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8. Stakeholder orientation, managerial discretion and nexus rents

Robert A. Phillips, Shawn L. Berman, Heather Elms and Michael E. Johnson-Cramer

A growing research tradition in management studies deals with how firms manage relationships with their various stakeholders. Among the features distinguishing this research tradition from other approaches is its claim to produce *managerial* theory. Explaining this notion, Donaldson and Preston (1995: 67) write: 'The stakeholder theory is managerial in the broad sense of that term. It does not simply describe existing situations or predict cause–effect relationships, it also recommends attitudes, structures, and practices that, taken together, constitute stakeholder management.'

In the pursuit of such a theory, stakeholder researchers have often accorded great importance to managerial decisions and actions as factors which shape firm–stakeholder relationships (for example, Freeman, 1984; Berman et al., 1999; Phillips, Freeman and Wicks, 2003; de Luque et al., 2008). When social scientists ask, 'What effects can a firm's treatment of its stakeholders have on its performance?' and ethicists ask, 'What moral obligations do firms have to treat their stakeholders in certain ways?' the uniting assumption is that managers (and by extension, their firms) have latitude to choose their course of action in managing these relationships.

However, this latitude is not without limits. A few stakeholder researchers have emphasized the role of external factors in influencing firm behavior toward stakeholders. They argue that, because firms exist and function within a constellation of constituencies with varying levels of power (Mitchell, Agle and Wood, 1997), their actions are necessarily constrained. The network structure of the actors surrounding a firm affects how it behaves toward them (Rowley, 1997), and the patterns of resource dependencies and group identities impact upon how and when stakeholder groups act to influence the behaviors of these firms (Pfeffer and Salancik, 1978; Frooman, 1999; Rowley and Moldoveanu, 2003). In this picture, managers have a lesser degree of latitude to choose their

own course, as external constraints often trump managerial preferences and practices. This perspective raises serious questions for proponents of a managerial stakeholder theory. As social scientists, we cannot hope to explain the importance of stakeholder management as a factor affecting a firm's social or financial performance without acknowledging the external forces that condition this effect. As ethicists, we cannot reasonably hold firms accountable for mistreating stakeholders if we have no sense of the limits of their freedom to do otherwise. Any successful attempt to produce a genuinely managerial stakeholder theory rests on our ability to weigh the relative importance of managerial choice and external constraint in firm–stakeholder relationships. To date, however, the question of choice and constraint in stakeholder theory has been left implied at most – and more often ignored entirely.

Building on prior research (Phillips et al., 2010), we make explicit the implied assumptions – both managerialist and determinist – in stakeholder research. We argue that three elements – managerial discretion (Hambrick and Finkelstein, 1987; Shen and Cho, 2005), stakeholder orientation (Hosseini and Brenner, 1992; Berman et al., 1999) and nexus rent (Coff, 1999) – interact in important and under-examined ways. A firm's orientation toward its stakeholders determines how it will use the discretion accorded to it by external and internal circumstances. The interaction between these two factors affects a firm's ability to create value in the short term and influences the level of discretion available to the firm in the long term. We argue that the interplay of discretion and orientation create a vicious (or virtuous) cycle, in which the firm either creates or destroys goodwill with stakeholders, thereby making it more or less likely that stakeholders will grant discretion in the future. This argument suggests an account of stakeholder management that is sensitive to variation in managerial discretion, an account that is *more* constrained than typical moral and instrumental prescriptions about how firms should treat stakeholders and *less* constrained than descriptions premised on more deterministic theories.

Before developing this line of reasoning, it is important to put the status of managerial choice in stakeholder research into its proper context – our intention for the next section. Following that, we go on to describe the conceptual building blocks – managerial discretion, stakeholder orientation and nexus rent – which we use to build our model. The third and fourth sections advance lines of reasoning concerning the relationships among these constructs, these include testable propositions about the role of managerial discretion. We conclude by discussing the model's implications for future research.

MANAGERIAL CHOICE IN STAKEHOLDER RESEARCH

As we have described elsewhere, (Phillips et al., 2010) the question of how much managers' choices matter is not a new one. For decades, theories of strategy have tended towards either voluntarism or determinism, depending on how they handle the problem of managerial choice. Voluntaristic theories assume managerial decisions and actions are a substantial cause of the outcomes of firm activities. Deterministic theories situate managers and firms largely at the mercy of forces beyond their control with a decreased (even negligible) role for the effects of managerial actions on firm performance. This said, the most interesting theoretical insights often reside in the tensions and ambiguities that exist between these perspectives (Astley and Van de Ven, 1983; Hrebiniak and Joyce, 1985). For example, several voluntaristic approaches have emerged as explicit attempts to counter-balance the prevailing determinism of organizational sociology. The initial formulation of strategic choice theory (Child, 1972, 1997), the growth of the strategic management literature (Hoskisson et al., 1999; Harrison, current volume) and recent efforts to interject strategy into predominantly deterministic theories (Scott, 1995; Stevenson and Greenberg, 2000; Dobrev and Kim, 2006) all proceed from the hope that a well-developed understanding of strategic choice offers a starting point for a more robust view, which depicts managers as having 'degrees of strategic freedom' within constraining environments (Bourgeois, 1984).

From its inception, stakeholder research has largely rested on voluntaristic assumptions about managerial choice (Freeman, 1984). Though mindful of the power stakeholders wield over the firm – by definition, able to affect the achievement of its objectives – Freeman (1984: 74) explicitly frames his work as a contribution to the strategic management literature. Freeman (1984: 74) makes a clear 'plea for voluntarism' as 'the stakeholder philosophy' and much of the subsequent stakeholder research takes a similar voluntaristic perspective (see also Phillips et al., 2010). Thus, for example, some have argued that managerial decisions to engage (or not) in opportunistic behavior toward stakeholders can result in higher contracting costs and, ultimately, can impair firm performance (Jones, 1995). There is also empirical support for the hypothesis that how managers think about stakeholders, whether they value stakeholder relationships intrinsically or instrumentally, can affect the firm's performance (Agle, Mitchell and Sonnenfeld, 1999; Berman et al., 1999). There are also strong ethical criteria by which to judge the morality of managerial choices, as they manifest themselves in firm behavior (Evan and Freeman, 1993; Donaldson

and Preston, 1995; Phillips, 1997). The resulting view of firm–stakeholder relationships, focused on what firms *can* and *should* do to manage stakeholder interactions, clearly rests on voluntaristic assumptions.

