Markus C. Becker

# Towards an integrated theory of economic governance – Conclusions from the governance of ethics

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KIeM
Konstanz Institut für WerteManagement

Fachhochschule Konstanz
University of Applied Sciences
Brauneggerstraße 55
D - 78462 Konstanz
Phone .49 .7531-206 404
Fax .49 .7531-206 187
eMail: kiemgr@fh-konstanz.de

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Abstract

A number of review articles on theories of governance have recently come to the conclusion that theories of governance are characterized by a very strong focus on particular aspects of governance, both with regard to governance problems (e.g., incentives, contracts) and theoretical approaches employed (agency theory). At the same time, however, the problems that firms (and managers) are facing are typically multi-layered and complex. For instance, financial flows, knowledge flows, flows of goods etc. all have to be governed simultaneously. In consequence, in a string of recent articles, calls have been issued to broaden governance theory in order to enable taking into account a wider range of governance dimensions and theories. For doing so, two initial steps are required: establishing the governance dimensions that matter, and describing the inventory of governance mechanisms available. After addressing these two steps, the paper the present article provides building blocks for an integrated theory of economic governance in four ways: on the one hand, it analyzes the effects of the characteristics of the additional governance dimensions on governance mechanisms and the interaction effects between governance mechanisms that are applied simultaneously. On the other hand, it follows up on a key finding: the relevance of identity for governing dimensions such as knowledge, stakeholder perceptions, and ethics. Building on the work of Wieland (e.g. 1996), the paper argues that intrinsic motivation and reputation are the main wedges to identity and therefore hold the key to governing the dimensions just mentioned. A first analysis of the characteristics of the various governance mechanism with regard to reputation is provided, to serve as a first input to discussion and further elaboration of an integrated theory of economic governance.

## 1. The fragmentation of theories of governance

Theories of governance can be found in different literatures, and on different analytical levels: in political sciences, economics (Williamson 1975, 1985), finance (Shleifer and Vishny 1997), and in management (corporate governance). Although the underlying problem of governance is the same on all these levels, it is striking how much the attention of extant theories of governance has been absorbed by a few particular issues. In management, there has been a 'near exclusive reliance on agency theory' (Daily, Dalton and Cannella 2003: 379). Many studies of governance in the management literature have been dedicated to the mechanisms available to protect shareholders from the self-interested behaviour of executives, such as effectively structured boards, compensation contracts that encourage a shareholder orientation, concentrated ownership holdings that lead to active monitoring of executives, or the market for corporate control (Daily, Dalton and Cannella 2003). In economics, transaction cost economics has provided the theoretical bases for analyzing issues of governance. The focus, therefore, has been predominantly on the role of contracts and incentives. These theories present great achievements, and it is not the aim of the present article to discuss their merits or possible criticism. Rather, the article takes issue with the *fragmentation* of extant theories of governance, i.e. the fact that we know a lot about *some* problem of governance, and about *some* governance mechanisms. Yet, firms do not face select and isolated challenges of governance (even though at certain times particular problems might be more prominent than others). The challenges they face are typically complex, including multiple dimensions. This has been mirrored, for instance, in the marketing channel literature, which argues forcefully that not just the physical flows of goods through a marketing channel needs to be managed, but also flows such as information, risk, etc. (Coughlan et al. 2001). The stakeholder literature has also taken this point on board (Clarkson 1995; Donaldson and Preston 1995). Under the term 'multiple task problem', the issue also surfaces in the literature on contracts (Gibbons 1998, Holmstrom and Milgrom 1994, Prendergast 1999), where it denotes the problem that contracts cannot completely specify all relevant aspects of employee behavior and its desired outcome – notably in other dimensions than the focal dimension.

A more integrated approach to economic governance is therefore clearly needed. In my understanding, the approach must be more integrated in two respects: it must take into account more dimensions, and more governance mechanisms. Let me briefly explain these two aspects.

Theories of governance often focus mainly on the dimensions of cost, risk, and the legal dimension (property rights). Over the last decade, however, at least three broad and powerful movements have occurred that have established four more dimensions that are of ever rising and now undeniable importance for management.

The first dimension, also chronologically, is services. About twenty years ago, the marketing literature made the 'service turn', recognizing that services had very different characteristics from physical goods – so different, in fact, that they needed to be treated separately (Lovelock 2001). Since then, we have seen the 'service economy' arise, and the statistics on the growing proportion of the tertiary sector speak for themselves. What difference does it make for aligning transactions with governance structures, when the object of the (exchange) transaction is (the right to) a service, rather then a physical good? A theory of economic governance that cannot take the particularities of services into account in seems little adapted to the contemporary business environment. In the light of the rising share and importance of the tertiary sector, not being able to accommodate services is a grave defect of theories of economic governance.

The second dimension is knowledge. It has by now been accepted that knowledge is the most important production factor, and that in the industrialized nations, the economy has indeed become knowledge-based (Grant 1996; Strategic Management Journal Winter Special Issue 1996). In the light of these developments, theories of economic governance that neglect the knowledge dimension miss the most important production factor – clearly an untenable situation. The recent foundation of the Center for Knowledge Governance (http://frontpage.cbs.dk/ckg/) is a further expression of the importance the topic has now attained.

The third dimension is what I summarily call 'stakeholder perceptions'. Maybe the most important amongst those is brand image. Due to a number of factors (amongst which sociological changes that regard the way in which goods and services are consumed, globalization, and increased competition), product, service, and corporate branding has developed into a huge movement. The number of new research centers on branding, and the interest by firms in branding have been growing massively the last years. While consumer brands are nothing new, today, even industrial goods producers are working to brand their products, including such 'invisible' products as industrial pumps (Grundfos). The practical relevance of branding is high due to the huge leverage in price that can be attained by branding.

The fourth dimension, finally, is business ethics. This is not the place to describe at length why business ethics matters (see Wieland 1999). Suffice it to highlight that the practical relevance – and the need for a theory – business ethics, in particular of approaches such as Value Management (Wieland 2002a), has been demonstrated by the string of recent scandals, ranging from Enron to Boeing just a few days ago.

In sum, my argument is that all these four dimensions are much too important in today's business world to be ignored in a framework of governance. In fact, ignoring them makes the governance framework miss out some of the dimensions that are most important today. Thereby, firms systematically neglect these dimensions and risk destroying their brand images, running into scandals of business ethics, or hollowing out their knowledge base.

The second aspect with regard to which a more integrative framework of governance is required is governance mechanisms. The number of governance mechanisms discussed is quite limited in each literature that deals with governance. Extant theories of governance are, one could say, partial. In economics, the dominant discourse is that of markets and hierarchies (and hybrids) (Williamson 1985). In the managerial corporate governance literature, the discourse revolves around corporate boards and incentive contracts for managers. There are, however, many mechanisms used to manage challenges in the other dimensions, such as knowledge transfer mechanisms, mechanisms for influencing the perception of one's brand, etc. Considering a broader spectrum of governance mechanisms, amongst which such mechanisms used to deal with the specific problems raised by knowledge governance etc., is important because where the governance mechanisms considered are highly partial, there is a risk of missing out governance mechanisms that are important, for instance for understanding the performance impact of governance efforts.[1] Note that the link between governance mechanisms and performance outcomes is not a trivial one. Poppo and Zenger's (2002) discussion is instructive in showing that even the question whether combining contracts with relational governance will have positive or negative performance implications does not have a simple answer. Not being trivial means that there is a risk one might be focusing on the wrong dimension, and use governance structures that do not affect the important dimension in question (e.g., knowledge). One would then be in the situation of 'rewarding A, while hoping for B' (Gibbons 1998: 115). In such a case, a non-significant relationship of the governance structures employed with firm performance is to be expected – a testable hypothesis. An impressive example of precisely such a non-significant relationship between board configurations and financial performance of firms is what Dalton et al. (1998) find in their literature survey.[2] Neither do they provide support for the agency theory-prescribed relationship between equity ownership and firm performance. Neither inside nor outside equity ownership is related to firm financial performance (Daily, Dalton and Cannella 2003: 374).[3]

Summing up, the present paper heeds Daily, Dalton and Cannella's (2003: 372) call for a multi-theoretic approach to corporate governance by including multiple dimensions, and governance mechanisms. As Daily, Dalton and Cannella (2003) argue, such an approach is 'essential for recognizing the many mechanisms and structures that might reasonably enhance organizational functioning'. The paper builds on extant theories of governance. Its objective is to set those in a frame that addresses the multiplicity of governance dimensions, and to add both governance dimensions and governance mechanisms to the framework. It is structured as follows. After defining governance in section (2), I start from the governance problems firms

[1] The ultimate objective of governance is, of course, to influence (economic) performance.

