Principal-Agent Relationships on the Stewardship-Agency Axis

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This article provides an overview of the literature on nonprofit principal-agent relationships. It depicts the nature of agency theory and stewardship theory, analyzes the origin of their struggle within the nonprofit structure, and marks directions for a conciliatory approach. We open with an introduction to agency theory and discuss the two main components of its mathematical branch. We thereby contrast it with stewardship theory and elaborate on the arguments that can affect the position of nonprofit principal-agent relationships on the stewardship-agency axis. Analysis of the existing literature points to a lack of consensus as to which theory should be applied. We argue that the division of nonprofit principal-agent relationships into board-manager and manager-employee interactions may help to clarify the balance between agency theory and stewardship theory and may lead to the establishment of a strongly founded theory on nonprofit principal-agent relationships. We close with a discussion of how this article may prove valuable to nonprofit policymakers and other empirical researchers.

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Situating Agency Relationships Within Nonprofit Organizations

In this section, we define and describe the domain in which agency theory operates and the main assumption upon which it is built. Next, we discuss the nature and positioning of the stewardship framework. The section concludes with a discussion of the different elements that may aggravate or lessen the agency conflicts within the nonprofit framework.

What Is Agency Theory?

In order to explain the basic concepts upon which the foundations of agency theory are built, we start with a definition of principal-agent relationships. According to Jensen and Meckling (1976), a principal-agent relationship can be defined as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent” (p. 308). Such relationships are quite common. For example, a client (principal) might hire a lawyer (agent) to defend his case. A homeowner (principal) might hire a carpenter (agent) to fix her staircase. Although both examples describe interactions in a private setting, principal-agent relationships also commonly occur within organizations. Here, literature often hands the role of the principal to the board of directors, which contracts a manager to run the organization in the interest of the shareholders (or, in the case of a nonprofit organization, in the interest of the stakeholders).

Agency theory traditionally assumes that these principal-agent relationships will be characterized by a conflict between the interests of the principal and those of the agent, and that the agent will be motivated to pursue her own goals (Pontes, 1995; Sundaramurthy and Lewis, 2003). So when the agent's behavior is not controlled or restrained, the goals of the principal are unlikely to be attained. To counteract the agency conflicts that principal-agent relationships may bring about, mathematical and theoretical research has focused on mechanisms that may help the principal to control his agent. It distinguishes between two frameworks that start from different assumptions regarding the level of informational (a)symmetry between the principal and the agent. In the following paragraphs, we elaborate on the similarities and differences that both frameworks hold.

Two Information Frameworks Within Agency Theory

Agency theory generally distinguishes between the symmetric information model and the asymmetric information model (Levinthal, 1988). Both models assume that the principal is able to observe a certain outcome, produced by the combination of the level of effort exerted by the agent and the occurrence of a certain state of nature (referring to some exogenous variables that influence productivity

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levels but lie beyond the control of the agent), but differ in the amount of information available to the principal. The models also generally assume the agent is not very keen on taking risks. When offered the choice between a contract with a fixed fee and a contract with a variable pay that yields the same average height (lower than the fixed fee in case of an unfortunate outcome and higher in case of a good outcome), the agent will always opt for the certainty of the former. He can only be persuaded to opt for the latter when the average compensation level is significantly higher than the one under the fixed-fee contract. In other words, the agent is assumed to be risk-averse. The principal, on the other hand, is generally assumed to be risk-neutral.

Within the symmetric information model, it is assumed that the information possessed by the agent is also known to the principal. In other words, the principal is perfectly informed as to the character of his agent and is able to observe the effort exerted on the task. In such case, Levinthal (1988) and Perloff (2003) show that the principal can elaborate a contract that is optimal for both the agent and himself (a first-best solution) by founding the compensation schemes upon the exerted effort levels. By attaching the highest net utility (utility from income minus disutility from effort) to the effort level most desired by the principal, a utility-maximizing agent can always be persuaded to dedicate the level of effort preferred by the principal. Since income is contingent only on the effort level and is independent of the state of nature and of the realized outcome, the agent will also not be forced to bear any unnecessary risk. A first-best solution will be obtained.

Within the asymmetric information model, the informational symmetry between principal and agent is destabilized by the introduction of moral hazard or adverse selection. Moral hazard refers to the fact that the exact level of effort the agent dedicates to her task can be cloaked, leaving the principal to make an educated guess about his contractual counterpart's true efforts. The agent, however, will always know how much effort she dedicates to her task. Adverse selection, on the other hand, refers to the fact that the principal is unable to observe relevant characteristics of the agent before forging the contract.