Of course, not all stakeholder research has subscribed unambiguously to these assumptions. A key dividing line in the literature is that between those who explore the impact of managerial choices on a firm's performance and those who study the antecedents of these managerial choices (Donaldson and Preston, 1995; see also Phillips et al., 2010). Departing somewhat from voluntaristic assumptions, the latter rely on more deterministic theories of organization, such as network (Rowley, 1997) and institutional theory (Johnson-Cramer, 2003a, 2000b), to account for the choices that firms and their managers make in regard to stakeholders. This is not to say that these theorists reject the possibility of managerial choice outright or ignore the role played by managerial action entirely. Rowley (1997: 887), for example, writes of the need not only to understand stakeholder influences on the firm but also 'how firms respond to these influences'. Nonetheless, the tendency of this second stream of research is to appeal to more deterministic supporting theories, with concomitantly underdeveloped notions of human agency. And, importantly, the assumptions regarding the sources and extent of constraints on managerial decision making are often left unstated and under-examined in these theories.

In framing the differences between voluntaristic and deterministic perspectives, Astley and Van de Ven (1983: 251) urge organization theorists to find insights in the tensions between different perspectives and to counterpose these perspectives in order 'to bring points of convergence into dialectical relief'. One straightforward approach to achieving such convergence is to treat the degree of managerial choice not as a steady state, assumed to be either present or absent, but rather as a continuous variable whose presence or absence can radically affect the importance of organizational strategizing (Perrow, 1986). Stakeholder research must, therefore, incorporate a respect for *both* the power of managerial action and the constraints and catalysts stakeholders create for managers.[1] To achieve this, we turn to the notion of managerial discretion. This concept provides a bridge between theories in which managerial choices play a significant role and those in which such choices play a lesser role (Hambrick and Finkelstein, 1987). Incorporating the varying levels of discretion afforded managers helps us to account more completely for environmental influences and constraints on managerial choice. In the next section, we offer some background on this and other key building blocks from which we construct our revised understanding of firm–stakeholder interactions.

CONCEPTUAL BUILDING BLOCKS

In this section, we elaborate three concepts – managerial discretion, stakeholder orientation and nexus rent – upon which our model will be built.

Managerial Discretion

Hambrick, Finkelstein and co-authors' elaboration of the concept of *managerial discretion* (Finkelstein and Hambrick, 1990; Hambrick and Abrahamson, 1995; Finkelstein and Boyd, 1998; Finkelstein and Peteraf, 2007) is explicitly intended to link voluntaristic and deterministic theories. They define managerial discretion as 'latitude of managerial action' (Hambrick and Finkelstein, 1987: 371). As originally elaborated, the level of managerial discretion may be a function of the task environment, the organization, the individual manager or any combination of these. Table 8.1 reproduces Hambrick and Finkelstein's (1987) figure of characteristics that influence discretion and adds the 'activity' level characteristics later identified by Finkelstein and Peteraf (2007). Taken together, these characteristics comprise a powerful set of possible limitations on – and catalysts for – managerial choice and firm strategy formulation. Of course, not all firms face the same level of constraint. We can view a firm as possessing more managerial discretion than another firm. For example, managers

Table 8.1 Sources of constraint on managerial discretion

Task environment	Internal organization	Managerial characteristics	Activity characteristics
Product differentiability	Age	Aspiration level	Complexity
Market growth	Size	Commitment	Uncertainty
Industry structure	Culture	Tolerance for ambiguity	Observability
Demand instability	Capital intensity	Cognitive complexity	
Quasi-legal constraints	Resource availability	Internal locus of control	
Powerful outside forces	Powerful inside forces	Power base	
		Political acumen	

Source: Adapted from Hambrick and Finkelstein (1987: 379, Figure 2) and Finkelstein and Peteraf (2007).

in an older, large, highly regulated utility firm will have fewer strategic options at their disposal than managers in a firm with a highly differentiated product competing in a fast growing industry.

While Hambrick and Finkelstein's (1987) figure (and our reproduction of it) refers only to 'powerful outside' and 'powerful inside' forces, Hambrick and Finkelstein's (1987: 374, 378, original italics deleted) text explicitly defines discretion in terms of stakeholder acceptance, writing:

> To us, constraint exists whenever an action lies outside the 'zone of acceptance' of powerful parties who hold a stake in the organization. . .. Extending the concept to other types of stakeholders, one can think of board members, bankers, regulators, key employees, customers, as well as other parties, as all having their own zones of acceptance . . . A chief executive who is aware of multiple courses of action that lie within the zone of acceptance of powerful parties is said to have discretion.

This overlap makes the managerial discretion construct a particularly useful building block for a more sophisticated understanding of firm–stakeholder interactions, given that stakeholder behavior is, itself, a significant source of discretion or constraint. Managerial discretion offers a conceptually robust way to capture, in the aggregate, the constraints common to firms, without adopting the deterministic assumptions that accompany other notions of external control. Awareness of differentials in managerial discretion also allows researchers to compare firms with similar levels of constraint in order to better isolate the effects of proposed stakeholder-theoretic phenomena or better understand the moral challenges faced in managing stakeholder relationships.

Stakeholder Orientation

The concept of stakeholder management remains, for many purposes, only vaguely defined. Some studies point to the outcomes produced by firm action toward stakeholders (for example, Waddock and Graves, 1997) and 'good' stakeholder management is identified either by the priority afforded to particular groups (Mitchell, Agle and Wood, 1997). Others adhere to Freeman's original perspective, emphasizing procedural concerns such as communication, negotiation and monitoring (Calton and Kurland, 1996; Morris, 1997) or the thoroughness of procedural steps for managing stakeholder relations (Johnson-Cramer, 2003a) as the basis for describing a firm's approach to stakeholder management. Yet another approach focuses on the moral quality of firm behavior, with some positing a relationship between honesty and fair-dealing and firm performance

(Jones, 1995) or emphasizing the acceptance of particular moral claims (Phillips, 2003).