[2] Note that this conclusion holds across the many ways in which financial performance has been measured in the literature (Daily, Dalton and Cannella 2003: 374).

[3] This analysis included both accounting and market-based measures of financial performance (Daily, Dalton and Cannella 2003: 374).

are faced with, thereby identifying dimensions of governance in section (3). Section (4) provides an overview of the mechanisms available for addressing governance challenges in each dimension. In section (5), I analyze which are the effects of the characteristics of the additional governance dimensions on governance structures. Section (6) goes more in depth, looking at the governance of intrinsic motivation and reputation, before section (7) takes a different angle and asks what are the characteristics of the various governance mechanism with regard to reputation. To further promote a comprehensive governance framework, section (9) develops a first set of insights into the interaction effects between governance mechanisms that are applied simultaneously. A concluding section wraps up the paper.

## 2. Governance defined

Governance means to influence the way in which transactions (including, but not limited to exchange transactions) are adapted, coordinated, and safeguarded (Williamson 1985; Jones, Hesterly and Borgatti 1997). Focussing on transactions in governance provides an entry point for a dynamic analysis. It is also consistent with recent definitions of corporate governance. Daily, Dalton and Cannella (2003: 371), for instance, define governance 'as the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations'. As they explain in their recent survey of the corporate governance literature, such a definition stands in contrast to previous research on corporate governance, where the overwhelming emphasis was on the control of executive self-interest and the protection of shareholder interests in settings where organizational ownership and control are separated (Daily, Dalton and Cannella 2003). One of the conclusions of their 2003 review of the corporate governance literature is therefore a shift to a more encompassing notion of governance. Understanding governance as influencing the way in which transactions (including exchange transactions, in which organizational resources are deployed) are adapted, coordinated, and safeguarded (Williamson 1985; Jones, Hesterly and Borgatti 1997) does indeed seem to be a fruitful working definition.

So far, governance is often understood in a very specific sense. Although that is a means to be precise, it also is restrictive. For instance, in the finance literature, the problem surfaces as one of 'corporate governance', dealing 'with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment' (Shleifer and Vishny 1997: 737). Similarly, in the economics literature, corporate governance is defined as addressing an 'agency problem, or conflict of interest, involving members of the organisation … [where] transaction costs are such that this agency problem cannot be dealt with through a contract' (Hart 1995: 678). Recently, however, consensus is building for a more encompassing understanding of governance. Huse (2003: 211) for instance argues that 'governance is not only control, incentive and ownership structure. It is also the allocation of decision rights, as well

as normative and value based control' (see also recent contributions in the Journal of Management and Governance). And even corporate governance is 'not just a matter of defining incentive schemes to realign managers and workers to a simple and general objective, nor [..] just a choice of the optimal power structure, given technological conditions and human capabilities [..] it is a genuine organizational problem, concerning investment strategies and the way people and assets interact' (Lacetera 2001: 35-6).

## 3. Dimensions of governance

For identifying the dimensions of economic activity that have an impact on economic performance ('dimensions of governance' in the following), mapping flows within and across firms might be a good starting point. Marketing channel theory does precisely that. According to a leading marketing textbook, a marketing channel is "a set of interdependent organizations involved in the process of making a product or service available for use or consumption" (Coughlan et al. 2001: 3). Within such a channel, multiple flows occur. Channel flows are the activities and processes that marketing channel members engage in that are both costly and at the same time add value to the channel (Coughlan et al. 2001). Marketing channels are not just a conduit for physical delivery of the product (and for payment). Rather, taking all the flows in the marketing channel into consideration has been recognized as crucial for 'optimizing' marketing channel performance (Coughlan et al. 2001). Mapping the flows, i.e. identifying what channel flows are performed in the marketing channel, by whom, and at what levels is helpful in several aspects of channel management: detailed knowledge of the flow performance in the channel helps diagnose and remedy shortcomings in the provision of service outputs; the concept of channel flows can be used to design a new channel or revise a currently existing channel to minimize the cost of providing desired service outputs; finally, knowing which channel members have incurred the cost of performing what flows helps in allocating the profits of the channel equitably (Coughlan et al. 2001). The following flows in a marketing channel have been identified: physical possession, ownership, promotion, negotiation, financing, risking, ordering, payment, information (Coughlan et al. 2001: 89).

We can take the spectrum of flows as described by the marketing channel literature as a starting point for drawing up a list of the dimensions of importance in economic governance.

### 3.1 Physical dimension

The exchange of physical goods is what commerce is about. Manufacturing activity is (still) an important source of employment. There is no need to argue at length while the physical dimension is important to consider in governance efforts. I just want to highlight two points. First, governing manufacturing activities has been shown to be important because it is in manufacturing where product quality is being decided. Total Quality Management (TQM) is

the prime example, and the impact of Japanese producers on markets such as consumer electronics and automobiles shows that the issue is not a trivial matter. The issue has been further aggravated by increased competition due to globalization. No manufacturer can afford any more to neglect quality (and thus, governing manufacturing, logistics, etc.). The rising importance of logistics management, supply chain management, and quality management bears witness to this (Kirby 2003). The second point I want to emphasize here is the challenge represented by the growth of services. Because services are also produced, I will discuss them in the physical dimension, even though that might seem counter-intuitive.

Services are distinguished from physical products by the following characteristics: intangibility, inseparability, variability and perishability (Lovelock 2001). Intangibility means that services cannot be displayed. Customers cannot see the result or evaluate before purchase. Inseparability refers the fact that the production and consumption of services take place simultaneously, leading to problems in trading services, as the customer has to be present for many services. The involvement of the customer (and possibly other customers) is also the reason for variability in service outcomes. Service quality is therefore particularly difficult to control. Finally, perishabilty denotes the fact that services cannot be stored to meet variations in demand

### 3.2 Legal dimension

It was John R. Commons (1934) who remarked that for exchange transactions, it is the legal, not the physical dimension that matters. The legal distinction of property and possession comes into play here. One can possess an object that is someone else's property. Similarly, one can retain property rights, but cede the right to use the object (usury rights) – the case of renting an apartment. Therefore, not just the aspect of physical delivery has to be managed, but also and primarily the exchange of (property) rights: 'Transactions are not the exchange of commodities in the physical sense of delivery, they are the alienation and acquisition of the rights of future ownership of physical things, as determined by the collective working rules of society.' (Commons 1934: 58). In modern firms, we see two specialized departments taking care of these two dimensions: the logistics department, and the legal department.

Agency theory is the wedge that has been pushed into the gap between exchange of physical goods and exchange of rights opened up by Commons. One of the key insights of principal-agent theory is that residual claims, i.e. the right to appropriate gains not clearly allocated by the prevailing contract, fulfil a crucial function for dealing with incentive problems (Alchian and Demsetz 1972). The importance of property rights and the legal dimension is demonstrated impressively where they are not respected, namely in many developing countries. The importance attached to the discussion on intellectual property rights, for instance the patenting of genes, is another reminder of the importance of the legal dimension.