The introduction of an informational asymmetry is not necessarily a problem. If the agent's interests are perfectly aligned with the principal's, asymmetry will not affect the level of benefits streamed toward the principal. However, one of agency theory's basic assumptions is that a conflict exists between the interests of the principal and those of his agent. The principal will thereby be forced to apply new ways of contracting in order to minimize the deviation from the first-best solution. In the case of moral hazard, the deviation from the first-best solution is elicited by the fact that compensation can no longer be based on the level of effort (cloaked from the principal) exerted by the agent. Compensation should instead depend on the

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outcome. Outcome-based compensation would induce the agent to exert more than the minimum level of effort. The reasoning behind this argument is that because the principal is unable to evaluate his agent's effort and the agent draws disutility from exerting it, a fixed fee would only stimulate the agent to perform at the minimum level. Raising the fees would not alter this situation. The agent can be expected to accept higher wages (since higher wages result in higher utility), but also to minimize her effort (in order to minimize the disutility derived from it). Raising the fixed fee would therefore only widen the gap between gains and costs faced by the agent—and feed her bank account—but would not alter her choice of effort.

Because the basis of the compensation schemes must be altered from effort-based pay (fixed fees) to outcome-based pay (contingent pay) and outcomes are partly influenced by states of nature that are beyond the agent's control, the agent will be forced to accept a risk factor into her contract and may be held accountable for factors she cannot control. Such an arrangement would be inefficient. When a risk-neutral individual enters into a contract with a risk-averse individual, it is efficient to leave all of the risk in the hands of the risk-neutral party. Therefore, a trade-off exists within the asymmetric information model, forcing the principal to trade higher incentives for his agent for less efficiency in the risk-bearing features of the contract (Holmström, 1979; Shavell, 1979).

As noted by Levinthal (1988), switching compensation schemes to outcome-based pay is not the only possible response to the introduction of an informational asymmetry into the principal-agent relationship. Instead of attempting to improve the incentives within the asymmetric information model, one might also try to pull the relationship back toward the symmetric information model. When the asymmetric information is rendered by moral hazard, such an attempt may be generated by introducing a monitor into the relationship, thereby enlarging the principal's knowledge of the agent's effort. If such monitoring could be made perfect, the signal sent by the monitor would be a perfect indicator of the agent's effort, allowing the principal to revive the connection between effort and compensation and to free the agent from the inefficient risk-bearing arrangements within her contract. Procuring a perfect monitor can be difficult, especially within nonprofit organizations, where accurate output measurement is often hard to attain. It can also be costly and introduce new complications into the principal-agent relationship. For example, the monitoring officer might pursue interests that depart from those of the principal—or the officer might collude with the principal's agent (Mishra, 2002).

A Special Case of Agency Theory: Stewardship Theory

Stewardship theory differs from traditional agency theory in that it questions the assumption that a principal-agent relationship will always be characterized by agency conflicts. The theory embodies

two branches. The first branch depicts a relationship in which the goals of the agent conflict with those of the principal. Unlike traditional agency theory, however, the first branch assumes that the agent will be motivated to act within the interests of the principal and that she will not pursue her own goals (Davis, Schoorman, and Donaldson, 1997). This implies that the agent values the effect of her actions on the utility of the principal and that pursuing her own objectives generates higher costs (in utility terms) than benefits. In such case, the agent can attain a higher utility level when she cooperates with the principal. The second branch extends the theory by assuming that the agent's goals are perfectly aligned with those of the principal (Sundaramurthy and Lewis, 2003).

Although previous research tends to characterize stewardship theory as completely different from agency theory and to view both frameworks as being mutually exclusive (Donaldson and Davis, 1991; Davis, Schoorman, and Donaldson, 1997; Westphal, 1999), it is our view that stewardship theory should be seen as a limiting case of the agency framework. On an axis of ascending agency conflicts that start from zero at the left-hand side, stewardship theory constitutes the lower end (Figure 1). All other points reside under the agency framework. Since numerous positions can be proposed, the question arises where on the axis one should locate the principal-agent relationships encountered within the nonprofit organization.

Positioning Nonprofit Organization Principal-Agent Relationships on the Stewardship-Agency Axis

Now that we have a clear picture of the different aspects that stewardship theory and both models within the agency literature represent, the question arises as to how to assess the principal-agent relationships we

Figure 1. Positioning Agency and Stewardship Theory

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find within nonprofit organizations. Literature is not yet clear on the exact position of nonprofit principal-agent relationships on the stewardship-agency axis. While it presents arguments to defend a position toward the right-hand side, it also provides arguments that draw the mark toward the left. For clarity, we first concentrate on arguments that favor a position toward the right.