Among the various solutions that have emerged in response to the conceptual problem of specifying stakeholder management, the most promising for our purposes here is the notion of *stakeholder orientation* (Hosseini and Brenner, 1992; Berman et al., 1999). Stakeholder orientation can be defined as 'managers' attitudes and actions towards stakeholders' (Berman et al., 1999) consisting of the totality of 'a firm's overall approach toward managing stakeholder relationships' (Phillips et al., 2010: 178). It is a predisposition on the part of the firm and its managers to acknowledge (or not) and engage with (or not) stakeholders. Depending on whether they view stakeholders as means to an end or as having intrinsic worth, Berman et al. (1999) describe firms' stakeholder orientations as either instrumental or intrinsic. This predisposition may originate in the values of the firm's CEO and top management (Agle, Mitchell and Sonnenfeld, 1999), or it may reside in the overall cultural values and attitudes of the firm as a whole. Most notions of stakeholder orientation place some emphasis on the priority that a firm accords certain claims in distributing value among stakeholders. The simplest way to differentiate among firms by stakeholder orientation is to view them as either shareholder- or stakeholder-focused (cf., Friedman, 1970; Freeman, 1994). Firms may also adopt an orientation with a clear rank ordering of stakeholder claims (Mitchell, Agle and Wood, 1997). Though many firms prioritize in favor of shareholders, many others have built their reputation by prioritizing the claims of other stakeholders (for example, Nordstrom and customers, SAS Institute and employees). Detailing the myriad of prioritization schemes, however, produces countless orientations, which quickly become unwieldy and offer little hope of generalization.

We contend that a more useful standard is to categorize orientation according to the breadth of stakeholder claims recognized by a firm (Logsdon and Yuthas, 1997; Johnson-Cramer, Berman and Post, 2003). At one extreme, there are firms which hold a *narrow* orientation, these firms consistently privilege the interests of a single stakeholder (or a few stakeholders) over the claims of other stakeholders. The typical shareholder-centered approach to management, according to which all firm activities should be for the ultimate benefit of shareholders alone, represents one (though not the only) example of a narrow stakeholder orientation. At the other extreme lie firms that exhibit *broad* orientations and for which multiple stakeholders receive consideration in firm decisions. We can capture these extremes more formally by defining the breadth of a firm's orientation as the number of different stakeholder groups the firm purports to benefit or engage. Thus, a firm with a broad stakeholder

orientation might be expected to expend more resources on employee benefits, community service and product quality or spend time pursuing the well-being of employees, the community or customers than would a firm with a narrow orientation – the latter generally preferring to maximize the benefits and well-being of a single stakeholder group, even if it comes consistently at the expense of the claims of other stakeholders.

Nexus Rent

The final theoretical piece in our model is performance. The most common dependent variable in empirical studies of firm–stakeholder relationships is some measure of firm financial performance. Much has been made of the need to establish a link between the way a firm treats its stakeholders and the resulting financial performance, though this line of research has produced few consistent results (cf., Griffin and Mahon, 1997; Margolis and Walsh, 2003). Jones (1995) and others have stressed the need for stakeholder researchers to develop a performance measure which does not separate financial performance from overall firm performance – shareholders and other financiers being important stakeholders in their own rights. He and others (Berman et al., 1999; Jones and Wicks, 1999) have argued that a proper estimation of firm–stakeholder relations requires a measure which does not assume stakeholders to be mere instruments of shareholder wealth generation but as having intrinsic importance.

Coff's concept of 'nexus rent' is a step in the direction of such a measure. Following Jensen and Meckling (1976) in defining the firm as a 'nexus of contracts', Coff (1999) developed the concept of nexus rent to describe the totality of rents generated by the firm and its stakeholders irrespective of whether they are reflected in profits, share price or other financier-specific measures. Nexus rent, 'is the sum of all the rent in the nexus regardless of which stakeholders appropriate it' (Coff, 1999: 121). A firm may perform very well in terms of having a competitive advantage in the marketplace, but this performance would not show up in standard measures of financial performance in cases where employees receive pay greater than their opportunity costs, customers receive value in excess of their best available alternatives, and so on.

This measure of performance is distinct from both measures of firm *financial* performance as well as firm *social* performance. Regarding financial performance, we would expect to see a relationship between nexus rent and narrower financial performance captured in net earnings or share price. The gains accruing to shareholders are an important subset of nexus rent and the magnitude of nexus rent will naturally influence the size of all stakeholders' shares – including those of shareholders and other

financiers. However, as Coff (1999) points out, assuming that all rents will or *should* accrue to shareholders incorporates generally unstated normative assumptions. Unlike prior concepts such as organizational rent (Amit and Schoemaker, 1993, cited in Coff, 1999), nexus rent makes no assumption that all rents are or should be appropriated by shareholders.

However, the size of the nexus is not unlimited and nexus rent is thus also to be distinguished from concepts of corporate social performance (CSP). Nexus rent is the direct result of a firm's core business – the activities by which it creates value – rather than the broader social activities that are central to discussions of social performance (see Elms, Johnson-Cramer and Berman, current volume). Clarkson (1995) argues that firms have their primary impact on society through direct stakeholder relationships. Looking beyond these relationships to a firm's broader social impacts, he argues, serves only to muddy the conceptual waters. In order to avoid the difficulty that scholars of CSP have had in bounding their subject, we view nexus rent as more limited in scope than CSP. Many of the elements of nexus rent, such as working conditions for employees, may be a sub-set of CSP. But, dimensions of CSP, such as corporate philanthropy unrelated to the core business, would not be included in a measure of nexus rent.

While also marking a return to an older literature in strategic management on the nature of organizational effectiveness as performance toward multiple constituencies (Pickle and Friedlander, 1967; Friedlander and Pickle, 1968; Walsh, Weber and Margolis, 2003), nexus rent is also well-matched to the emergence of stakeholder theory in mainstream organization studies and strategic management literatures. A broader – but nevertheless delimited – set of variables is more conceptually consistent with the target phenomena of stakeholder theory than are historical measures of performance. Nexus rent is, as such, a better representation of the success or failure of stakeholder management activities (Rowley and Berman, 2000).

STAKEHOLDER ORIENTATION AND MANAGERIAL DISCRETION

Firm-level decisions interact with various constraints in shaping firm–stakeholder relationships. One outcome of these interactions is an effect on the magnitude of nexus rent, the total value created for the all stakeholders of the firm. Explaining why some firms outperform others is one of the main goals of any school of strategic management, and framing performance broadly invites scrutiny of a firm's decisions and actions toward a wide range of constituencies. Viewed in isolation, however, the

relationship between how a firm behaves toward its stakeholders and the resulting performance is slippery at best (Griffin and Mahon, 1997; Margolis and Walsh, 2003). This has prompted demands for better theory about the relationship between stakeholder management and performance (Rowley and Berman, 2000). The weakness of existing theory lies not merely in its being underdeveloped, but in the tendency to underemphasize or ignore completely the constraints on managerial choice. These constraints limit the effect that stakeholder management can have on the amount of total value the firm produces.