### 3.3 Cost

The importance of governing the cost dimension, i.e. of making cost one parameter in governance efforts, is obvious and symbolized by the fact that there are now specialized deparments for taking care of it (controlling). Note, in passing, the increased emphasis on governance in the historical development from accounting to controlling. While in economics, the costs taken into account were at first only production cost, Coase (1937) was the first to argue that transaction costs, too, should be taken into account (see also Williamson 1985).

### 3.4 Risk

In building up a list of dimensions, we have so far followed the historical development of economics and management. Production cost and price (influenced also by product quality) have since long been key categories of economics. Property rights and transaction cost were added. In recent years, risk has emerged as another major focus of governance efforts. Events such as the Leeson scandal, where stock market speculations of one individual trader led to the bankruptcy of Barings Bank, forcefully made the point that not only need a firm control its cost and product. It also needs to control its exposure to risk. We can now witness the emergence of specialized departments for risk management. While a large body of knowledge on financial risk exists, current research efforts are focused on operational risk. Clearly, the intention is to develop and operationalize theories of operational risk in order to better govern such risk. No longer is risk management a 'rocket-scientist' staff function only to be found in firms with CEO who has a likening for such things. If your competitors engage in risk management and manage to diminish their exposure to risk, then not doing the same similarly well means a competitive disadvantage.

### 3.5 Knowledge

Not only has knowledge been accepted as the most important production factor by now, and has it been recognized that we are moving towards a knowledge-based economy. Many more specialized literatures have by now also turned to investigating how to manage the knowledge in processes such as new product development (Takeishi 2002). Often, such a turn towards knowledge is not just inspired by the general insight that knowledge is the most important production factor in a knowledge-based economy. Rather, it has become evident that mistakes in managing knowledge, or overlooking knowledge as a factor that management attention should be devoted to, can be very costly from a strategic point of view. One example from the new product development literature is that firms, which decided to pursue a heavy outsourcing strategy in product development later realized that they had lost the capability to evaluate components developed by their suppliers (Ahmadjian and Lincoln 2001; Becker and Zirpoli 2003). Similar examples can be found in many more specialist literatures. Moreover, the importance of devoting management attention to knowledge is further underlined by the strategy literature. There, based on a Penrosian (1959) fundament, the argument has been that what matters for performance is knowledge in its application, thus shifting the focus to compe-

tences (Prahalad and Hamel 1990). In particular, dynamic competences have emerged as the strategically most sensitive form of knowledge (Teece, Pisano and Shuen 1997).

Knowledge is different from the classical production factors, land, labor and capital in three ways. First, knowledge is non-exclusive. It travels easily and is it difficult to exclude agents from the benefits of knowledge, leading to positive externalities (spill-overs). Second, knowledge is a non-rivalry good. It is not used up when it is used, leading to the fact that it can be re-used an unlimited number of times, in principle. Also, an in principle infinite number of people can use knowledge without anyone being deprived of it. The marginal cost of use of knowledge is zero. Third, knowledge is a production factor in the generation of new knowledge. Knowledge produces new knowledge. Knowledge is therefore cumulative and path-dependent (Carlile and Rebentisch 2003).

### 3.6 Stakeholder perception

The perception of business activity by other economic actors (competitors, customers, regulators, etc.) has always played a role in economic theory and in management theory (see theories of imperfect competition, strategy, game theory). It has, however, recently gained heavy influence on management practice and thinking with two recent trends: stakeholder theory and branding. Both are powerful arguments for taking the perception of economic actors (mainly) outside the firm very seriously. Let me briefly illustrate both. One aspect of stakeholder theory is a focus on investor relations (acknowledging that investors determine the share price, which largely serves as the leading performance indicator). On the other hand, other stakeholders, such as lobby groups, also influence performance. Stakeholder theory has therefore much reinforced (and maybe in some cases introduced) the awareness that the business activity of a firm, on all levels, from those of the CEO to those of a part-time employee in a call center, are observed by stakeholders and are object of scrutiny. The second trend is branding. The power of branding lies in the huge margins that can be leveraged by building up a brand. Ultimately, a brand is a perception in the customer's head (Keller 2003). Branding activity is directed at (extant and future) customers and it probably the best example of what it means to govern, or influence, perceptions.

Both arguments therefore establish the perception of other economic actors as an important dimension that needs to be the focus of governance efforts. The practical relevance of stakeholders lies in the fact that they can damage the firm's economic interest (see the Shell example). The practical relevance of branding lies in that it seems to be one of the most powerful competitive weapons, and a huge source of profits.

### 3.7 Ethics

Both the shareholder value and stakeholder movement, as well as the branding movement, have made a very strong point about the relevance of perception. Yet another way in which perception by other economic actors has become important is in business ethics. Because the

voice of stakeholders has become stronger, not only brand preferences, but also preferences for ethical behaviour are now expressed and used in the purchase decision. Furthermore, regulators and supranational organisations such as the International Labour Office (ILO) have also become more vigilant and demanding regarding business ethics. In 2003, it is no longer a feasible option to minimize production cost by using child labour. There is, at the very least, a high risk of a highly detrimental effect to performance if that is detected. As documented in a recent 'editor's comment' in the Academy of Management Review (Donaldson 2003) with the title 'Taking Ethics Seriously – A Mission Now More Possible', business ethics has also made deep inroads in the academia, established itself, for instance, as an integral part of Business School curricula. Clearly, it is no longer feasible to ignore the ethical dimension of conducting business. Incidents are accumulating where pension funds, for instance, force firms to change their behaviour, their board composition, or the like (Donaldson 2003).

For all the dimensions just described, it seems that practice has faced – or is still facing – challenges without too much guidance from theory being available. Theory is in the process of catching up. The emergence of the field of 'knowledge governance', for instance, is a sign for that.

## 4. Identifying governance mechanisms

Having argued which governance dimensions are indispensable to take into account in economic governance, the question is what impact taking additional dimensions has on the question which governance mechanisms should be used. The first step to answer this question is to describe the spectrum of governance mechanisms available.

### 4.1 Price mechanism

The price mechanism is one of the two classical governance mechanisms, the other one of course being authority (hierarchy). The *working principle* underlying the price mechanism is a matching mechanism – buyers and sellers are matched by a Walrasian auctionator (see also markets where they are at their purest, such as stock markets or internet markets). The *advantage* of the price mechanism is that all information necessary is contained in the price. Furthermore, the price mechanisms provides high-powered incentives – when there is sudden rise in the demand for a product, the price will also rise if no increase in supply reaches the market, providing a strong incentive to producers to either invest in the production of the good in question or shift from producing some other good, to producing the newly demanded one. The *prerequisites* for the price mechanism to work are transparency of the market (availability of information, low information cost, fast speed of information acquisition), and measurability of

performance (in order to set prices).[4] The effectiveness of the price mechanism is *limited* by a number of instances, amongst which the lack of the prerequisites just described. The limits to the effectiveness of the price mechanism arising from the first set of prerequisites have been explored by the behavioural theory of the firm (March, Simon): if information is not given to all, then search is necessary. Cognitive resources, however, are bounded (Simon 1955). Individuals therefore search only until a satisfying alternative is found, not the optimal one (March and Simon 1958). Asymmetric information also complicate the working of the price mechanism (Akerlof 1970). The second set of limitations refers to problems in price-setting. These can arise from measurement problems (leading to long-lasting disputes about the price) or a lack of a reference price (when the good is to be traded the first time). Furthermore, certain goods present limits to the price mechanism: public goods, characterized by non-excludability and non-rivalry. Non-excludability means that when one user is consuming the good, others can benefit, too and cannot be excluded from benefiting. The implication is that there is no incentive to purchase the good, but rather to free-ride once someone has done so. Non-rivalry means that the marginal cost of consuming another unit of the good is zero. The implication is that the marginal-cost pricing method cannot be applied, and the price needs to be set otherwise, providing an argument for intervention.