The first argument in support of a right-side mark draws on the theory of ineffective principals. Fama and Jensen (1983), Preston (1988), McLean (1989), and Brody (1996) argue that nonprofit organizations lack efficient principals (boards) who can hold agents (managers) accountable. Unlike for-profit organizations, nonprofit organizations do not possess a variety of shareholders who expect high returns from their investments and who have financial incentives to control their agents. Finding appropriate principals who can effectively control their staff is difficult. For example, the nondistribution constraint (Hansmann, 1986) makes it impossible for nonprofit organizations to control their managers through ownership (Steinberg, 1990). Handing ownership to the community, with the board as its representative, does not provide an alternative since the community is generally scattered and ill defined (McLean, 1989). Therefore, nonprofit organizations may foster even more room for managerial discretion, less oversight, and more harsh agency relationships than for-profit organizations do.

The second argument refers to difficulties with output measurement. Middleton (1987), Steinberg (1990), Alexander and Fennell (1993), Mooney and Ryan (1993), and Brickley and Van Horn (2002) indicate that nonprofit organizations generally have complex (or vague) objective functions and that it is often hard to measure their output accurately. The combination of both factors can be expected to hamper accurate measurement of managerial performance, detection of shirking agents, and creation of efficient incentive structures. Consequently, informational flows between the principals and their agents may be slackened, thereby widening the presence of moral hazard and adverse selection within the agency relationship (Magnus, Smith, and Wheeler, 2003). Again, agents seem to be on the winning side.

Literature also provides two arguments that favor a clear mark toward the left-hand side of the stewardship-agency axis. First, supporters of stewardship theory argue that the presence of a margin for managerial discretion alone is not sufficient to presume its use. Drawing on more general research by Ouchi (1980) and Mooney and Ryan (1993), supporters defend the proposition that agents' discretionary behavior may be lessened by their ethical considerations¹ and by the fact they may integrate some of their clients' interests into their own utility function. Thus, taking the decision that is best for the client would also be (at least in part) best for the agent, thereby rationalizing the fact that little of the discretionary room would be used. The use of stewardship theory would thus seem to gain credibility, even when

effective principals are not around. Francois (2001) and Steinberg (1987) provide similar theories. Francois's (2001) model shows that under certain conditions the absence of residual claimants may just stimulate nonprofit agents not to shirk. Assuming all workers (for-profit and nonprofit) are concerned with how their effort affects level of service, Francois shows that residual claims will stimulate shareholders to apply additional input factors when output seems to fall short of the target, whereas nonprofit organizations will not adjust. In such case, agents who are concerned with the level of service will be able to shirk in for-profit organizations but not in the nonprofit counterparts. Steinberg (1987), on the other hand, argues that when informational asymmetries exist between sellers and buyers concerning the quality of a product, the aim to maximize profits may stimulate agents to mislead consumers, while the nondistribution constraint will not. Finally, Slivinski (2002) shows that nonprofit organizations can indeed attain an efficient effort and production level when their output includes a public good. In the second argument, Phelan (1993) and Metzger and Dalton (1996) even weakened the assumption of the absent principals by stating that nonprofit organizations are often more attached to their constituents than their for-profit sector counterparts.

The self-selection hypothesis takes a special place in this discussion and develops as an endogenous determinant of where nonprofit organizations will lie between both extremes.² The self-selection hypothesis states that job applicants objectively compare offers from the for-profit and nonprofit sectors and opt for the sector most likely to correspond to their goals (Young, 1983; Wittmer, 1991; Callen and Falk, 1993). Nonprofit applicants are thereby assumed to reflect a stronger commitment and loyalty to the mission of the organization (Callen and Falk, 1993; Handy and Katz, 1998), to mark the ability to directly serve the public needs as their main priority (Wittmer, 1991), or to have preferences that correspond with the fiduciary role of the organization to which they apply (Hansmann, 1986). In such case, the assumed lack of efficient principals and proper output measures (described above) loses most of its effect. Nonprofit workers may then act in the interest of the organization even when there is no principal or monitor. Empirical findings by Mirvis and Hackett (1983) and Rawls, Ullrich, and Nelson (1975) are consistent with this self-selection argument. An additional argument connected to this reasoning that supports the stewardship theory was provided by Oster (1998) and Glaeser (2003). They suggest that the nonprofit sector is often characterized by a segmented labor market that is quite diverse and weakly mobile: Social services are run by social assistants, hospitals are run by former physicians, and so on. In such cases, stewardship theory seems more applicable. However, the self-selection works both ways. When applicants are aware that nonprofit organizations may indeed lack efficient principals and output measures, selfish agents may well decide to opt for these jobs. That way, nonprofit organizations may end up more to the left than expected.