In this section, we examine the interplay between choice (that is, stakeholder orientation) and constraint (that is, managerial discretion). The interaction between these two factors produces four possible states, each differs from the others in the degree to which managerial choices prove suitable for producing value for the firm's stakeholders. The propositions outlined here explain the likely patterns of variation in nexus rent across these four states.

Low Discretion–Broad Orientation

In a state of low managerial discretion, the firm has few available strategic options from which to choose. At the same time, top managers in a firm with a broad orientation hold an overarching view that the firm should have a broad commitment to satisfying the claims of a wide range of stakeholders. These conditions often give rise to at least two pressing concerns for managers. First, many of the constraints typically associated with low discretion relate directly to the level of resource munificence available to the firm (Boyd, 1990). Firms find themselves without the resources necessary to perform well. Second, low discretion is rarely a disembodied condition, but traces directly to the presence of a small set of powerful stakeholder groups seeking to satisfy their interests exclusively – often at the expense of the firm and its other stakeholders (Pfeffer and Salancik, 1978). Those strategic options which remain open to such a firm are likely to be those most clearly suited to serving the interests of this small group. How, managers wonder, can a highly constrained firm both spread the value it creates among multiple stakeholders and, at the same time, appease a narrow group of powerful stakeholders?

If genuinely committed to a broad stakeholder orientation, managers may find themselves awkwardly juggling this orientation with stakeholders' demands for focus by attempting to achieve numerous goals with too little discretion. The likeliest result will be a very low level of nexus rent. This comes about for one of two reasons. First, a broad stakeholder orientation places high demands on a firm's strategic decision-making

process, as firms that consider the multiple stakeholder impacts of their strategies employ more comprehensive decision processes (for example, broader environmental scanning, engaging others to check presumed impacts of decisions, and so on; Fredrickson, 1984). In their study of strategic decision processes at 318 firms, Baum and Wally (2003) found a direct relationship between decision speed and performance, moreover, since decision speed also mediated the relationship between environmental conditions and performance, faster decisions are especially important in resource constrained environments, which usually afford firms little discretion.

Second, even if a firm can overcome the difficulties associated with strategy formulation, it still faces the problem of creating coherent strategy content. When successful, firms implementing a broad orientation succeed, in part, because market and non-market pressures on the firm align, and the strategic options for addressing each are complementary (Post, Preston and Sachs, 2002). A firm, for example, that undertakes 'green' activities (that is, actions friendly to the natural environment) often finds it possible to position these activities as customer – or employee – friendly, thereby reaping higher revenues and lower labor costs (Hart, 1995). Under low discretion circumstances, however, the likelihood of a coincidence between market-based and non-market claims is lower, by virtue of a more limited menu of strategic options of either sort from which to choose. In this condition, the activities of the broadly oriented firm closely resemble those of a firm which has diversified into unrelated activities. These activities often incur greater costs and lead to lower overall performance (Porter, 1987). Thus, even though many stakeholder groups receive some of the value generated by the firm, the total value available is not as large as it might be if the firm had simply chosen strategies to maximize value for a narrow set of stakeholders. Examples of how the low discretion–broad orientation condition influences nexus rent are found in the common experience of older firms in mature and commodity industries, especially those that are highly regulated. The recent headline-grabbing failures at British Petroleum (for example, Deepwater Horizon, refinery explosions, charges of market manipulation, and so on) on the heels of its 'Beyond Petroleum' campaign are suggestive of these challenges.

At first glance, this condition would seem an unlikely combination. How often do firms with relatively low levels of managerial discretion assume a broad stakeholder orientation? At least two groups have typically occupied this space. First, mature firms (for example, utilities, steel) with a long history of societal stewardship often find themselves committed to a broad orientation despite environmental shifts that leave them with little

strategic choice. Second, firms in transition to another orientation/discretion combination may find themselves in this space, at least in the short term. For example, entrepreneurial ventures with explicit commitments to environmental or social causes may adopt a broad orientation despite low discretion. As we suggest later in this chapter, this combination need not always spell disaster for such firms. However, at any given point in time, and at least in the short run, we propose that a broad orientation, coupled with conditions of low discretion, leads to the inefficient investment of resources and a maladapted, mismatched strategy.

Proposition 1: In a state of low discretion–broad orientation, nexus rent will be the lowest, relative to other states.

Low Discretion–Narrow Orientation

This state combines constrained managerial choice and a narrow view of which stakeholders merit the firm's attention and resources. In contrast to the low discretion–broad orientation firm, firms in this state essentially choose among limited strategic options the best strategy for providing value to a limited set of powerful stakeholders. In prioritizing stakeholders in this way, firms reap the benefits largely forfeited by broadly oriented firms. At a minimum, the firm avoids the costs of comprehensive decision processes and incoherent, mismatched strategies. The net effect on nexus rent is clear: under low discretion conditions, the narrowly oriented firm outperforms the broadly oriented one, at least in the short run.

At first glimpse, this argument might seem less germane to the matter of nexus rent than to the more common notion of shareholder value, or firm financial performance. How can it be better for all stakeholders, if the firm attempts only to maximize value for a narrow group of stakeholders? Understanding this requires us to distinguish between returns generated on behalf of the favored stakeholder groups and those generated on behalf of less favored groups. We argue that the tendency toward coherent strategies undertaken by narrow firms will generate the highest outcome possible in a low discretion circumstance for the favored stakeholders. At the same time, any actions undertaken by the firm on the behalf of less-favored stakeholder groups are more likely to complement the core strategies of the firm, since narrowly oriented firms only create value on behalf of these groups instrumentally (that is, if it promises greater returns for the privileged stakeholder group; see Donaldson and Preston, 1995). Many of the 'comparison companies' in Collins and Porras's (1994) *Built to Last* are characterized as relying on a 'classic

profits-only perspective' (1994: 63), which results in adequate, but not 'visionary' returns. Thus,

Proposition 2: In a state of low discretion–narrow orientation, nexus rent will be the second lowest, relative to other states.

High Discretion–Narrow Orientation

As we argued in an earlier section, the two states in which firms have high levels of discretion more closely approximate the voluntaristic context in which stakeholder researchers have usually imagined firms to operate. Many of the classic arguments concerning the relationship between 'doing good' and 'doing well' seem to apply in distinguishing between firms in these two states. In the high discretion–narrow orientation state, firms have wider latitude for strategic choice but tend to prefer those options that create and allocate value for only a few stakeholder groups. Of course, instrumentality in relationships is hard to mask over time (Frank, 1988), and these less favored stakeholder groups will distrust such firms, have deep concerns about the potential for opportunism in the relationship, mobilize more readily against them, and exact higher contracting costs as insurance against future dishonesty (Hill and Jones, 1992; Jones, 1995; Wicks, Berman and Jones, 1999; Rowley and Moldoveanu, 2003). These reactions will be more acute because stakeholder group members perceive that firms have a great deal of latitude in making choices.

