

AGENCY THEORY IN A CROSS-CULTURAL CONTEXT: PREDICTIONS FOR A GLOBAL ECONOMY

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Abstract

In a globalized marketplace, multinational organizations face multiple challenges across a variety of cultural contexts. Using Geert Hofstede's (1983) dimensions of culture, this paper extends Eisenhardt's (1989) work on agency theory by exploring the applicability of agency theory to determine the optimal mechanism between behavior-based contracts versus outcome-based contracts in different cultural contexts. Four propositions are developed using dimensions of culture; power distance, uncertainty avoidance, individualism/collectivism, and masculinity/femininity; to help better understand the role culture has on the principal – agent relationship.

Keywords

Agency Theory, Outcome-Based Contract, Behavior-Based Contract, Hofstede Cultural Dimensions

Introduction

In an increasingly globalized world, multinational organizations must deal with an array of challenges, many related to cross-cultural differences. At the highest levels of the organization, the goals of the individuals who own the organization (principals) and the individuals who manage (agents) can be out of alignment due to agency issues. To mitigate cross-cultural issues, a better understanding of the role culture plays in the principal–agent relationship is necessary.

Agency theory is an important organizational theory relevant to management practices in general, as well as an organization's strategy, organizational dynamics, and human resource practices. The heart of agency theory is the description of the relationship between a principal and an agent, where the agent is employed to represent the principal. In describing agency theory, Jensen and Meckling (1976) elucidated the primary ethical consideration of agency: that is when both parties want to maximize their outcomes the agent may not act in the best interest of the principal.

Long before Jensen and Meckling, Adam Smith (1937[1776]) noted that a non-owner manager of an organization might not work sincerely for the owner's benefit and this theme permeates agency discussions to this day (McCraw & Berle, 1990; Panda & Leepsa, 2017; Wilson, 1968). Fama and Jensen (1983) pointed out that agency problems arose when the firm's decision-maker was not the real risk carrier of the firm's wealth. Eisenhardt (1989) suggested agency problems are caused by the difference in goal and risk preference between two parties (Eisenhardt, 1989). According to agency theory, agents do not always expend the best efforts to meet the firms' objectives. Recognizing this, scholars recommend mechanisms to monitor and control agents to align agent actions with the best interests of the principals in mind to protect those interests.

Some of these mechanisms meant to align principals and agents include Jensen and Meckling's (1976) recommendation to offer agents ownership by granting them stocks or equity ownership. Agent equity ownership transfers some of the principal risk to the agent. Joint ownership now aligns both parties' interests (Jensen & Meckling, 1976). Another option includes executive incentive packages designed to motivate agents to pursue the needs of the organization and not use organizational property for their own benefit because their incentive is high enough to fulfill their own personal needs (Core, Holthausen, & Larcker, 1999; Fama, 1980). Murphy (1985) studied corporate performance and managerial remuneration (essentially executive incentives) and observed a relationship between changes in executive salaries and shareholder wealth. Stock options are also a mechanism to

encourage managers to act toward increasing shareholder wealth. Eaton and Rosen (1983) revealed that if executive compensation was weighed heavily on stocks, these practices could help managers to act in ways that are congruent with shareholder interests. Finally, the board of directors can also provide oversight as to agent behaviors to make sure they maximize owner wealth (Rosenstein & Wyatt, 1990). Each of these mechanisms or interventions was shown to strengthen the fiduciary behavior of the agent when representing the principal.

While these mechanisms, defined by Eisenhardt (1989) as illustrative of “Positivist Agency Theory” have been suggested for resolving agency problems, these same mechanisms have been criticized for lacking rigor and being difficult to test (Perrow, 1986). As such, Eisenhardt suggested refining the positivist approach into a description of the principal-agent relationship. Positivist theory suggests various protective mechanisms and principal-agent theory suggests which opportunities are efficient under different contexts (Eisenhardt, 1989); the key idea of which is that “principal-agent relationships should reflect efficient organization of information and risk-bearing costs.”

Eisenhardt (1989) developed a series of propositions for consideration regarding contract types (see Appendix A). Behavior-based and outcome-based contracts include reference to the equitable units of exchange between the principal and the agent which are necessary to resolve problems related to a cooperative structure. The outcome-based contract is based on aspects such as commissions, stock options, and equity ownership and involves minimal monitoring, little managerial direction or effort, and straightforward measures of results because it focuses on the desired outcome rather than the process or context to achieve such outcomes. In contrast, a behavior-based contract is based on aspects such as salaries and hierarchical governance and involves considerable monitoring, a high level of managerial intervention, and subjective measures to evaluate and compensate the agents (Anderson & Oliver, 1987; Eisenhardt, 1989).

Proposition 1	When the contract between principal-agent is outcome based, agent likely to behave in interests of principal
Proposition 2	When the principal has information to verify agent behavior, agent is more likely to behave in the interest of principal
Proposition 3	Information systems are positively related to behavior-based contracts and negatively related to outcome-based contracts
Proposition 4	Outcome uncertainty is positively related to behavior-based contracts and negatively related to outcome-based contracts
Proposition 5	The risk aversion of the agent is positively related to behavior-based contracts and negatively related to outcome-based contracts
Proposition 6	The risk aversion of the principal is negatively related to behavior-based contracts and positively related to outcome-based contracts
Proposition 7	The goal conflict between principal and agent is negatively related to behavior-based contracts and positively related to outcome-based contracts
Proposition 8	Task programmability is positively related to behavior-based contracts and negatively related to outcome-based contracts
Proposition 9	Outcome measurability is negatively related to behavior-based contracts and positively related to outcome-based contracts
Proposition 10	The length of the agency relationship is positively related to behavior-based contracts and negatively related to outcome-based contracts

Source: Eisenhardt (1989)

Table 1: Eisenhardt (1989) Propositions

Conceptualizing the principal/agent problem in such terms has aided in providing insight into deterring and predicting agency problems, however, there is some question about the validity and generalizability of agency theory to different cultural contexts outside of the west (Ekanayake, 2004). This paper provides a series of propositions concerning the applicability of agency theory across different cultures using Hofstede’s cultural dimensions as a lens.