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We argue that the struggle between stewardship theory and agency theory might be solved by dividing internal nonprofit principal-agent interactions into two main relationships. Instead of applying one theory to fit the organization as a whole, we propose to divide the study of principal-agent relationships within nonprofit organizations into (1) board-management interactions and (2) management-employee interactions. As such, we allow for the possibility that the theory ruling the first type of internal relationship differs from the dominant theory in the second one, and that even within both relationships players may start from different viewpoints than their contractual counterparts. In the next section we elaborate on these internal nonprofit principal-agent relationships through an extensive survey of the existing literature on board, management, and employee behavior and interaction.

Principal-Agent Relationships Within Nonprofit Organizations

This section explores existing literature on the actors' behavior in the two internal relationships and extracts guidelines that may mitigate the tension between stewardship theory and agency theory.

The First Internal Principal-Agent Relationship: Board and Management

The first internal principal-agent relationship concerns the interactions between the nonprofit board of directors (the principal) and its manager (the agent). There seems to be little consensus about how both actors relate to each other in this relationship; theoretical and empirical agency literature remain fairly thin. However, literature does exist regarding board behavior.

Although external principal-agent relationships (between stakeholders or donors and the board, and between clients and employees) are beyond the scope of this article, we need to briefly consider the nature of boards. In the first external principal-agent relationship, the nonprofit board of directors takes the role of the agent who is asked to perform services on behalf of the organization's stakeholders or donors. We will not enter the debate on whether the board should be accountable to all stakeholders or only to its donors and whether agency conflicts arise between either party and the board (see Kaplan, 1999). Instead, we start from the proposition that the board has objectives it embeds in a mission statement. In the first internal principal-agent relationship, the board takes the role of principal, acting as the prime defender of the mission statement and as champion of its achievement. Considering the assumptions of the agency perspective, the board should therefore decide whether to apply measures to control the behavior of agents who may pursue objectives of their own.

Although strong board control is considered important or even vital in normative (agency) literature (Fama, 1980; Fama and Jensen, 1983; Jensen, 1986; Weisbach, 1988; Ostrowski, 1990) and well-functioning boards surely exist within the nonprofit sector, Middleton's (1987) empirical research suggests that many nonprofit boards often exercise only weak control over the behavior of their agents. Glaeser (2003) also believes that corporate control is weak within nonprofit organizations and that the availability of control instruments is limited. According to Glaeser, nonprofit boards find it especially difficult to monitor the nature of services provided by the organization, thereby limiting their control to easily visible issues. In such case, room for managerial discretion and agency problems might be seriously increased within the nonprofit sector and raise the probability that the organization is bound to pursue the quirky preferences of its manager. As noted by Glaeser (2003), however, the nonprofit sector has not yet been characterized as harboring total chaos and despair. Although Glaeser does not reject the possibility that this situation results from the altruistic motives of the employees and managers, he believes it is the result of the competition process into which nonprofit organizations are thrown. In order to survive, nonprofits that are obliged to enter the product market must also attempt to retain their customers (for example, by building and maintaining a good reputation). Nonprofits that enter the market for donors face similar challenges. The proposition that competition may control inefficiencies is also defended by Bilodeau and Steinberg (2006). Building on earlier work (Bilodeau and Slivinski, 1997), they argue that even a nonprofit monopolist provider of a public good will not be able to depart far from efficient production because doing so would stimulate new entrepreneurs to enter the market and take their place.

So although the theoretical importance of an adequate functioning board of directors has already been pointed out (Herman and Tulipana, 1985; Herzlinger, 1994; Brown, 2002), empirical literature (most of which is focused on the United States) seems to conclude that board activity is low within nonprofit organizations, but that other elements protect these organizations from slipping into chaos and disaster. A logical question arises as to how much discretionary room management has, how much of the room is used, and which elements keep the organization within certain boundaries.

The striking divergence between theory and empirical evidence is remarkable. Several explanations of board neglect seem plausible.

A first explanation for the weak control by nonprofit boards might be drawn from Miller (2002). Her empirical research suggested that board members possess high confidence and trust in their management and make decisions based primarily on information provided by management and employees. In addition, they strongly believe their agents would not pursue interests of their own and would always act within the lines of the mission. Although not stated

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by Miller, these conclusions may suggest that nonprofit board members start from stewardship theory. The assumption of goal alignment made by the board indeed rationalizes its decision not to exercise full control over its management and to confine itself to weak governance practices to detect possible and unexpected changes within the goal alignment. When you are certain your manager desires the same outcome you do, why would you risk distorting the relationship by signaling distrust via control measures? Suggesting that the board starts from stewardship theory, the question arises whether the agents also start from this approach and how the principal-agent relationship might evolve when agency theory applies on the agent's side. It may also be interesting to learn whether the implementation of intermediate sanctions (making the board members personally liable for violations of their duty of care) would disturb a stewardship relation between the board and its management. Board members might possibly increase monitoring efforts, perhaps reducing trust and creating non-stewardship-like behavior on the part of the manager.