What is missing from this picture, though, is the central role played by managerial discretion in exacerbating the effects of narrow stakeholder management. Many of the stakeholder reactions posited by existing research only manifest when these groups perceive the firm to have some measure of discretion. In a high discretion state, these attributions of discretion are well-founded, and the resulting distrust, conflict and contracting costs are even more likely to have their effect on performance. Here, the causal mechanisms associated directly with managerial choice, including both process features and strategy content implied by a firm's stakeholder orientation, have even more evident effects than in the low discretion state. For example, firms undertaking downsizing in profitable times are often perceived more negatively than those doing so in dire economic circumstances (Leana and Van Buren, 1999). Electronic Data Systems (EDS) announced it would cut 3000–4000 jobs even as its profits increased fourfold and the value of contracts signed doubled (Associated Press, 2006). Goldman Sachs added EDS to its list of five least favorite stocks in September of 2007.

Given the flexibility granted by high discretion contexts, the less comprehensive strategy formulation undertaken by narrowly oriented firms leads to missed opportunities and suboptimal results (Fredrickson and Iaquinto, 1989). Since high discretion environments afford so much more opportunity to find 'win–win' strategies that integrate across the interests of multiple stakeholders, narrowly oriented firms forego collaborative opportunities in their desire to create value for a narrow set of stakeholders. Nexus rent is likely to suffer both in the value created for the privileged group (due to the costs inflicted by less favored groups) and in the foregone value which might have been created for these other groups. Thus,

Proposition 3: In a state of high discretion–narrow orientation, nexus rent will be the second highest – outperforming the low–narrow state but underperforming the high–broad state.

High Discretion–Broad Orientation

This state combines a high degree of managerial latitude with a view that stakeholders should share in the allocation of value created by the firm. In this state, managers likely feel driven to attend to stakeholders as intrinsically valuable, and this orientation, facilitated by a high discretion environment, translates into the highest level of overall nexus rent. As stated at the outset, this is the combination that most stakeholder researchers seem to have in mind in their writings and prescriptions. When these conditions occur, broadly oriented firms interact with stakeholders in ways that allow firms to capture the full benefits of trust and fair dealing (Calton and Lad, 1995). Even when the managers take actions that some stakeholders disagree with, they rarely privilege the same stakeholder consistently over time, thereby avoiding the penalties associated with opportunism and dishonesty (Jones, 1995). Many firms commonly cited as examples of 'good stakeholder management' operate with a wide degree of discretion. Firms such as Starbucks and Interface Carpet have successfully differentiated their products and services, allowing them substantial managerial discretion. Since these firms distribute the value created by the firm in a broad fashion – with all the process and content benefits already identified – the aggregate value creation of these firms will tend to be high. Thus,

Proposition 4: In a state of high discretion–broad orientation, nexus rent will be the highest, relative to all other states.

A DYNAMIC MODEL

To this point, we have focused on the relatively short-term effects that the interaction between stakeholder orientation and managerial discretion can have on nexus rent. Most major studies of managerial discretion (Finkelstein and Hambrick, 1990; Hambrick, Geletkanycz and Fredrickson, 1993; Finkelstein and Boyd, 1998) similarly cast the concept in purely static terms. Finkelstein and Peteraf (2007) have recently begun to consider the dynamics of discretion. They convincingly claim that research emphasis should be directed primarily at the high-discretion manager: managers who, at the individual level, perceive themselves to have high discretion and act as such, sometimes despite constraints deriving from other sources. This is, in no small part, because managers who perceive themselves as having low discretion – irrespective of the magnitude of other constraints – are less likely to employ what discretion they have due to this perception.

Moreover, high discretion managers are, they argue, more likely to resist the constraints they do perceive – perhaps by selecting managerial activities that are complex, uncertain and unobservable (Finkelstein and Peteraf, 2007). We contend that constraint can be resisted in one of two ways. On the one hand, the firm can make strategic decisions that reduce the power of stakeholders and, concomitantly, increase the discretion of the firm. This notion of reducing the control exercised over the firm by external constituents is central to many schools of strategic management and organization theory (for example, Selznick, 1949; Stinchcombe, 1965; Pfeffer and Salancik, 1978; Porter 1980) and has begun to emerge as an option within managerial discretion theory itself (Finkelstein and Peteraf, 2007: 242).

Yet, this is not the only way that a firm's decisions regarding stakeholders can result in changes to managerial discretion. Rather than relying on the involuntary acquiescence of overpowered stakeholders, firms may also choose strategies to which stakeholders are likely to respond by voluntarily yielding discretion. As we argue below (summarized in Figure 8.1), constraint may also be diminished by adopting a cooperative orientation toward the actors who bear and wield the factors of constraint and latitude. A manager can rely on cooperation rather than coercion to convince stakeholders to lessen constraints of their own volition. Through the adoption of a broad stakeholder orientation managers can indirectly 'resist' constraint and thereby broaden their degree of discretion over time.

Because managerial discretion is so readily understood in stakeholder terms (recall Hambrick and Finkelstein's 'zone of acceptance' passage above) and because of normative stakeholder theory's emphasis on

