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Stakeholder Theory

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STAKEHOLDER THEORY

Stakeholder theory's central management insight is that effectively managing relationships with a firm's stakeholders is the primary responsibility of managers and is central to value creation.

Stakeholder theory advances the notion that organizations that take particularly good care of a broad group of their stakeholders (i.e. customers, suppliers, employees, communities) will function more effectively and create more value. This value may then be used to sustain and grow the organization, and to give back to the stakeholders who helped to create it. This type of firm behavior will be referred to herein as managing for stakeholders. Stakeholder theory is both managerial and prescriptive because it deals very specifically with manager behavior and the relationships between a firm and its constituencies. The theory also rests on a strong ethics foundation. This entry begins with a detailed elaboration of some of the fundamental concepts of stakeholder theory, followed by a description of its evolution and importance.

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FUNDAMENTALS

The description provided in the introduction contains several concepts that require further explanation and elaboration: who are an organization's stakeholders, what does it mean to take particularly good care of them, what is "value", and how does taking care of stakeholders help an organization create more of it?

Defining Who Is and Is Not a Stakeholder

Stakeholders are groups and individuals who have an interest in the activities and outcomes of an organization and upon whom the organization relies in order to achieve its own objectives. For instance, customers are a stakeholder because they acquire goods and services from the firm in exchange for money that is then used to continue the firm's operations. This is an example of an economic stake. Suppliers and employees are other examples of stakeholders with an economic stake in the organization. Stakeholders might also have an equity stake in the firm, such as shareholders. In addition, stakeholders may simply have an interest in what the firm does because it influences them in some way, even if it is not a direct market effect. In the early stakeholder literature these stakeholders were sometimes referred to as kibbutzers. Special interest groups, for instance, try to influence firm decisions in conformance with their own agendas. Of course, stakeholder interests also tend to be interconnected, which means that stakeholder coalitions often form around particular issues and any particular organizational action could be received either favorably or unfavorably across a variety of stakeholder groups.

The third type of stake, the influencer or kibbutzer stake, highlights an important point: just because a stakeholder has an interest in the organization does not necessarily mean that the organization is particularly interested in that stakeholder. Although there is no universally accepted definition of who merits classification as a legitimate stakeholder from the organization’s perspective, in general stakeholders are considered salient to the managers of an organization if they have power and legitimacy. Stakeholders have power if they possess critical resources that the firm needs or if they have the ability to influence outcomes through political, coercive or other means. Legitimacy pertains to cultural and societal norms. For instance, a stakeholder may be considered salient to a manager because doing so is considered desirable, proper or appropriate given the circumstances. In addition to power and legitimacy, a stakeholder that might not normally be considered very important could become important in urgent situations, where urgency means that a particular stakeholder’s claim is time sensitive or critical to the stakeholder.

Another way to determine which stakeholders should receive primary attention from an organization is the principle of fairness. This principle suggests that the organization’s legitimate stakeholders should include those from whom the organization has voluntarily accepted resources. Primary stakeholders would include employees, customers, financiers, suppliers and local communities. They might also be considered primary because they are integrally linked to the value creating processes of the organization. Secondary stakeholders can dramatically influence an organization but typically are not a part of the firm’s operating core. Examples of secondary stakeholders include the government, the media, special interest groups, consumer advocate groups, and competitors.

Stakeholder theory received criticism early in its development from people who claimed that it advances the position that all stakeholders should have equal standing with the firm. While it may be true that stakeholder theory advocates for moral and just treatment of all of a firm’s stakeholders, it does not argue that all stakeholders are equal. This is especially pertinent with regard to the resources an organization devotes to serving particular stakeholders and the value it allocates back to them. Fairness would suggest that more value and attention should be allocated to stakeholders who are central to the organization’s objectives and who contribute the most to the firm’s value creation processes.

Stakeholder Treatment and Business Ethics

Treatment of stakeholders is central to stakeholder theory. Although there is no consensus on exactly what it means to treat stakeholders well, certain principles exist regarding treatment of stakeholders that are widely accepted among those who advance the theory. These principles rely primarily on ethical thinking which means, in part, that the actions of a firm with regard to its stakeholders are judged by core rules that are based on socially accepted norms of behavior (i.e., lying is wrong). Firm behavior, from a stakeholder perspective, may also be judged based on outcomes. That is, firms are expected to produce favorable outcomes based on achievement of goals that are morally important. For instance, a for-profit corporation is expected to create products and/or services that satisfy consumer needs and wants, to provide a means for employees to take care of the physical needs of themselves and their families, to help in the communities in which they operate, and to provide fair returns to stockholders, among other things.

Organizational justice theory is a helpful tool for judging firm behavior with regard to stakeholders, and for understanding how particular behaviors can influence firm outcomes.

