the two forms of trust, personal trust can be said to be an *individualized* source of obligation, grounded in personality traits ascribed to a specific party. Institutional trust builds a *generalized* source of

obligation, based on factors other than the personality traits of the other party.

External sources of obligation are connected to norms, the violation of which is sanctioned by the community within which the (agency) relation is embedded. I believe that two groups of norms can usefully be distinguished: formal and informal norms. Formal norms are explicit and are enforced by specialized institutions such as legal courts. Informal norms are more diffuse, and are not enforced by specialized institutions, but rather by the community members themselves. The importance of this kind of informal norm for business agreements has been established by Macaulay (1963). Examples of general business norms found by Macaulay are:

Commitments are to be honoured in almost all situations. One does not welsh on a deal (Macaulay 1963: 63)

and:

One ought to produce a good product and stand behind it (*ibidem*).

Likewise, Beale and Dugdale (1975: 47) mention 'customs' and 'unwritten laws' that are widely accepted and provide a basis for settling disputes. Analogous to the internal sources of obligation, the external sources can be classified into individualized and generalized sources. Formal norms (as incorporated in the bodies of law relevant to the enforcement of exchange agreements, mainly contract law) form an individualized source. If parties envisage the possibility of legal enforcement of their agreement they will *ex ante* compose this agreement in such a way as to mould the working of the enforcement mechanism to their specific wishes, by explicit specification of conditions and of damages to be paid in case of non-compliance. In this way, the outcome of a possible lawsuit is made fairly predictable. Socially mediated enforcement mechanisms, because of their informal nature, are much less easy to individualize. Take for example the norm that 'one should not welsh on a deal'. It is already difficult to specify the agreement in such a way that the parties themselves know what 'to welsh' on that particular deal would be, and much more so to specify it in such a way that the reaction of the social environment would become predictable. The only thing that can be said is that there will be a rather diffuse pressure to keep to the norm. In short, informal norms are a generalized source of obligation.

Together, the four sources of obligation build a classificatory scheme of internal vs. external and individualized vs. generalized sources of obligation (see Figure 1).

Figure 1
Sources of
Obligation

		Internal to the relation	External to the relation	
	Personal trust		Formal norms	Individualized
	Institutional trust		Informal norm	Generalized

Empirical Evidence

There is some empirical evidence suggesting that the typology of sources of obligation advanced above, touches ground. In an investigation into the relationship between subsidy-receiving firms and the government department granting these subsidies (a relationship that can usefully be conceptualized as one of agency), questions regarding the binding force of the agreement between the parties were organized on the basis of the scheme (Noorderhaven 1990). The respondents' answers showed that all four sources of obligation were indeed recognized as possible threads in the bond between the parties, although the importance attributed to the different sources varied between the respondents. Moreover, the results suggest that the four sources of the typology, in fact, form two polarities. However, the relationship studied in Noorderhaven (1990) is an inter-organizational relation spanning the gap between the public and the private sector, and therefore it will presumably show some peculiarities of its own. Consequently, these results cannot readily be transposed to the kind of intra-organizational relations envisaged here. Moreover, the small size of the sample calls for caution in drawing conclusions. Nevertheless, some tentative inferences can be made.

In the research, 21 representatives of the firms and of the government department were asked to comment on the importance of six items related to the various sources of obligation. These items were: the function of personal relations (related to personal trust), the moral obligations towards the other party and the fear of negative publicity in the case of a conflict (informal norms), the legal enforceability of the agreement (formal norms), trust (institutional trust), and dependency on the other party. The last item can be seen as an indication of the power differences between the parties. From the interview answers, ordinally scaled variables were derived (for particulars, see Noorderhaven 1990: Ch. 5).

On these six variables, an analysis of principal components (based on Spearman rank correlation coefficients) has been performed. In the analysis, components with an eigenvalue larger than one were retained for varimax rotation. Application of this criterium resulted in three principal components, explaining 72% of the total variance. In Table 1 the rotated component loadings with a higher absolute value than .5 are shown.

Table 1
Principal
Components of
Six Variables

	1	2	3
Legal enforceability	-.929		
Trust	.745		
Personal relations		-.568	
Moral obligation		.634	
Publicity		.836	
Dependency			.949
% of variance explained:	27.7	25.7	18.4

In this table, Component 1 shows a polarity between *institutional trust* and *legal enforceability*. In Component 2, positive loadings on *moral obligation* and *publicity* contrast with a negative loading on *personal relations*. Finally, Component 3 only shows a high loading on the *dependency* variable.

These results suggest that two basic dimensions may lie at the basis of the typology of sources of obligation. Formal norms and institutional trust appear to be functional equivalents: a party attaching relatively much importance to the one, tends to see the other as relatively unimportant, and *vice versa*. The same can be said about the relationship between informal norms and personal trust, although the loadings on this component are much lower.

The fact that *dependency* forms a separate dimension in the analysis of principal components points at weak correlations between this and the other variables. This finding probably partly reflects an inadequacy in the measurement of dependency: the informants were asked to assess their own dependency on the other party. In the answers to this question, ambiguities abound, but it probably also reflects the complexity of the relationship between dependency, leading to power differences between the parties, and the various sources of obligation. On the one hand, the fear of becoming dependent on the other party may motivate a party to search for safeguards, e.g. in the form of explicit legally enforceable contract conditions. But on the other hand, once in a position of dependency, a party may be inclined to stress the importance of informal norms that limit the other party's freedom to exploit its vulnerability. Likewise, the question of the conditions under which one, rather than another, source of obligations becomes operational cannot be answered on the basis of the present analysis. Clearly we are in need of a theory generating a deeper understanding of these mechanisms.

Conclusions

Several conclusions can be drawn on the basis of the discussion in this paper.

In the first place, it has been shown that the applicability of agency theory to the analysis of organizations is impeded by the fact that, in this kind of analysis, the existence of the agreements that purportedly form the basis of organizations cannot be explained. In some of the contributions to the agency literature legal enforcement is referred to, but postulating effective external enforcement mechanisms is at odds with the basic assumptions of the theory. Furthermore, the function ascribed to the legal system in these contributions is not in accordance with the findings of empirical research. Thus, an agency-theoretical analysis of organizations entails inconsistencies.

Second, I have put forth that these inconsistencies can be resolved by taking uncertainty and information costs seriously. If we take these two

conditions into consideration, utility-enhancing behaviour would be postulated rather than utility maximation, and the basis for explaining agreements between parties becomes considerably less slippery. However, we should be aware of the fact that this step severely restricts the scope for elegant model-building, which is so dear to agency theorists.

Third, the discussion of the enforcement of contracts suggests that the nature of the obligations that bind the parties to organizational relations should be made the object of investigation, rather than postulated to consist of, for example, formal contracts enforced by legal courts. The typology of four sources of obligation advanced in this paper should be seen as a first step to a systematic study of these obligations.

Finally, I believe that the study of the sources of obligation underlying exchange relations, and the relationship between the importance attached to the various sources and observed power differences between the parties, may offer a basis for building a bridge across the gulf between economic and sociological approaches to the phenomenon of organization. A systematic discussion of different sources of obligation can be the first step to an analysis of both the sources of, and the restrictions to, power relations as crystallized in a particular exchange context. Thus, the power and the exchange perspectives need not be mutually exclusive, but can perhaps be joined in a fruitful way.

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