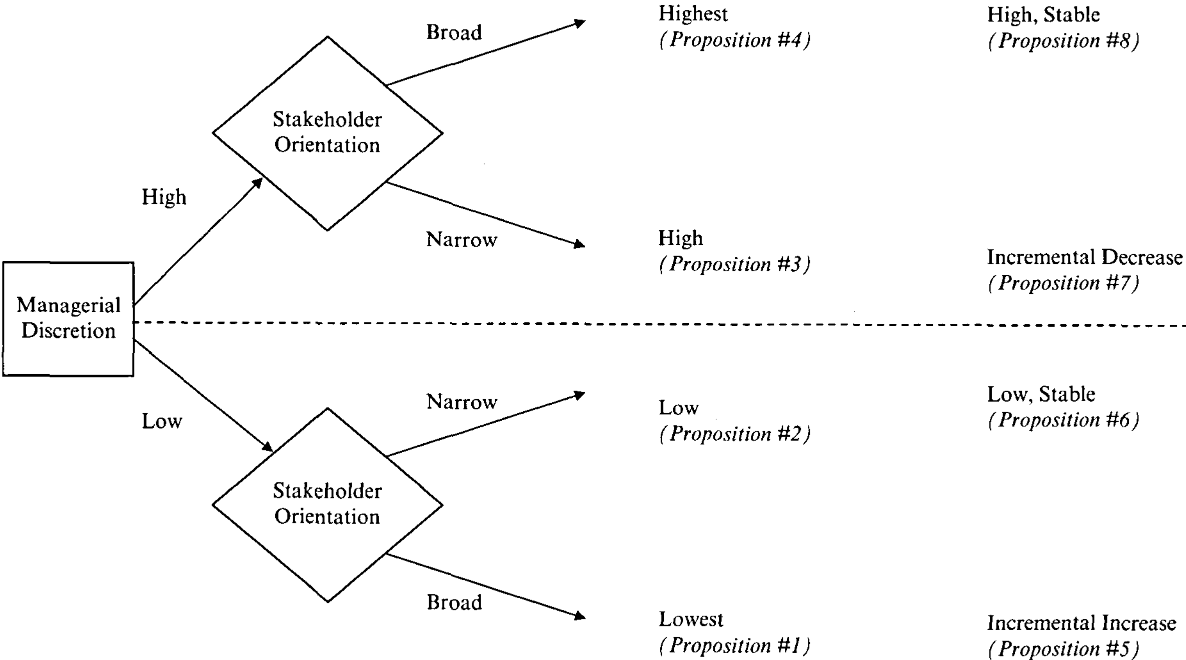

Figure 8.1 Managerial discretion and stakeholder orientation

cooperation (Phillips, 2003), it is especially fitting that we explain the evolution of a firm's discretion as a function of its stakeholder orientation. We argue that a firm's stakeholder orientation and its present level of discretion (aggregated across all levels for the purposes of this exploratory analysis) will interact to affect future levels of discretion by eliciting a combination of voluntary and involuntary reactions from stakeholders.

Low Discretion–Broad Orientation

It is axiomatic that underperforming firms often fail. Per our earlier discussion, firms in low discretion environments that adopt broad stakeholder orientations underperform those adopting narrow orientations in the short term, and many such firms will disappear. We contend, however, that those firms that survive will do so either by converting to a narrow orientation or by appropriating increased discretion *because they maintained a broad stakeholder orientation.* This occurs in three specific ways.

First, broadly oriented firms tend to monitor stakeholders more closely and position themselves to better understand stakeholder needs (Freeman, 1984; Post, Preston and Sachs, 2002). Such firms are more likely to introduce products, for example, that appeal to a broader range of customers, thereby expanding their industry segment and escaping previous industry constraints. Expanding its customer base in this way, the firm gains greater power over – and becomes more appealing to – extant and potential customers and thereby attains greater latitude. Second, a broad orientation can also attract new sets of stakeholders explicitly motivated by involvement with broadly oriented firms (Waddock, 2005; Arena, 2006). The appeal of green products, socially responsible investments, and employee-friendly work environments all attest to the market for virtue (cf., Vogel, 2005). Broadly oriented firms are well placed to satisfy this demand, to motivate non-participating groups, and thereby find another avenue for increasing future managerial discretion. Finally, while managerial choices may result in the expansion of the stakeholder set, broad orientation may also appeal to existing stakeholders, who appreciate the firm's values, find them more worthy of greater trust (Jones, 1995; Wicks, Berman and Jones, 1999) and reward them with greater discretion.

We contend that many stakeholder groups will afford this latitude despite the firm's current underperformance. Broadly oriented firms signal greater trustworthiness to stakeholders (Jones 1995). Trust leads these latter groups, in turn, to monitor firm behavior less (Wicks, Berman and Jones, 1999) thereby permitting firms greater latitude. Consider the role of trust in the evolution of eBay and other electronic commerce firms

that emerged during the original internet boom (Cohen, 2003). These early days were characterized by shoestring budgets, long hours, a great deal of informational vulnerability, but with the promise of a lucrative future. Many firms did not survive the bursting bubble. But among those that did, high levels of stakeholder trust – generated by a broad stakeholder orientation – played a key role. And many of these firms now enjoy far greater managerial discretion than in those formative years. Thus,

Proposition 5: In low discretion environments, a broad stakeholder orientation will lead to increased discretion in the long term.

Low Discretion–Narrow Orientation

Narrowly oriented firms in a low discretion environment elicit markedly different reactions from across their stakeholder set. A narrow orientation distinguishes sharply between the few groups receiving the greater part of the value generated by the firm (that is, the most favored stakeholder groups) and the many groups receiving much less value from the firm (that is, the non-privileged stakeholder groups). This distinction plays an important role in determining the future level of discretion available to the firm's managers. We argue that the net effect of a narrow orientation, given low levels of present discretion, will be a stable but low level of future discretion. Such a result arises from a combination of very different reactions from the firm's most favored stakeholder group(s) and the firm's non-privileged stakeholders.

For the most favored stakeholder group, the narrowly oriented firm is a fairly attractive partner. It outperforms similarly situated firms with a broad orientation, and it reserves the greater part of its returns for its most favored stakeholders. Having received a high proportion of the value generated by the firm, such stakeholders are likely to be satisfied. However, the question remains whether these stakeholders will seek to pursue a significant revision of the terms of the firm–stakeholder relationship. We contend that they have little incentive to do so. If future discretion, at least insofar as it is voluntarily given, represents a conscious investment of a stakeholder's share of the firm's rents, then two main considerations seem to determine the likelihood of a further investment. The first consideration is the natural inertia that comes with satisfaction. Stakeholders tend to respond when dissatisfied or underserved, when they perceive their interests as being violated or when they have urgent claims (Mitchell, Agle and Wood, 1997; Rowley and Moldoveanu, 2003). This tendency toward inaction not only ensures that the firm's most favored stakeholder groups

will continue to afford the current level of discretion but also suggests that stakeholders will tend not to act (that is, to offer more or fewer avenues for discretion).

The second consideration is the dominant stakeholder group's evaluation of the firm's ability to extract greater rents from the least favored stakeholders. The return on a stakeholder's investment in offering greater latitude to a firm is that the firm can take advantage of that latitude to create greater value. Such value creation usually requires further investments from other stakeholders. For example, a firm's stockholders may elect not to demand greater dividends from the firm, allowing it greater discretion by permitting its managers to reinvest the funding in capital projects or new product development. The eventual return on this investment, however, also relies on employees' willingness to extend their efforts on the firm's behalf, customers' willingness to entertain new products from that company and so forth. Unfortunately, for the narrowly oriented firm, these investments by non-privileged stakeholder groups are not likely to be forthcoming (Frooman, 1999; Frooman and Murrell, 2005). Non-privileged stakeholders will have limited incentive to invest additional resources – or even limited additional resources – due to the firm's history of narrow orientation. This will be readily apparent even to the most favored stakeholder, making it less likely also that they will invest in offering the firm expanded discretion.