The second and third explanations for the weak control exerted by nonprofit boards—the influence of board composition and the managerial power approach—are strongly connected. The main discussion concerning board composition focuses on the advantages, disadvantages, and balance between insider and outsider participation, CEO duality, and board member diversity.

Similar to the definition of Callen and Falk (1993), we label a board member as an insider trustee when he receives some sort of remuneration from the organization. If not, we consider him an outsider trustee. According to Lorsch and MacIver (1989), the main advantage of insider board participation lies within their broad knowledge of organization-specific information. Especially on issues concerning internal difficulties and organizational strengths and weaknesses, insider input may greatly improve decision making. However, Callen and Falk note that the remuneration and employment of the insider trustees might give them an incentive to pursue their own interests within the decision making process. They might, for example, raise their pay or favor their own departments. Additionally, insiders may be more favorable toward management, because the manager may be able to influence their future careers (Herman, 1981; Westphal and Zajac, 1995). In organizations where CEO duality is allowed (that is, the manager is also appointed chairman of the board), management can even have direct control over board decisions. When seen from a pure agency perspective, such a framework might entitle the poacher to steer the actions of the foresters to his own advantage. Dalton and Kesner (1985), for example, considered an organizational structure in which a number of higher management officials were entitled to participate in the board's decision making process. Drawing on the assumption that the outside recruitment of a new CEO would bring significant change to the organization's strategies and functioning and that such change might include the

replacement of some management officials, empowered managers may have an incentive to block the recruitment process. Thus, efficient board functioning would be obstructed by insider participation. Outsider participation, on the other hand, is believed to raise the board's awareness of alternative strategies and technologies (Fama and Jensen, 1983) that might be useful for improving the organization's strategies or operational norms (Westphal and Zajac, 1995) or for increasing donations (Ostrower and Stone, 2005).

As a result of the potential bias surrounding insider trustees, the percentage of outsiders on the board is often viewed as a measure for corporate governance (Beatty and Zajac, 1994). However, as noted by Lorsch and MacIver (1989), Westphal and Zajac (1995), and Alexander and Fennell (1993), there is no ground to assume that outside board members will automatically be more independent than insiders. These researchers argue that the outsiders may be demographically similar to the manager, pursuing the same goals and sharing the same interests, which of course raises the probability they will favor management decisions, execute lower levels of control, and issue more positive performance evaluations. In such case, no improvement will be found. Although empirical research by Callen and Falk (1993) did not reveal that board composition significantly influenced the board's technical or allocating efficiency, Callen, Klein, and Tinkelman (2003) found that an increase in the proportion of major donors on the board lowered the proportion of administrative expenses to total expenses and raised the proportion of program expenses to total expenses.

Literature also devoted attention to the level and effects of board member diversity. Unfortunately, the intensity and direction of the diversity effects were not straightforward. Brown (2002) found that board member diversity did not influence board performance significantly but indicated that more diverse boards would more frequently and more effectively consult their constituents. Recent research on Flemish school boards by Du Bois and others (2005) also indicated that board member diversity influences board policies. Nonprofit organizations generally do not have a single overriding objective but instead have multiple goals. Therefore, more diverse boards can help to represent each of these objectives in the policymaking process. Other research concluded that heterogeneous groups would be more innovative and creative, but that they would also be less communicative, share weaker ties, rotate faster, and have more difficulty reaching consensus (Brown, 2002). Thus, more diversity within the board is not necessarily better. For an extensive review of the literature on the level and causes of the diversity itself, see Ostrower and Stone (2005).

Bebchuk and Fried (2003) use the insights on insider-outsider balance, CEO duality, and demographic similarity to introduce their managerial power approach. According to these authors, the weak control exercised by the board may be explained by the manager's influence on

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incumbent and future board members. They note that when the manager's support is needed in order to be elected to the board or to renew the mandate, both inside and outside board members may be favorable to management and new board members may be demographically similar to the manager. So by enhancing their grasp upon board election, managers may gain control over their principal, obtain higher levels of compensation, and enlarge their power over the organization (the power of the choice). As such, compensation arrangements should be considered part of the agency problem, rather than an instrument to reduce agency conflicts (Bebchuk and Fried, 2003). Extending the framework, similar effects can be expected to surface when managers are entitled to participate directly in the board's decision making process.