### 4.2 Authority

In much of the economics literature, organizations are characterized by hierarchy (Williamson 1975, 1985). The *working principle* underlying authority is direction: authority means to have the right to direct work (Foss and Foss 2002). This is why authority can complement (‘fill out’) the incompleteness of employment contracts. The *advantage* of authority is that it is precisely this capacity of authority to complete incomplete contracts. While the prerequisites of the price mechanism have been acknowledged widely, the *prerequisite* to authority, however, is often overlooked. Authority means the right to direct work, by giving orders. Giving an order does not necessarily mean that it is executed, however. Barnard (1938) has pointed out that authority needs to be accepted: “The decision as to whether an order has authority or not lies with the persons to whom it is addressed, and does not reside in ’persons of authority’ or those who issue these orders” (Barnard, 1938: 163).[5] It cannot be brought about by order. What does such an acceptance of authority depend on, though? The point is an old one. Both Barnard (1938) and Simon (1947) have pointed out that authority needs to be accepted.

[4] Finally, it should be noted that the market itself is an institution. In order to function, a sufficiently stable institutional setting is required, for instance an accepted price-setting mechanism, rules of exchange, and so on. Post-Cold-War Russia provides an example of what happens when the market does not have a stable institutional setting.

[5] In this context it is interesting to note that John R. Commons, who Williamson (1985) credits with originating the notion of a transaction, had clearly recognized that the actors had a crucial role when he wrote: “A transaction, *with its participants*, is the smallest unit of institutional economics.” (Com-

Barnard describes a “zone of indifference in each individual within which orders are acceptable without conscious questioning of their authority ... The zone of indifference will be wider or narrower depending upon the degree to which the inducements exceed the burdens and sacrifices which determine the individual's adhesion to the organization” (Barnard, 1938: 169). Beyond the *limits* to authority arising from the fact that authority needs to be accepted, there are other limits to the governance power of authority. Famously, Hayek (1937; 1945) was the first to take a strong stance on the issue. He argued that directing work of subordinates requires detailed knowledge of the work that is to be directed. Because of limited cognitive resources (Simon 1955) of the holder of authority, however, there are limits to the work that he can direct. The problem is further aggravated by problems in acquiring knowledge about what the subordinates are doing. Due to specialisation, such knowledge is specialized, detailed, and can include large tacit components, which in turn present problems in transferring such knowledge (Szulanski 1996). Because a superior can only direct a subordinate regarding the activities he or she knows about, “[i]f the subordinate is knowledgeable about activities that the superior is not, the superior could not direct the subordinate to engage in those activities” (Minkler 1993: 576). Finally, increasing complexity further makes it more difficult to give the right detailed orders in exercising authority.

### 4.3 Contracts

The *working principle* of contracts is to provide legally binding commitments. Such commitment gives security, as it resolves uncertainty to a certain degree. A second working principle of contracts is to provide extrinsic incentives (indirect incentives such as monetary rewards). The *advantage* of contracts is that they can provide solutions to incentive problems. The human resource and corporate governance literatures have much to say on this and on different forms of remuneration schemes, option plans and the like, in employment contracts. The *prerequisite* to writing a contract is that its components can be specified. Systematically, that is not the case with future events, for instance. A new technology to be developed can only be described in rough terms, and the contract needs to be incomplete, to be ‘closed’ by negotiations about the interpretation about the ‘rough-term’ clauses. Likewise, contracts cannot completely specify all relevant aspects of employee behaviour and its desired outcome. Where contracts are incomplete, they need to be complemented by some other governance mechanism. In the case of employment contracts, the complement is authority. But there are further *limits* to the governance power of contracts arising from problems in addressing incentives (Shapira 2000). First, incentive contracts are only powerful to the extent that the underlying performance can be measured. As Alchian and Demsetz (1972) have pointed out, measurement problems arise for instance in team production where inputs and/or outputs cannot be

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mons, 1934, p. 58; italics added). It seems that subsequently, the focus has shifted more towards structure – the term ‘governance structure’ clearly favouring the structural aspect.

unambiguously attributed to the individuals involved. There are other instances of measurement problems, though, such as inobservability of in- or outputs, or time constraints and bounds to rationality and cognitive resources of the monitors (Shapira 2000). Second, the governance power of incentive contracts is limited by the ability to enforce presumed contract violations (Shapira 2000: 53).[6] Further limits arise from devising incentive schemes that break down the performance goals of, say, a department, to the individual level. Furthermore, financial goals cannot always be broken down into operational goals for employees. Finally, another limit is that contracts offering incentives to reach given goals can give rise to dysfunctional behavioral responses. Employees focus only on activities that are rewarded, and neglect others (Osterloh and Frey 2000).

### 4.4 Psychological contracts / Relational governance

In contrast to legally binding contracts, there are also contracts (a subclass of implicit contracts), which are socially binding. The *working principle* is by emotional loyalty that has been engendered in personal relationship. Over a history of repeat interactions, knowledge about each other has built up, some stability of expectation about the behaviour of the other, trust, and an emotional loyalty. The expression 'psychological contracts' is Jones, Hesterly and Borgatti's (1997). What they have in mind seems to largely overlap with what other authors have described as mechanisms of 'relational governance'. The *advantage* of psychological contracts is that they can address incentive problems by intrinsic motivation.[7] Motivation is intrinsic if an activity is undertaken for one's immediate need satisfaction. Intrinsic motivation 'is valued for its own sake and appears to be self sustained'.[8] The ideal incentive system is in the work content itself, which must be satisfactory and fulfilling for the employees' (Osterloh and Frey 2000: 539). *Prerequisites* for psychological contracts are repeat interactions (history). The *limits* of psychological contracts are that changing intrinsic motivation is more difficult, and the outcome more uncertain than is the case with extrinsic motivation. Furthermore, intrinsic motivation can also have an undesirable content (Osterloh and Frey 2000).

### 4.5 Psychological contracts / Relational governance

The *working principle* underlying hostage exchange is to create credible commitment by setting up (symmetric) vulnerability of the partner that before had an incentive to exploit the vulnerability of the other partner. The *advantage* of this governance mechanism is concen-

[6] Asymmetries of power, perspectives and aspirations between managers and employees present further limitations of the governance power of contracts.

[7] Open-source software is a good case for the relevance of intrinsic motivation. It shows that the free exchange and mutual sharing of knowledge (i.e., not governed by contracts or markets) appears to be sustainable between firms (Lerner and Tirole 2001).

[8] Although many economists admit the existence of intrinsic motivation, they leave it aside because it is difficult to analyze and control (e.g., Williamson 1985, p. 64). (Osterloh and Frey 2000, 539)

trated in the protection against opportunistic behaviour. *Prerequisites* are that a hostage needs to be available, exchangeable, and its value stable over time. These also present the *limits* to hostage exchanges. The basic limit to hostage exchanges are possible inefficiencies (opportunity cost of the 'hostage', for instance the asset).

### 4.6 Reputation

A corporate reputation is a set of characteristics attributed to a firm, inferred from the firm's past actions (Weigelt and Camerer 1988: 443). Reputation is not situation specific but holds a cross situations. It is built up by being awarded status in a series of individual situations. Contrary to reputation, status is situation specific.