Consider, for example, a firm that has consistently maximized stockholder wealth at the expense of employees. The firm's narrow orientation may manifest itself in lower wages, less generous healthcare benefits, higher expectations for overtime and fewer opportunities for training and skill enhancement. These employees may resent the firm's treatment, but they lack both the incentive and the means to act against the firm. They realize that there will be little return to allowing the firm discretion at their own expense unless all stakeholders are equally willing to grant discretion similarly. At the same time, a group like this may also have a difficult time mustering the resources for collective action to further constrain the firm's current level of discretion (Olson, 1971; King and Soule, 2007). Such employees may have fewer job opportunities because they have not had opportunities to develop and less money saved to allow them to entertain a lengthy transition to another job. Together, these factors imply that such groups will have limited incentive to increase – and limited potential to reduce – the discretion available to the firm. These conditions often prevail in contexts of low-skill manufacturing and resource extraction – particularly in less developed nations (Sachs and Shatz, 1996). And the constant demand for lower prices by their contract buyers reduces the means and incentive to change. In sum,

Proposition 6: In low discretion environments, a narrow stakeholder orientation will lead to stable but low levels of managerial discretion in the long term.

High Discretion–Narrow Orientation

The situation shifts somewhat when the focal firm inhabits a high discretion environment. The most favored stakeholders of a narrowly oriented firm may well behave here as they do in the low discretion case. Non-privileged stakeholders, however, have an incentive to further constrain the firm and somewhat greater resources to do so. Such non-privileged stakeholders in this circumstance will see that they are not benefiting from their relationship with the firm to the same degree as other, privileged stakeholders. Different from the low discretion situation, however, stakeholders' feelings of inequity or injustice are accompanied by the knowledge that broad discretion firms are *able* to distribute performance more equitably or fairly across stakeholders. These stakeholders will distrust the firm and will seek opportunities to shift current value distributions in their favor, through whatever constraints they have at their disposal, in a way that requires greater equity and fairness (Adams, 1965; Colquitt et al., 2001).

But, will non-privileged stakeholders be any more able to exert influence over the focal firm than similar groups in the low discretion environment? We contend that they will. As we have argued above, the combination of narrow orientation and high discretion evidences higher nexus rent than the low discretion–narrow orientation combination, *ceteris paribus*. Though the benefits of the firm's performance are concentrated on one or a few stakeholder groups, all stakeholders of a higher performance firm are better endowed with resources to overcome the barriers to collective action. A small proportion of a larger return is always bigger than the same proportion of a smaller return. An employee group (or any stakeholder) in a dynamic, growing industry – however small their allocation of the firm's value – will always be better placed to mobilize against the firm than corresponding groups in a shrinking market. If, as others have argued (Rowley and Moldoveanu, 2003), the resources for collective action merely constitute a minimum threshold for action, then it is the combination of resources, distrust and a heightened sense of inequity (that is, that the firm is not using available discretion in a fair manner) that results in the sort of collective actions that can decrease managerial discretion over time (Hayibor, 2005). Private security contractors such as Blackwater USA face a growing call for increased accountability, oversight and regulation due to an allegedly inadequate concern for employees and civilians. Thus,

Proposition 7: *In high discretion environments, a narrow stakeholder orientation will lead to decreased managerial discretion over time.*

High Discretion–Broad Orientation

In the high discretion environment, it is the broadly oriented firm that is best placed to reap the benefits of stakeholder goodwill that, in turn, lead to high future discretion. After all, in the short term, as we argue above, managers who are relatively free from constraints can – whether for moral, instrumental or managerial reasons (Donaldson and Preston, 1995) – treat stakeholders as they wish. They can demonstrate wider breadth of concern for stakeholder well-being and, according to stakeholder theory, this will benefit both firm and stakeholders over time. The arguments for the relationship between these characteristics and nexus rent are well-known (Freeman, 1984; Jones, 1995; Jones and Wicks, 1999; Post, Preston and Sachs, 2002; Phillips, 2003) and include an increase in trust, lower costs of safeguarding, greater stakeholder commitment, moral obligation and greater feelings of fairness and equity. In the long term, higher nexus rent leads (asymptotically) to still greater trust and greater future latitude of managerial and firm activity (Wicks, Berman and Jones, 1999). This 'virtuous cycle' mirrors the 'vicious cycle' faced by the low managerial discretion–narrow orientation firm.

Evidence of this 'virtuous cycle' can be seen in the frequent overlap among the reputation lists that appear annually in various publications (for example, 'Best Places to Work', 'Most Trustworthy', 'Best Corporate Citizen', and so on). This overlap can be seen as indicative of a broad stakeholder orientation for those companies (for example, Starbucks, Costco, Merck, Google, Nike, and so on). Notably, many of these companies are in industries where one might expect to see limited managerial discretion (for example, health care, hotels, retail, financial services). Even so, an on-going commitment to a broad stakeholder orientation engenders on-going favorable perceptions among stakeholders leading, in turn, to this 'Best of. . .' overlap. Thus,

Proposition 8: *In high discretion environments, a broad stakeholder orientation will lead to increased managerial discretion over time.*

IMPLICATIONS FOR FUTURE RESEARCH

Several important streams of inquiry in stakeholder theory appear to have reached an impasse. In recent years, researchers have continued their

search for a relationship between individual stakeholder performance measures – often operationalized using data from the Kinder, Lydenberg and Domini ratings database – and measures of financial performance (for example Waddock and Graves, 1997). Yet, progress toward a deeper understanding of firm–stakeholder relationships has given way to calls for greater theoretical insight into why the social performance–financial performance relationship may or may not exist (Rowley and Berman, 2000; Margolis and Walsh 2003). Accounting for managerial discretion as a factor in firm–stakeholder relationships may shed new theoretical light on this stream of inquiry and open the door for advancement beyond this apparent impasse. We argue that the propositions developed in the previous section have at least three implications for future empirical research in this area.