Taking these arguments into account, we conclude that a significant number of nonprofit boards of directors exercise only weak control over their management because of an inappropriate balance between inside and outside members or because of an inefficient demographic similarity. Both of these causes may stem from the presence of managerial power. Establishing a board member selection procedure that is independent of the manager may limit managerial power on the board but may also carry the risk of introducing self-perpetuating boards to the organization's structure.

Miller (2002) offered a fourth explanation for boards' weak control of management. Her research suggested that when board members were aware that they should be accountable to the community, boards employed better control and monitoring instruments. Such boards instituted extensive mechanisms to check and report whether the organization's actions were in line with budgetary constraints and the mission statement. They also channeled input from their constituents into the decision making process. Because board members felt accountable to their constituents and were aware of constituents' expectations of organizational performance, they could more easily build evaluation criteria. Boards whose members believed they were accountable only to the board and themselves paid less heed to such criteria. Miller also discovered that when the board could not reach agreement on how to measure the organization's efficiency, board members tended to use their own views to decide which aspects were most important. For example, lawyers focused on legal and contractual issues, and accountants focused on financial issues. Within this line of reasoning, weak board control might be explained by an insufficient perception of community accountability and expectations and a lack of agreement on measuring instruments.

The indications of low control by nonprofit boards can be helpful when analyzing the applications of agency theory and stewardship theory in the principal-agent relationship between boards and management. While stewardship theory applies when board members are convinced that the manager will act in the interest of the organization—and therefore exercise low control—agency theory

applies when sufficient board control is impaired by managerial control. By studying the origins of low board control, one may thus reveal which theory describes the reality. Our aim is to discover whether self-selection (and a tendency toward stewardship theory) can be considered the dominant theory to describe managerial behavior, or whether agency theory and goal conflicts should be invoked. On the assumption that board behavior is inspired by stewardship theory, the former model might help to explain the absence of chaos and despair within the nonprofit sector, and the latter model might allow interesting questions on the subtle interactions between both theories to be explored.

Although agency theory is generally accepted as the main framework within for-profit organizations, literature on nonprofit activity is not completely clear on which of the theories should be applied to the manager. Contributing to the agency perspective, research by Brickley and Van Horn (2002) found no direct evidence that nonprofit hospital managers had explicit incentives to focus their professional attention on altruistic activities. Instead, they argued that for-profit and nonprofit managers were given the same incentives to concentrate on the financial performance of their hospital. The fact that managerial turnover was strongly related to financial performance and that the competition hypothesis could not be founded strengthens this proposition. (The competition hypothesis states that the financial focus of the nonprofit organization manager is elicited by the high competition by for-profit organizations in the market and that the manager would concentrate on altruistic performance if competition were low and the probability of survival were high.) However, contributing to the stewardship perspective, Wittmer (1991) found that nonprofit managers did differ from their colleagues working in the for-profit sector. Because of self-selection, socialization, and other factors, nonprofit personnel cared more about serving the public than about extrinsic rewards like income (although income remained an important element). In addition, research by Buelens, Pepermans, Flion, and Mentens (1999) found a difference in the motivation to manage between for-profit and nonprofit managers. Some authors also provide findings that are counter to Brickley and Van Horn (2002). While Ballou and Weisbrod (2003) found that nonprofit hospitals are likely to provide their managers with incentives that stimulate focus on the quality of care, Erus and Weisbrod (2003) and Roomkin and Weisbrod (1999) found that nonprofit hospital managers were given different incentives than their for-profit sector colleagues.

As noted earlier, little consensus seems to exist on the applicability of classical agency theory in the case of nonprofit organizations. Some authors suggest that agency problems may be low; others claim that dilemmas will be high. More research is therefore needed.

When we assume that agency theory conflicts with stewardship theory within the principal-agent relationship between boards and

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managers, we are forced to evaluate which of the two theories presented by Bebchuk and Fried (2003)—the optimal contracting approach or the managerial power approach—is dominant. When the optimal contracting approach applies, management will be unable to influence board election and renomination and will not attain voting rights within the board. Under such circumstances, one can assume that the board will have the ability (applied or not) to institute incentive mechanisms that stimulate the manager to act within the interests of the stakeholders. Board behavior will be clearly distinguished from managerial influence, facilitating analysis of the board-manager relationship.

Introduction of the managerial power approach, on the other hand, complicates the relationship. When the managerial power approach applies, the manager has attained substantial influence over the (re)election of board members or over the board's decision making process. It then becomes likely that stewardship theory as the main vision within the board can no longer be assumed, and that weak board control is instead elicited by inefficient board composition and functioning.

According to Provan (1991), the manager has an informational advantage over the board. Provan's research suggested a positive relationship between the amount of information an individual receives within the organization and the height of her influence on the decision making process. Because the manager receives the most information, she can be assumed to have the highest influence on decision making.