Reputation is a governance mechanism because it can influence behaviour. Notably, it is a governance mechanism that can complement incomplete contracts, as I will explain in this section. The *working principle* of reputation is two-fold: reputation reduces behavioural uncertainty by providing information about the reliability and goodwill of others (Jones, Hesterly and Borgatti 1997), and by constraining the space of behavioural possibilities taken into consideration by actors, due to the fact that choosing an option that contradicts the reputation already gained entails the cost of destroying that reputation (Al-Najjar 1995). For an explanation of how the use of reputation as a mechanism for creating credible commitment by increasing the attention drawn to possible violations, see Wieland 1996, 2004 forthcoming). The *advantage* of reputation is that it can serve as an informal governance mechanism to complement incomplete contracts. For some classes of goods, it is impossible to write complete contracts. For all goods, for instance, which are ordered while still under development, it is by definition impossible to provide the precise technological specifications at the time when the good is ordered. The contract necessarily has to contain a clause that will specify 'the latest technology' or something similar. One important class of incomplete contracts are employment contracts. They do not specify in detail what the employee will do, but rather provide a general framework of duties and rights. The details in this framework are then filled in by authority, i.e. managerial orders. Recall that as described above, there are important limits to the governance power of authority. Where authority does not suffice to solve governance problems, reputation offers itself as an alternative.

Such an alternative is even more pertinent in the case of a different kind of incomplete contracts, relational contracts. In relational contracts, the parties to the contract will work out a solution to problems that might arise from the incompleteness of the contract by themselves, without having recourse to a third party such as a court. For that to work, the reputation of the parties to the contract matters, because the implicit parts of the contract need to be interpreted by the parties. Reputation fulfils a crucial role in forming expectations about the behaviour of others. Both reputation and status are generated in interaction with others, and is being attributed to an actor by other actors. Thereby, it is specific to the person with which a reputation

has been built up.  Reputation and status are therefore the product of interpretation of the behaviour of an actor in interaction.

But what is the *prerequisite* for accumulating reputation? Just like authority, reputation has to be built up in the eye of the beholder. It is attributed to an actor by someone else. Reputations have *limitations* in their use. For instance, information about reputation may be inaccurate or misinterpreted; when diffused across long chains of links, information may become distorted as it is filtered by participants; furthermore, over-reliance on reputation may reduce new and innovative information as actors limit their range of partners to a small, increasingly in-bred group (Jones, Hesterly and Borgatti 1997).

### 4.7 Restricted access to network

The *working principle* underlying the access restrictions to networks is to reduce the number of actors one interacts with. The *advantages* are threefold: it reduces coordination costs. At the same time, to have fewer partners means that interaction frequency increases (*ceteris paribus*), which can augment both the actors' motivation and ability to coordinate smoothly. Furthermore, it also facilitates safeguarding exchanges. Having fewer partners decreases the total amount of monitoring a firm must do (Jones, Hesterly and Borgatti 1997: 928). The *prerequisite*, or way in which it is implemented is by status maximization (Jones, Hesterly and Borgatti 1997). Status maximization refers to attempting to interact with partners with high status, excluding such partners with a low status.[9] Additionally, repeat interaction is required, in order to reap the positive effects linked to increased frequency described above. To a certain extent, these also depend on rich relations, i.e. more than arm's-length relations that involve personal identity. *Limits* to restricted access are inadequate incentives for innovation. Closing the network off too much leads to 'not-invented-here' syndromes, and impedes innovation because less variation penetrates the network members. Furthermore, the more access to the network is restricted, the more important is the quality of those that are admitted.

### 4.8 Macroculture / Common overlap of knowledge

With the term 'macroculture', Jones, Hesterly and Borgatti (1997: 929) refer to 'a system of widely shared assumptions and values, comprising industry-specific, occupation or professional knowledge, that guide actions and create typical behaviour patterns among independent entities'. Its *working principle* is to provide shared, or common, overlap in knowledge. Often, such knowledge pertains to fundamental issues of doing business, such as assumptions about products, customers, markets, and so on. The fact that such knowledge is shared leads to a number of *advantages*. First, it enables communication because a common set of references

[9] This principle is, in fact, a causal factor leading to the stratification of networks.

exist. The literature on knowledge transfer has argued strongly that a common set of mental categories and references (or in other words, a common language), is necessary in order to communicate, and to acquire knowledge (Cramton 2001). Second, shared overlap in knowledge provides some degree of stability of expectation about the behaviour of the other party, as assumptions usually translate into some behavioural options being excluded. The *prerequisites* of common overlaps in knowledge (or macrocultures) are socialization mechanisms, such as professional socialization (education, informal interactions with members of the profession), media that are focused on one community, and community-based events (trade shows etc.). The *limits* of common overlaps in knowledge (or macrocultures) pertain to the genesis: building overlaps takes time, the more so the more they are on the underlying level of assumptions, beliefs, etc. Furthermore, it often takes third-party institutions such as guilds, professional associations, or professional education institutions in order to support the professional socialization process.

Having established which governance dimensions matter, and provided a structured description of those and the governance mechanisms available to govern them, we are now prepared to address the question what consequences taking into account the additional dimensions has on economic governance.

## 5. Consequences of the additional governance dimensions on governance mechanisms

I will answer the question in several steps. The first is to focus on the consequence of the particularities of each governance dimension for economic governance [→ the governance mechanisms to be employed]. For instance, what difference does it make for aligning transactions with governance structures, whether the object of the (exchange) transaction is (the right to) a physical good, or (to) a service?

### 5.1 Services

A number of characteristics that distinguish services from physical products, have consequences on the governance of service production and exchange.

*Services are intangible*. They cannot be displayed and inspected. One implication of intangibility is that without inspection, buyers rely on cues, communications experience and word of mouth to make judgements (Lovelock 2001). Intangibility makes many services difficult to evaluate before purchase. Because the pre-purchase evaluation of service quality is vague and partial, reputations play a strategically important role in service markets (Weigelt and Camerer 1988; Wieland 1996, 2004 forthcoming). The reason is that in searching for cues to evaluate services, such cues will only be as helpful as their source is trustworthy. The solution to the evaluation problem via proxies ultimately depends on the reputation of the proxy. The

intangibility of services therefore increases the importance of reputation as a governance mechanism.[10]

*Customers do not obtain ownership of services*. Therefore, customers cannot consume the service simply by contract. Service providers are involved, which need to be motivated to provide the service, and provide it well. Because it is difficult to specify and evaluate services, contracts on service provision will systematically leave a grey zone that cannot be dealt with in a contract. When is a haircut – as specified in the contract that is concluded when you take a seat in the barber's chair – unacceptable? Unless the service is below the threshold of some formalized, or unanimously accepted, criteria for acceptability, it is impossible or very costly to intervene with formal governance structures such as claiming a breach of contract. Intrinsic motivation therefore plays an important role in influencing the service provider to provide a certain level of service quality that lies in the (considerable) grey zone between unacceptability, average and excellent service quality.

## 5.2 Knowledge

As services do, knowledge has characteristics which make an important difference for governance. That is particularly true for tacit knowledge, on which I focus in the following.

*Because tacit knowledge is personally held, no property rights on tacit knowledge can be acquired*. It is only possible to acquire the rights to *use* the knowledge held by employees, who always remain the owner of their knowledge, and of the competence to generate it and to contribute it to a cooperation (team production) (Wieland 2002b). Tacit knowledge therefore cannot be accessed via the acquisition of property rights. The implication for governance is straightforward: (formal) contracts are systematically less important in governing knowledge. Rather, the holder of tacit knowledge has to be *motivated* to cooperate and share (transfer) his or her tacit knowledge.