Performance Variability

The model presented has implications for the study of the relationship between nexus rent, CSP[2] and financial performance. Recent meta-analyses suggest ambivalence in the findings, which at various times both support and refute the premise that relates 'doing good' and 'doing well'. However, the numerous studies and meta-analyses of the relationship between CSP and financial performance have uniformly ignored the differences in constraints facing firms (Griffin and Mahon, 1997; Margolis and Walsh, 2003). If, as we suggest, discretion interacts with orientation to determine performance levels for all stakeholders (including financial measures of shareholder return), then managerial discretion might be a hidden force which distorts the underlying relationship. Certain combinations of discretion and orientation will generate different levels of performance variability. In general, performance in low discretion environments will be more stable, performance in high discretion environments will be more variable. Future research might, then, start by seeking to confirm a more fundamental relationship between managerial discretion and the variability of stakeholder performance. Beyond this, future studies would be well-served to account for differences in managerial discretion among subjects.

Industry Effects

One growing area of research is the role that industry effects might play in moderating the stakeholder orientation–financial performance relationship. This is a promising avenue for future research but remains atheoretical, insofar as there are few insights into why the relationship between social and financial performance might vary so markedly from industry to

industry. At best, those who have explored industry effects observe simply that, 'industries are different and have different stakeholder issues'. Our typology implies that useful theory could be developed suggesting systematic differences between low discretion and high discretion industries. Industry-level factors such as structure and attractiveness play no small role in determining a manager's level of discretion. So also may the nature of activities typical of an industry (that is, complexity, uncertainty and observability; Finkelstein and Peteraf, 2007) play an important role. If managerial discretion moderates the effects of stakeholder management, then we should not be surprised to find that, in general, controlling for industry helps to clarify the empirical results somewhat in studies of the impact of stakeholder management.

Beyond this basic proposition, future research might look even more closely at the multi-level nature of discretion for clues into how important industry effects really are. Managerial discretion derives from sources at multiple levels of analysis, of which industry level is but one (though arguably the most potent). The empirical findings on how industries matter in firm–stakeholder relations will become clearer still if future researchers parse the effects of discretion originating at the managerial, firm, industry and activity levels of analysis.

Perceived Discretion

An additional area of burgeoning interest is the question of why firms adopt certain stakeholder orientations. Stakeholder researchers have long been aware that how managers perceive their external environment can play an important role in how they address and prioritize various stakeholder claims (Mitchell, Agle and Wood, 1997). The managerial discretion literature also recognizes that how managers perceive their environments may influence the level of discretion they believe they have – and thus their behavior (Carpenter and Golden 1997). Though our arguments underscore how important it is to account for managerial discretion as a constraint on – and catalyst for – firm and managerial behavior, future researchers may also want to account for how managers subjectively assess the level of discretion available to them. By combining the four possible orientation/discretion combinations from our model with insights into how managers perceive discretion, we might find answers to two of the more compelling questions in stakeholder research. To wit, why do so many high discretion firms cling to a narrow stakeholder orientation despite the increasing calls for a broader allocation of value? And second, what accounts for those firms that press on with broadly oriented strategies despite significant environmental constraints?

The answers may lay in managers' tendencies to over- or under-estimate the discretion available to them. Carpenter and Golden (1997) suggest that managers' locus of control, a stable personality difference that reflects the extent to which individuals believe they are in control of, or are controlled by, their environment (Rotter, 1966) is negatively associated with their perceptions of discretion (cf. Key, 2002). Managers who believe that they are more or less constrained by the environment than they actually are may adopt inappropriate stakeholder orientations. Firms may underperform as a result of managers' misperceptions. The prevalence and persistence of narrow stakeholder orientations may, for example, be associated with systematic managerial beliefs that environments are more constraining than they are in reality. Misperceptions may also help to account for why some firms pursue broad orientations, even when they increase the risk of short-term underperformance. Managers who perceive less constraint than really exists may follow through on stakeholder-oriented values and press forward with a broad orientation despite the manifest dangers. Studies of entrepreneurs show that the entrepreneurial personality includes a high estimation of one's ability to control the external environment. We suspect that such managers will tend to over-estimate the discretion afforded them by industry and firm-level determinants. Should future researchers press forward with this insight, they might well discover why so many firms commonly associated with broadly oriented stakeholder management tend to be founder-controlled firms or those where the founding values have been particularly well assimilated into the firm's culture. Inconsistent, incorrect or ambiguous perceptions of latitude may confound the theorized relationships.

Additionally, although previous research has identified managerial perceptions of discretion as a key feature of their relationships with stakeholders, stakeholders' perceptions of managerial discretion have not yet been emphasized. These stakeholder perceptions may also play a role in stakeholder behavior, and thus in managerial discretion over time. Stakeholders who perceive higher levels of discretion than exist may be more susceptible to dissatisfaction with managerial behavior than stakeholders with more realistic perceptions of managerial discretion. The former may thus be more likely to attempt to intensify constraints on managers. Future studies might examine the interaction between managerial and stakeholder perceptions of discretion. If 'ought' implies 'can' (Danley, 1988) unrealistic perceptions of managerial discretion may result in unreasonable or irresponsible stakeholder demands. Managers who encourage such beliefs may be guilty of their own irresponsibility.

Finally, organizational ethicists who study stakeholders from a normative perspective and make moral prescriptions concerning how stakeholders

should be treated must take greater consideration of the extent to which managers and firms are free to follow these prescriptions. The constraints of law (Ribstein, 2006; Hasnas, 2007), politics, history and path dependence, firm viability, and physical possibility all impinge upon the ability of firms and managers to act according to the moral ideals of stakeholder ethics. These constraints should inform future normative stakeholder scholarship and organizational ethics (Phillips and Margolis, 1999).

CONCLUSION

As stakeholder theory continues to mature, it grows more complex. Researchers have suggested many moderating and mediating variables between stakeholder management and performance. We argue that managerial discretion is an important variable in this chain. While managerial discretion may be a vital intervening variable in its own right, the propositions offered here suggest that explanations using discretion are even more powerful when discretion is combined with orientation. We explicate four combinations of discretion and orientation. Bringing managerial discretion into the conversation about firm–stakeholder relations gives an opportunity to bring further clarity into stakeholder research. We hope that future research explores this fruitful area.

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NOTES

1. For the sake of simplicity and consistency with most of the prior literature, we refer throughout this article to the 'constraints' that stakeholders may impose. However, following our prior article (Phillips et al., 2010), we want to explicitly emphasize that in many cases, stakeholders also expand and catalyze the ability of managers to advance firm strategy.

2. As discussed above, we distinguish between nexus rent and historical conceptions of CSP. The 'social' in CSP implies a broader set of constituencies than denoted by aggregate stakeholder performance. Our model nevertheless has implications for the study of both.

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