Distributional justice occurs when a stakeholder perceives that its allocation of value from the firm is fair relative to what the firm's other stakeholders receive or what the stakeholders of other firms receive. For instance, an employee might feel that her salary and benefits are fair compared to what other employees receive within the firm or compared to what people who perform similar tasks in other firms receive. Procedural justice pertains to a stakeholder's perception of the fairness of an organization's decision-making processes. A supplier, for example, may not like the fact that a bid was rejected, but can handle the rejection much better if the selection process was perceived as fair. Interactional justice deals with fairness in the way stakeholders are treated in day-to-day transactions and communications with the firm. Firms that exhibit organizational justice can expect most of their stakeholders to reciprocate with similar behaviors. Thus, cooperative relationships are developed based on trust.

Stakeholder theory's inclusion of ethical considerations increases its practicality because business and ethics are inseparable in real life. All business decisions contain ethical dimensions because they all influence outcomes for multiple stakeholders. The attempt to consider business decisions in the absence of ethical considerations is referred to as the separation fallacy.

Stakeholder Theory and the Value Created by an Organization

Much of the business literature is founded on the notion that financial profits (and associated shareholder returns) are the primary objective of the corporation. This obsession with the bottom line is easy to understand because financial profits are easily measured, whereas other types of value are difficult to measure. Also, a very popular stream of thought called agency theory argues that managers have a fiduciary responsibility to maximize returns to shareholders, and that any manager behavior that works to reduce those returns represents an agency problem. Further, some authors have argued that shareholders are the only firm stakeholder who receives residual returns—that is, shareholders do not have a well-defined contract with regard to the returns they will receive and they only receive returns after all other stakeholders with explicit contracts are paid. The ensuing shareholders vs. stakeholders debate has filled many thousands of journal pages, with stakeholder advocates arguing that managers (and boards of directors) have legal responsibilities as well as moral obligations to all of their stakeholders and not just to the shareholders. This treatment of the debate is oversimplified, but it will suffice for purposes of this entry.

Value is defined much more broadly in the stakeholder literature. An organization creates value by providing utility to a wide range of stakeholders. Customers and clients receive utility as they make use of the products and services of the firm, employees in a positive work environment may receive personal enrichment and growth from the work they perform, communities may benefit from a cadre of organizational volunteers who provide services to local charitable organizations, and so forth. Voluntarism is one of the defining characteristics of stakeholder theory. That is, the organization, through its managers and employees, behaves in certain ways because of an organizational culture that is based on a set of widely understood principles, and not due to compulsion.

According to stakeholder theory, organizations that manage for stakeholders provide more value to their stakeholders than they need to provide just to keep them engaged with the organization.

This type of behavior, when combined with trust stemming from organizational justice and adherence to ethical principles, leads to trusting, respectful and mutually beneficial relationships with stakeholders, and a high level of reciprocation. Stakeholders are more likely to share valuable information with such a firm, which can lead to both efficiency and innovation. These sorts of firms have excellent reputations, which makes their products and services more attractive to existing and new consumers. Resources are easier to obtain because stakeholders expect to be treated well in exchange for what they provide to the firm. Contracting costs are reduced because stakeholders are more trusting of the firm and therefore fewer features of the contracts between a firm and its stakeholders have to be written down and carefully monitored. All of this leads to firm growth, efficiency, flexibility and therefore an increased ability to both plan and carry out plans. Basically, these types of firms just run better. Firms of this type are also much less likely to become victims of negative stakeholder actions such as walkouts, boycotts, legal suits and bad press. Consequently, their securities may be seen as less risky (and thus more valuable) to investors.

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EVOLUTION

Stakeholder theory rests on some easily understood concepts and principles whose origin it is impossible to trace with precision; however, practically everyone who works in the stakeholder area acknowledges R. Edward Freeman, currently of the Darden School at the University of Virginia, as its intellectual leader. By Freeman's own account, many of the ideas contained in his landmark book, *Strategic Management: A Stakeholder Approach*, were developed at the Wharton Applied Research Center at the University of Pennsylvania in collaboration with colleagues including James R. Emshoff, Arthur Finnel, Ian Mitroff (and Richard Mason), Thomas Saaty, Russel Ackoff, and Eric Trist. Nonetheless, from among this group of scholars it was Freeman who in 1984 published the book that would provide an intellectual framework upon which an entire stream of management inquiry and debate would be built.

Freeman thought he was writing a textbook for the strategic planning process that could be used by both students and executives. The book is very applied. It was written with the express purpose of helping managers (and future mangers) to effectively guide their organizations in an environment that had become increasingly complex, turbulent and interconnected. The book's greatest influence on academia was first felt in the business ethics literature. Business ethics scholars embraced the stakeholder approach to management because of its moral foundation. In particular, social responsibility scholars found it especially helpful as a means to defend socially responsible firm behaviors. Ironically, the emerging strategic management discipline for whom the book was intended largely ignored Freeman's work, in spite of the fact that many of its early thought leaders advocated for a strategic management process that incorporated morality and social responsibility. Early neglect of stakeholder theory by strategists was perhaps at least partially a result of the field's obsession with economic models from the 1980's forward.