*Tacit knowledge poses measurement problems* (Wieland 2002b), as becomes particularly salient in the case of team production involving tacit knowledge. The implication for governance is that because of problems with measuring tacit knowledge inputs, it is often very difficult to provide explicit, monetary incentives for individual efforts in knowledge processes (Foss et al 2003). One is therefore constrained to design extrinsic incentives based on outputs. But in that case, the issue of team production presents problems in attributing the rewards (Alchian and Demsetz 1972). Another problem with setting incentives appealing to extrinsic

[10] For instance, producers can establish a neutral – for instance industry-wide or cross-industry – evaluation panel that gives marks to service providers. Another possibility is to offer generous warranties of the kind 'fully satisfied or your money back', with no questions asked. The reason the warranties have to be of the most generous kind because services are difficult to evaluate, the service output is difficult to define and any warranty that has some kind of service specification therefore is bound to bear the risk for disputes. Obviously, the warranty is only as good as the reputation of the manufacturer (e.g., it is no good any more if the manufacturer goes bankrupt).

motivation is that they work indirectly: in order to incentivize a certain behavior (for instance writing a post-mortem analysis after a project is finished, in order to make the experience acquired available within the firm), monetary incentives are offered. In designing those, the problem is that the actors maximize the rewards, but not by producing the behavior originally intended. For instance, examples from call centers demonstrate that there are many ways to increase the total time spent on the phone if that is the criterion for rewards (for instance by leaving the phone open when taking breaks etc.), and the number of calls (by letting 'the line drop' and calling again) if that the number of calls is rewarded. Obviously, both are far from the ultimate objective of call centers to provide good service. Because it is impossible to measure tacit knowledge, extrinsic incentives are 'far proxies' which carry the risk of incentivizing rewards, but not the underlying behavior they were intended to incite. Providing extrinsic incentives for supplying tacit knowledge inputs therefore runs into severe problems. For this reason, intrinsic motivation has a crucial role as a possibility to incentivize economic actors to share their tacit knowledge, and contribute it to cooperative efforts (Osterloh and Frey 2000).

### 5.3 Stakeholder perception

By its very definition, *perception means to attribute a judgement to what one observes*. One observes objects, behaviour, and so on, and makes a subjective judgement on their qualities, amongst others. The perception of behaving ethically responsively, for instance, emerges at the stakeholders'. It is in the eyes of the beholder. A firm can attempt to behave in such a way that it fulfils commonly accepted criteria of ethical behaviour – but the perception is attributed by those who perceive the firm's behaviour.

Perception is not tradable (even if trademarks are – the perception of a trademark is not the same as the trademark, and can change fast, however). For this reason, the *price* mechanism cannot govern the perception dimension. It is clear that perception also lies well outside the power of *authority* (in the sense it is used in the present context, as direction of work). Actors cannot be 'ordered' to have a certain kind of perception or even judgment. Neither are *contracts* very powerful for governing perceptions such as brands images, for multiple reasons. The power of contracts to protect reputations is limited by the fact that the damage to a firm's reputation, or a product's brand, that can be done by one employee is much higher than the contractual sanctions that are possible towards that employee. (Try to make an employee pay compensation for having destroyed the Coca-Cola brand). Furthermore, there are limits to how precisely one can control and enforce contractual sanctions for protecting the brand image customers will have. Franchise systems have taken the limits to the extreme. Adding to the argument made above on the grey zone of services quality, it can be argued that in order to make the customer perceive a service as excellent, it is necessary to be really convinced and engaged. Because of the problems in designing extrinsic incentives, achieving this with extrinsic incentives is very difficult, if not impossible. Rather, intrinsic motivation, involved

in *psychological contracts*, seems capable of yielding such a perception at the customer's. The most directly applicable governance mechanism, however, clearly is *reputation*. Reputation, after all, is but one kind of perception (of actions of the past; Weigelt and Camerer 1988). In fact, the rising importance for managing stakeholder perception leads directly to a rising importance for reputation as governance mechanism. Completing the list of governance mechanisms, *restricted access* might reinforce perception by virtue of the fact that when access is restricted, the group that is in contact might be more similar, thereby supporting a certain consistency of perception. Finally, *macroculture* (common language) is a governance mechanism that can support the governance of stakeholder perceptions. Clearly, it is necessary to 'speak the language' of the target segment concerned and develop a set of common knowledge, so that communities perceive business activity in the right light. Practical measures to implement such governance are boundary spanners, absorptive capacity, etc.

In conclusion, what is the impact on governance of taking the dimensions of services, knowledge, stakeholder perceptions, and ethics into account? We have seen three broad and wide-ranging changes:

- Contracts become more incomplete and therefore, informal governance mechanisms for completing incomplete contracts are becoming more important. In the bundle of 'formal plus informal elements of governance structures', the proportion shifts toward the informal end.
- Intrinsic motivation plays an increasingly important role for governance. It is a possibility for governance where extrinsic incentives run into limits.
- The importance of reputation as governance mechanism is increasing.

This massive shift in the proportion and importance of governance mechanisms should be seen against the background of the fact that of the four the dimensions particularly considered, three are non marketable (the exception being services). As argued above, all these dimensions are not negligible anymore today and have experienced huge growth in the last decade. Having identified the swing of attention that theories of governance are undergoing, I now turn to taking a closer look at the governance mechanisms just identified as becoming more important.

## 6. Governing intrinsic incentives and reputation

Based on a characterization of both a wider spectrum of governance dimensions and governance mechanisms, the preceding section has argued that as the dimensions of services, knowledge, stakeholder perceptions and ethics become more important, the formal elements of governance structures decrease in governance power and importance. Contracts become more

incomplete. Governance becomes more complex. It is not sufficient any more to concentrate on elaborating extrinsic motivation schemes such as golden parachutes, stock option packages, and the like. Rather, the void needs to be filled increasingly by informal governance structures. For the four governance dimensions considered, intrinsic incentives and reputation are the main candidates. The present section therefore focuses on those two governance mechanisms and attempts to illuminate their working principles. This will contribute to getting a better idea of how they can be applied.

Intrinsic motivation refers to immediate need satisfaction, e.g. to being motivated by doing something for its own sake. The opposite of intrinsic motivation is extrinsic motivation, which derives from indirect rewards, such as for instance financial rewards. There are three sources of intrinsic motivation:

- carrying out an activity for its own sake (the pleasure of painting, for instance),
- pursuing a self-defined goal, or
- feeling required to fulfil the obligations of personal and social identities (Osterloh and Frey 2000).

Intrinsic incentives have the implication that they are contained in the work content itself and are self-sustained. No incentives do therefore need to be set.

From a governance point of view, the question that arises is “How can intrinsic motivation be influenced?” To assure that employees carry out an activity for its own sake, one can attempt to select such human resources that have a propensity for the work at hand. Assuring that employees pursue self-defined goals, at least to a certain extent, can be implemented by delegating more decision rights on how to execute tasks to employees (empowerment, delegation). These two measures are basic HR management measures. The third issue, the importance of identity providing as an entry-point to intrinsic motivation for governance efforts is less common. In fact, having identified identity as the main wedge for governance efforts of the knowledge, stakeholder perception, ethics, and service dimension is one of the main results of the considerations in this article.

But how does governance via intrinsic incentives work? To attempt to govern via intrinsic motivation seems paradox at first glance. Building on Wieland (2002; see also Grier and Deshpandé 2001), however, one can argue that the entry point for governing intrinsic incentives is identity. There are two kinds influences of governance mechanisms on identity, a direct and an indirect one.

The various governance mechanisms have a *direct* influence on identity: The *price* mechanism, by definition, works via price signals. It is limited to extrinsic incentives (Wieland 2002b) and has no influence on intrinsic motivation. *Authority*, in the sense of the right to direct work (Foss and Foss 2002) does precisely mean to *not* have employees decide which task they like best. Note also that one of the two remaining ways to influence intrinsic motiva-

tion – delegation and empowerment – translates into an endogenous limit to authority. As shown above for the four governance dimensions considered here, formal *contracts* are not very powerful. They will systematically be very incomplete, and their governance power derives form the informal governance mechanisms that complete them. Contracts have no particular influence on identity. *Psychological contracts / relational governance* foster identity via increased interaction frequency and richer personal relationships, which can be perceived as gratifying and as making the interaction pleasant in itself. The realm of relational governance is definitely where to find the governance mechanisms that have an influence on identity. *Restricted access* and *macroculture* might be able to reinforce an identity due to the more intense interaction enabled by a smaller community that shares a larger overlap of common concepts. In conclusion, as price mechanism and authority become less powerful, the focus of the powerful governance mechanisms moves to the realm of relational governance, reported to be superior to more formal organizational arrangements also for governing knowledge processes (Foss et al. 2003).