Next to a potential continuous moral hazard problem, there are two main times when informational asymmetry may become an important factor within the board-management relationship. The first is during the selection process of the (potential) manager (adverse selection). As noted by Pontes (1995), candidates are better informed about their characteristics than the board and may try to use the informational asymmetry to exaggerate their competence and willingness to work. Through signaling (via academic qualifications, memberships in professional associations, prior employment recommendations, and government licenses), applicants can attempt to lessen the asymmetry and to convince board members of the strength of their candidacy. Fortunately, in some cases (as, for example, in the health-care sector) the threat of legal accountability for serious professional errors functions as an automatic restraint upon applicants, limiting their own candidacies to jobs that lie near or within their competencies. It is up to the board to reveal which applicant is the best candidate for the job. Second, informational asymmetry may become important at board meetings where the manager is asked to present the current state of the organization or is asked for advice. In such scenarios, the manager will be best informed on how the figures were computed, why certain aims were reached or not, and how the organization can respond in the future. Again, it is up to the

board to lessen the informational asymmetry; they may choose to conduct an audit, for example (Bamberg and Spremann, 1987).

To identify mechanisms that may limit the agent's use of the discretionary room offered through difficulties with monitoring and output measurement, research has studied the effects of efficiency wages. As noted by Yellen (1984), the efficiency wage framework predicts that agents may refrain from shirking activities when their compensation level is significantly higher than the one they could receive from alternative employers. In such case, the cost of dismissal will be so high that even the smallest probability of being caught (and dismissed) will stimulate the agent not to shirk. So by compensating his agents more than what they may receive from alternative employers, the principal will need only limited monitoring instruments to guarantee that employees will act within the best interest of the organization. While studies of this efficiency wage framework often focus on for-profit settings, Ito and Domian (1987) show that the framework may also apply to nonprofit organizations.

Although plausible, the efficiency wage theory suffers from major flaws. According to Steinberg (1990), use of the efficiency wage structure causes difficulties when hiring new agents. The height of the wages will automatically attract applicants who are interested in earning a lot of money and who may not care as deeply about the organization's mission. When it is hard to distinguish those who embody the mission (and apply for that reason) from income-oriented applicants, selection procedures gain complexity. Steinberg (1990) also notes that some organizations work the other way around. In order to guarantee that only those individuals who truly care about the mission apply for the job, some nonprofits even lowered their wages (shifting income-oriented applicants to the higher wages of the other employers).

In addition, efficiency wage theory might imply a positive income spiral when seen at the macro level. If only one organization within the sector were to offer efficiency wages, it would find itself in a favorable position when hiring new employees. When it is assumed that income is still an important variable within the utility function of the worker, potential nonprofit workers would prefer working at the organization offering the efficiency wages. In such case, the organization will be able to select applicants from the best workers within the sector. In response to their disadvantaged position on the labor market, however, other organizations in the sector may respond by raising wages to a corresponding level, thereby eliminating the cost of dismissal to the agents and destroying incentives for goal alignment. When the first organization sticks to its policy, a positive income spiral is initiated. Steinberg (1990) also notes that paying employees high wages may lower the motivation of the organization's volunteers, thereby reducing their effort level. Finally, efficiency wages may deter current and future donors and elicit outrage from the community. As noted by Oster (1998), donors are quite reticent about financing nonprofit organizations that promise high

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compensation levels to their personnel. Two main arguments elicit their concern. First, when more resources are spent on compensation, less money can be allocated for mission-related activities. Second, nonprofit organizations provide society with goods and services that are hard to evaluate, which means that high compensation levels may be more easily interpreted as potentially fraudulent. Thus, one may argue that there are limits on the use of compensation schemes in stimulating a nonprofit manager. Fortunately, when seen from a managerial power perspective, one might also claim that those effects constrain board and management in the creation of excessive compensation levels (Bebchuk and Fried, 2003).

When sketching board-management relationships, one must also consider the time horizons over which principals and agents maximize their utility functions. It may prove valuable to investigate whether Clarke and Darrough's (1983) findings on this can be applied to a nonprofit setting. Clarke and Darrough (1983) argue that the principal's time horizon (in our case the board's) is longer than the agent's. During the decision making process, an organization's board generally starts from a "going-concern" perspective in which the institution is assumed to flourish through the following decades. A manager, however, might choose to evolve from one organization to another during her career, maximizing her utility over the period in each contract. The difference between time horizons may provide a new source of agency conflicts. Suppose, for example, an agent is confronted with a pay-for-performance mechanism based on the amount of funds raised within a certain period. If the agent already knows she will leave the organization at the end of the term, she might choose to maximize the funds in the current period (deplete-and-depart strategy). As noted by Steinberg (1990), fundraisers with outcome-based compensation schemes may lie or keep silent about the organization's controversial goals or exaggerate its efficiency when they are contacting potential donors. In such scenarios, future results are sacrificed for short-term benefits. Because those future results are important to the organization, new incentives should be built into the contract. According to Steinberg, one example of such incentives is the introduction of a compensation scheme that links the height of the payment to a moving average of the performance level.