Interest in stakeholder theory has blossomed in recent years, to the point that it might now be called a field of scholarship, albeit a field that is very diverse. Its popularity is probably a function of several forces: an increasingly complex and interconnected external environment that stakeholder theory is especially well suited to address, acknowledgement among business scholars and managers that too much emphasis on short-term financial returns has led to unfavorable outcomes for businesses and society, numerous highly visible business scandals that have raised public awareness of ethical issues, and a global sustainability movement. The diversity of the field is demonstrated in a book published in 2010 called *Stakeholder Theory: The State of the Art*, that contains nearly a thousand references, including references from the economics, strategic management, finance, marketing, management, accounting, information technology, health care, law, business ethics, social responsibility, environmental policy and public policy/administration disciplines. A conference on stakeholder theory in Barcelona in 2011 attracted scholars and practitioners from twenty-five nations and the Strategic Management Society just formed a special interest group on Stakeholder Strategy intended to promote research and debate.

Much of the literature on stakeholder theory thus far has been devoted to either defining and justifying the stakeholder perspective or, from an empirical perspective, proving that seeking to satisfy a broad group of stakeholders is economically justifiable. Moving forward, stakeholder theory offers the opportunity to redefine capitalism as a way to create value for stakeholders, as well as a lens through which best practices for stakeholder engagement can be identified.

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IMPORTANCE

Managing for stakeholders is associated with higher costs in some areas. A firm that gives more value back to its stakeholders than is absolutely needful to ensure their continued involvement with the firm might pay more to employees in wages and benefits than its competitors pay, and is likely to offer a more attractive value proposition to its customers for its products and services than the market might otherwise demand. Surrounding communities tend to be beneficiaries of philanthropy and service from firm employees in a variety of ways. Furthermore, firms that manage for stakeholders will incur human and financial costs associated with higher levels of communication with and concern for stakeholders. Although stakeholder theory embraces a much broader view of value creation than mere financial returns, many management scholars have expressed the opinion that the financial benefits associated with managing for stakeholders are likely to exceed the financial costs. Consequently, they argue that managing for stakeholders should be associated with higher financial performance.

The bulk of the empirical and anecdotal evidence to date supports the notion that firms that manage for stakeholders tend to have higher financial performance. Even some of the theory's most ardent detractors have come around to the idea that this type of management is congruent with shareholder value creation. Consequently, the shareholders vs. stakeholders debate is not particularly important – if the stakeholder approach leads to high shareholder returns then why should shareholder advocates object to it?

Causality is an issue that requires more empirical research. Some researchers argue that managing for stakeholders is a luxury that follows financial success and that this is the source of the positive correlation. This may be true in part, but some research indicates that causality works in the opposite direction is well. That is, excellent stakeholder treatment can enhance firm performance. Nevertheless, it is important to understand that since stakeholder theory measures value more broadly than merely financial returns, even a firm with average financial returns may be creating substantially more value by providing more utility to a wider range of its stakeholders. Research that supports a positive financial correlation with the managing-for-stakeholders approach may be useful in silencing the shareholder advocates that have tended to be its most vocal critics, but leading stakeholder scholars tend to be more interested in the bigger picture of the total impact of firms that practice this sort of management and in defining a set of best practices for increasing the total value a firm creates.

Stakeholder theory has had an enormous impact on business practice. Most of the annual reports of the largest companies in the U.S. and many other industrialized nations include some version of the stakeholder concept or at least stakeholder terminology. The popularity of the concept is part of a global trend towards more socially responsible or sustainable management practices. Many companies are now taking the concept seriously and make very deliberate efforts to satisfy their primary stakeholders, while other companies may simply use the terminology as a sort of "window dressing" because it is politically fashionable.

Stakeholder theory has also found its way into the political arena, with politicians in some nations now using its principles and terminology when debating public policy issues. A global movement to make businesses more responsible to a larger number of stakeholders is reflected in an United Nations Global Compact that includes Ten Principles built around human rights, labor, the environment and anti-corruption. Many other groups have emerged on a global scale to promote stakeholder-friendly business practices, such as the Caux Round Table, a global network of business leaders, and the Conscious Capitalism Institute, which includes scholars, corporate executives, consultants and thought leaders who engage in stakeholder-oriented research, teaching and practice.

-- Jeffrey S. Harrison

See also:

Corporate Social Responsibility, Human Capital Theory, Leadership Practices, Learning Organization, Organizational Effectiveness, Practice of Management, Stewardship Theory, Strategic Alliances

Further Readings:

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