An *indirect* influence of governance mechanisms on intrinsic motivation does, however, also exist. In attempting to understand how impact works, I build on the insight that identity is the entry-point to intrinsic motivations, at least from a governance point of view. The starting point of the argument is the insight that one of the processes by which identity is formed (confirmed, built, contradicted) is the allocation of status (Grier and Deshpandé 2001; see also Einwiller and Will 2002). It is not enough to 'decide' for oneself that one has the identity of teacher. It is necessary that interaction partners give signals that confirm the identity. More precisely, they do so by awarding status. For instance, the fact of being treated with respect by the pupils confirms the identity of the teacher. From this stepping stone we can now ask how the process of status allocation (being awarded status) works.

Note that status and esteem are not marketable (Wieland 2002b). It is impossible to give, or acquire, status by itself. It needs to be communicated 'attached to' something else. For instance, a gesture such as letting a person enter a door first, or an artifact (economic good) such as a two-year old rather than a brand-new company car, or the like. These are of course the exchange transactions we know. What new? The crucial point is that actors have a general human need for esteem (Wieland 2002b), both self-esteem and esteem by others. The esteem by others works by allocation of status. Because status can only be allocated attached to an economic good (Wieland 1996), the implication is that the status dimension is always present in each and every exchange transaction – or to be more general – each and every interaction. The point is crucial. Actors always observe the interaction for the consequences it has for their own status. For the present context, the conclusion is that the status consequences of governance mechanisms are central. In order to influence intrinsic motivation, governance mechanisms need to be designed such that they have a beneficial effect on the allocation of status or avoid negative repercussions of allocation of low status. I therefore now turn to looking at the effects that the various governance mechanisms have on the allocation of status.

## 7. Reputation effects of governance mechanisms

What effects do the various governance mechanisms have on the allocation of status?

### 7.1 Price mechanism

There are at least three different ways in which the use of the price mechanism has an influence on the allocation of status.

The price mechanism only works on a market. The *type of market (place) used* can confer a certain status of participants on that market. To illustrate the point, imagine yourself leaving a discount store of the lowest market segment, and an up-market gourmet caterer. Generally speaking, being observed using a marketplace can have the consequence of being attributed a certain status ('low-income', 'high-income', etc.). The theoretically more rigid version of the argument is to consider an exchange transaction on a particular market (place). Each party to the transaction, seller and buyer, do not only allocate a good and the corresponding sum of money. Attached to the good and money exchanged, they also allocate status (Wieland 1996), such as high- or low-class, and so on, showing for instance in the language, gestures, and respect. In order to see the status-allocation effect of market places clearly, consider the case of a buyer who is in a foreign city (maybe in a country he has never been in before) and for the first time enters a bazaar, a department store, and a fish market. For his counterparts, he has no history. Our buyer is not socialized into the interaction of these particular marketplaces. He acts on the bazaar just like in his local bakery. That market places allocate status can be seen by the way that he is treated in different ways in these three market places – even although the exchange transaction is always the same. He might have entered an extremely expensive department store and realize this by the respect expressed as a salesman runs to open the door. At the fish market, where everyone shouts and sellers do not want to respond to a question about the fish, our customer realizes that he is not considered a very valuable customer, in other words, someone with little money to spend.

Furthermore, the price mechanisms can work in *different types of market mechanism*. For instance, there are several types of auction, such as Dutch auctions, reverse auctions, etc. Depending on the type of auction used, the result of the matching between buyers and sellers is a different one. While it could be argued that because this changes who is successful in acquiring a good and who not – which again has a consequence on status, the main effect on status is a different one. Just like with market types, it is possible that different types of auction are considered of different status (and also those who use them). For instance, Dutch auctions could mainly be used in auctions of 'lost and found' objects held at the railway station, considered a strange way to acquire an umbrella or a suitcase. Other auction mechanisms such as

reverse auctions are mainly used on internet marketplaces or in public tendering. Using such a type of auction therefore would convey a status of being professional.

The final argument does, strictly speaking, not concern the price mechanism itself but the *object of the exchange* transaction that it governs. In the light of the fact that the largest part of exchange transactions seems to be governed by markets, however, the link is nevertheless a strong one. Of course, we know very well that (the acquisition of) goods also convey a certain status. In fact, some luxury goods are even called 'status symbols'. The associations (reinforced by marketing campaigns) and status of goods transfers to those who possess them (Keller 2003).

### 7.2 Authority

The authority mechanism is applied in a hierarchy. In a static sense, by this very set-up, authority allocates status: a particular place in the hierarchy, decision rights, etc. There is, however, also a way in which authority allocates status in a dynamic sense. Consider the interaction in which an order is given and received, for instance to write letter to a customer. Consider also that interactions take place in a context – a history of prior interactions, a particular point of time, a particular place, a particular hierarchy. Because of this context, the degree of detail in which the order is specified by who holds the authority, will be judged by the receiver of the order against an expectation of how detailed is should be. In both cases, the degree of detail necessary to give to a person will be in large part determined by the assumption about the knowledge and competences of that person. Think of how you would ask a 6-year old and an 18-year old to buy bread. When orders are given, the receiver also 'decodes' the underlying assumptions about his or her knowledge and competence level, and compares that assumption with his own perception. Status is allocated through the difference in perception of the receiver's competence.

### 7.3 Contracts

Establishing a formal contract (I focus on those kinds of contracts in the following) confers a particular status on the interaction partner: that of someone who is not trusted enough to operate without a formal contract to safeguard the business relationship (Poppo and Zenger 2002; Dyer and Singh 1998; Macaulay 1963). The same is true for each transaction carried out within the frame of a formal contract: sticking to the terms of the contract is equivalent to expressing a preference for not developing a close(r) relationship. The tougher version of the argument is to argue that the use of formal contracts has a pernicious effect on cooperation (Ghoshal and Moran 1996; Poppo and Zenger 2002; see also Tsai 2002 for the particular case of knowledge inputs to cooperation). The point is an old one. Macaulay (1963: 64) writes of contracts and contract law that 'their use may have, or may be thought to have, undesirable consequences. Detailed negotiated contracts can get in the way of creating good exchange

relationships between business units.' The reason is precisely that using an elaborate contract 'indicates a lack of trust and blunts the demands of friendship, turning a cooperative venture into an antagonistic horse trade' (Macaulay, 1963: 64). When Macaulay says 'indicates a lack of trust', he is clearly discussing the allocation of status.

*Psychological contracts* do not have such a destructive effect. *Reputation*, as explained above, is the result of the repeat process of allocation of status over a number of time periods. It is thus by understanding the allocation of status that one gets an idea of how reputation emerges and evolves. *Hostage exchange* mechanisms do have the same effect as formal contracts, if not even more pronounced ones. Access restrictions translate directly into inclusion or exclusion. Inclusion usually has positive, exclusion negative status associations.

## 8. Interaction effects among governance mechanisms

In the introduction, I have argued for a more comprehensive framework of economic governance. Up to now, the paper has extended the governance dimension of the framework, and the range of governance mechanisms. It has given a structured description of both and has identified both the consequences of the characteristics of the 'new' governance dimensions for governance structures, and the reputation effects of governance structures (because those feed into identity, which had been identified as the most promising lever for influencing intrinsic motivation – which in turn holds the key to governing knowledge, services, ethics, and stakeholder perceptions). One aspect however is still missing. 'More comprehensive' also means to take the simultaneous application of combinations of governance mechanisms into account. While these can be analytically separated, in practice bundles of governance mechanisms are applied, for instance a formal, incomplete contract, with a hostage exchange mechanism, restricted access and a particular psychological contract. An important question is therefore: 'What interactions are there among governance mechanisms used simultaneously to govern a transaction?' In this section, I offer a first attempt at collecting what we know about such interaction effects. Clearly, the matter is not simple and is a field of research that seems both promising and requiring substantial, long-term research efforts.