The Second Internal Principal-Agent Relationship: Management and Subordinates

While the first internal relationship focuses on the interaction between the nonprofit board of directors and its manager, the second one deals with the relationship between the manager and the organization's personnel. Again, literature is not yet clear on the applicability of agency or stewardship theory to describe the behavior of the actors within the manager-employee relationship. Honoring the conflicting arguments presented in the section about positioning nonprofit principal-agent relationships on the stewardship-agency

axis, supporters of stewardship theory still challenge the use of agency concepts within the nonprofit sector—and vice versa.

As the board's agent, one of the nonprofit manager's prime responsibilities is to run the nonprofit organization in accordance with the mission of the organization, while respecting its financial health. However, the financial aspect of a nonprofit organization is quite different from that of a for-profit organization. For-profits aim to maximize the profits they can extract from their activities and enter the profit level into their utility function. A nonprofit organization, on the other hand, will pursue different goals and will view the financial aspect as a necessary condition that should be met before the utility-deriving activities can be engaged in.

Acting as an agent in the first internal principal-agent relationship, the manager will likely need to recruit employees who will help him to pursue tasks set by the board and who may or may not pursue interests that correspond to his own. Thus, the manager becomes the principal in the principal-agent relationship between the employees and himself. (In other words, managers are both principal and agent, depending on the relationship that is considered. This vision was also shared by Beckman [1987], whose analysis pertains to a for-profit context.) Again, the question arises as to whether agency or stewardship theory is dominant at either side.

Starting from an agency perspective, Glaeser (2003) noted that employees may have a direct or indirect (controlling) influence on the manager. Thus, the framework of the managerial power approach that was introduced into the first internal principal-agent relationship by Bebachuk and Fried (2003) might also be applied within the second internal relationship. Glaeser (2003) notes that some employees, the so-called elite workers, possess more influence than others. The total amount of influence an employee has on the manager depends on the extent of his direct contact with the manager, the manager's background (for example, whether he comes from the same department), and the extent to which the employee can punish or reward the manager. Combined with Dansereau, Graen, and Haga's (1975) theory on the use of in- and out-groups by the manager,³ the content and functioning of such principal-agent relationships can be expected to differ among groups of employees. When analyzing and describing principal-agent relationships, such differences (and possible evolutions during the organization's life cycle) should be taken into account. Finally, research should investigate whether the arguments presented in the section about positioning principal-agent relationships on the stewardship-agency axis also apply to the second internal principal-agent relationship and determine their relative importance. Research should determine whether difficulties with limited control and incentive mechanisms and with accurate output measurement indeed elicit substantial agency conflicts between the manager and his subordinate employees, or whether self-selection and ethical considerations can temper these conflicts.

Conclusion

We have presented the current views on principal-agent relationships within the nonprofit sector. Based on the research conducted so far, we have argued that although the application of agency theory is widespread throughout the literature on the for-profit sector, it is not yet commonly used to describe labor relations in nonprofit organizations. The nonprofit literature is still not completely clear on whether agency or stewardship theory should be applied. Both theories, each starting from different assumptions on the characteristics of nonprofit personnel, seem to possess strong arguments and engage each other in a struggle for dominance. We suggested that stewardship theory should be viewed more as a limiting case of agency theory than as an opposing framework.

We also argued analysis of the relationships within nonprofit organizations should be divided into two areas of study: the relationships between the stakeholders (represented by the board of directors) and the manager, and between the manager and his employees. A solution may be found by acknowledging that these two categories of relationships may differ—as opposed to applying one framework to fit the organization as a whole.

Notes

1. According to Hansmann (1986), these ethical considerations may also explain why nonprofit managers adhere to their fiduciary responsibilities and why the nondistribution constraint is generally respected.

2. The size and impact of the arguments mentioned may differ among various nonprofit subsectors, and some industries may therefore lie more to the agency or stewardship side than others.

3. According to Dansereau, Graen, and Haga (1975), superiors divide their employees into in- and out-groups. During his interactions with out-group workers, the superior will deploy the “supervisor style,” in which his influence is mainly drawn from the authority specified in the formal employment contract. His willingness to negotiate on role development with out-group employees will also be scant. In-group workers, on the other hand, will face the “leadership style.” They will receive increased leadership attention and support and will be less likely to perceive their supervisor as a source of job problems.

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