*Crowding-out of extrinsic and intrinsic motivation*. I have argued that for governing the four 'new' governance dimensions, intrinsic motivation holds a key. Because of that, interaction effects pertaining to motivation are particularly relevant. And in fact, such interaction effects between intrinsic and extrinsic incentives seem to exist. Extrinsic and intrinsic motivation are not additive (Osterloh and Frey 2000). Rather, there is a 'crowding out' effect. Tangible rewards undermine intrinsic motivation for tasks for which the experimental subjects show an intrinsic interest in a highly significant and very reliable way and the effect is moderately large. This undermining is particularly true for monetary compensations that were perceived by the experimental subjects to be controlling and therefore tended to crowd out

intrinsic motivation (Osterloh and Frey 2000). Using extrinsic and intrinsic incentives simultaneously therefore has disturbing consequences.

*Authority crowds out (psychological contracts on) knowledge sharing*. A similar relationship has also been found for the knowledge dimension. Investigating the influence of formal hierarchical structure (centralization of decisions) on knowledge sharing within a multi-unit firm, Tsai (2002: 179) finds that formal hierarchical structure 'has a significant negative effect on knowledge sharing, and informal lateral relations, in the form of social interaction, have a significant positive effect on knowledge sharing among units that compete with each other for market share, but not among units that compete with each other for internal resources'. Even despite the qualification of the result for particular cases of inter-unit competition, there are cases where a crowding-out effect of authority and knowledge-sharing exists (Tsai 2002: 186). More generally, these findings point to limits in the possibility to freely combine formal and informal elements of governance mechanisms.

*The price mechanism and restricted access contradict each other*. In principle, price mechanism and restricted access exclude each other. Ideally, a market should have many participants in order to ensure liquidity of the market, and to conclude transactions fast (that is, find buyers and sellers fast, which is more likely with a high number of both). This tension could possibly help explain why there are problems with 'bringing the market in the firm', and where are the limits to combining these two governance mechanisms.

*The price mechanism and macroculture are opposed regarding the knowledge dimension*. In fact, there is a strong underlying tension between the price mechanism and macroculture. Going back to Adam Smith, one basic idea underlying the price mechanism (the functioning of the market) is the division of labor and specialization.[11] The economy is organized according to the division of labor, actors are specialized, and the participants that act on markets have asymmetric knowledge (in a broad sense: their competences, not just in the narrow sense of the information about market prices). The more so, the better. On the other hand, the governance mechanism of macroculture is also based on the same observation, but draws the opposite conclusion. One could say, it is the Hayekian conclusion. Because actors have asymmetric knowledge, this should be reduced in order to improve governance (coordination). This is why macroculture fosters shared knowledge overlaps.

Let me draw a first conclusion. As mentioned, this section has presented nothing but a first attempt to identify interaction effects among governance mechanism if applied simultaneously. Already, the tensions uncovered between certain pairs of governance structures identifies combinations which seem not viable, or at least to introduce noise and friction in the system. Other trade-offs and crowding-out effects have been identified, which simply mean that one should choose one side and not combine both in one bundle of governance mechanisms.

[11] Otherwise, the argument for using the market to purchase goods rather than manufacture them oneself would be much weaker.

A final observation concerns authority: as explained above, there are three sources of intrinsic motivation: carrying out an activity for its own sake, pursuing a self-defined goal, and feeling required to fulfil the obligations of personal and social identities (Osterloh and Frey 2000). Not only does authority not contribute to the last one, which seems to be the most powerful. Authority also blocks the other two possibilities of reaching intrinsic motivation. Given that intrinsic motivation is indeed a crucial lever for governing the 'new' governance dimensions, authority is a bad choice.

## 9. Conclusions

The dimensions of services, knowledge, stakeholder perceptions (including brand image) and ethics are not negligible any more today. It is imperative for theories (and the practice) of governance to take those into account. Not being able to do so leads to huge gaps in the theory and competitive disadvantage in practice. The paper has given a first (indicative, not complete) inventory of the governance mechanisms available for dealing with the governance of the multiple dimensions identified. As has been argued, taking into account the 'additional' dimension of governance identified (as compared to the dimensions that traditionally have been taken into account in theories of governance), lead to a massive shift of attention, from formal governance mechanisms such as contracts and organization structure, to informal governance mechanisms such as the reputation management mechanisms. In this context, taking the additional governance dimensions into account reveals a fact that has wide-ranging consequences: the 'objects' of the additional governance dimensions almost all have the characteristic of not being marketable (services being the exception, to a certain degree). Obviously, the price mechanism as governance mechanism is therefore neutralized. Importantly, however, authority as governance mechanisms *also* runs into severe problems for these governance dimensions. The reasons are several, for instance Hayek's argument (1937; 1945) of the limits that knowledge poses to authority. The most important reason, however, is that these dimensions require an important input from the participants to the (exchange) transactions to be governed – the release and transfer of tacit knowledge that they hold personally, the association of a certain judgment with an act (ethics) or a product (product brand), for instance. The implications are two: In case of the additional dimensions – which are impossible to neglect – both the price mechanism and authority are nearly powerless. Governance mechanisms that can deal with those governance dimensions are therefore to be sought in the realm of relational governance mechanisms.[12] Furthermore, this diagnosis also provides a more focused guidance for which kind of relational governance mechanism we are looking for: a governance mechanism that can elicit the inputs from participants that we

[12] I interpret the 'hybrid' class of governance mechanisms as being filled mostly by 'relational' governance mechanisms

governance mechanism that can elicit the inputs from participants that we identified just above.
Eliciting efforts from economic actors is usually tackled as a problem of devising the right incentives. Above, I have described the reasons for which extrinsic incentives have limited reach in eliciting the kind of input that is required in the governance dimensions considered here. With extrinsic incentives being of limited use, the focus therefore shifts to intrinsic incentives. Those have three sources: the fact that an activity is carried out for its own sak, that the goal pursued is a self-defined goal, or a feeling of obligation which is due to personal and social identities (Osterloh and Frey 2000). The first two can be influenced by well-known human resources measures – but their reach for governance, and their leverage, is limited.[13]

The main wedge for governance efforts of the knowledge, stakeholder perception, ethics, and service dimensions therefore is identity. Accordingly, the key question therefore becomes: 'How can identity be influenced?' At this point, the crucial bridge is provided by the link between identity and status: identity is formed by the allocation of status (Wieland 1996).

In the remainder of the article, I have attempted to apply and add to Wieland's (1996) framework of the allocation of status, and extent its insights to an integrated theory of economic governance. Scrutinizing the characteristics of the various governance mechanism with regard to reputation, I have argued that because the price mechanism also works in markets, types of market (places), market mechanisms (such as various forms of auctions), and goods confer status to the participants of transactions. This argument provides a sociological entry point for identifying how market (places), market mechanism, and goods should be influenced (where possible) in order to use influence identity – and by the chain of argument that I have provided, thereby allow to use one of the few (and the most promising) possibilities for governing the dimensions in the focus here. An analysis of interaction effects between various governance mechanisms that might be used in a bundle adds further richness and provides guidance for the design of such bundles of governance mechanisms. The analysis confirms that authority might be a bad idea for the governance dimensions considered here.

In addressing the call issued by recent review articles of the governance literature, the contribution of the article has been two-fold: identifying the 'terrain' and direction in which theoretical efforts need to develop, and providing a first set of proposals. The topic is not only of prime importance, but also vast. The contribution of the article therefore cannot be more than providing a first structured groundwork for discussion.

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[13] For instance, due to restrictions and time lags involved in laying off employees, selection can only be applied to a small fraction of the employees involved in transactions.

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