Culture – Values and Norms

The notion of “culture matters” is a growing area of interest among management scholars. Katz and Kahn (1978) stated that agent actions are motivated by their values and norms. Those values are also the criteria for agent goal selection decisions (Hechter & Opp, 2001) and the acceptable actions for goal achievement (Katz & Kahn, 1978; Scott, 1987). Cultural norms have demonstrated effect on differences in agency behavior (Ekanayake, 2004). To understand agent behavior, Sullivan and McCarthy (2004) stated that we need to adapt to cultural constraints. Geert Hofstede (1997) made the analogy that culture is the computer code that controls the hardware or individual behaviors. He stated that culture affects the organization in many ways, such as organizational goals, structure, decision-making, and rewards systems (Hofstede, 1980). Specifically, Hofstede defined culture as “the collective

programming of the mind which distinguishes the members of one human group from another” (Hofstede, 2011; Taras, Kirkman, & Steel, 2010).

Hofstede (1983) identified four dimensions of culture in his widely accepted framework: uncertainty avoidance, individualism/collectivism, power distance, and masculinity/femininity. His work became an essential part of understanding behavior across cultures and has been widely used in predicting agents’ ethical decision-making in businesses (Kim & Kim, 2010). Over 100,000 employees in 50 different countries were used in his dimension analysis where he found that value systems vary between countries (Hofstede, 2011). Later, the fifth dimension was added: long-term/short-term orientation. In the 2000s, a sixth dimension was added: indulgence/restraint (Hofstede, 2011). We focus on the original four dimensions of Hofstede from 1983 which are described below.

Power Distance

Hofstede’s power distance index (Hofstede, 1983) measures the extent of acceptance for inequality (i.e., more vs. less powerful members) in terms of the cultural acceptance of power and status differences (Zenko, 1999). According to Hofstede, high power distance cultures are shown in the form of uneven income distribution, a teacher-centered education system, respect and fear of older people by younger people, and children having to obey parents (Hofstede, 2011).

Several findings are related to power distance. For instance, Arrow (1985) found that the cultural values of agents are a result of their early education processes, and that power is related to their work ethic when they grow up (Oviatt, 1988). Boudreaux and Long (1977) also stated that business students always learn to be responsible toward shareholders in high power distance cultures. A high power distance culture is manifested by the obeying of norms, following rules, and following authority (House, Javidan, Hanges, & Dorfman, 2002); disagreement with supervisors is not expected (Hofstede, 1980). As a result, the behavior of an agent should be certain and predictable, indicating a preference for behavior-based contracts to minimize agency conflicts.

Kwon and Adler (2014) stated that employees in a high power distance culture would accept hierarchical relations and differences in income inequality. Hence, they can accept less benefits than that of principals (Renneboog & Szilagyi, 2015), leading to a lower chance of moral hazard. Mamman, Sulaiman, and Fadel (1996), studied the attitude of employees toward the pay systems across cultures. Employees in a high power distance culture felt uncomfortable if their incentive was close to or greater than the principal’s benefit. In this case, one could assume that salaries and hierarchical governance are preferred as agent control mechanisms.

In contrast, low power distance culture is illustrated by legitimate power (rather than age, for example), even income distributions, flat or lower hierarchical structures, student-centered educational systems, and equality among family members (Hofstede, 2011). People would have less tolerance for differentials; hence, the outcome-based contract would be more likely to help leveling up the pay of agent (relative to that of the principal), so the mechanisms such as pay-for-performance are more likely to be preferred by agents in this culture (and hence, more likely to be effective). Low power distance has also been found to be strongly related to agents’ unethical actions (Christie, Kwon, Stoeberl, & Baumhart, 2003). As such, we propose the following:

Proposition 1: High power distance cultures will respond more positively to behavior-based contracts, whereas low power distance cultures will respond more positively to outcome-based contracts.

Uncertainty Avoidance

Uncertainty avoidance answers the question: to what extent can members in the culture handle novel situations (Hofstede, 1983), or “future uncertainty (Tosi, Rizzo, & Mero, 2000).” A strong uncertainty avoidance culture is shown in the form of higher stress, emotionality, anxiety, need for clarity and structure. In addition, teachers should have all the answers, staying in jobs is the norm even if it is disliked, and members have an emotional need for rules (Hofstede, 2011). To avoid uncertainty, employees in strong uncertainty avoidance cultures rely on strict rules, regulations, and security measures. They have less tolerance for behavior deviation (Tosi et al., 2000). They prefer secure jobs, want to minimize risk, and plan everything carefully to stabilize their career (Taras et al., 2010; Treven, Mulej, & Lynn, 2008). Hence, agent behavior in a strong uncertainty avoidance culture would be quite predictable, so we would argue that behavior-based controls are likely to be preferred. Moreover, the employee in a strong uncertainty avoidance culture would likely see an outcome-based contract as an uncertain situation. In this case, we could predict that when the perception of outcome uncertainty is high, the behavior-based control system would be preferred.

On the other hand, members of a low uncertainty avoidance culture might change jobs if they do not like their job, are comfortable with ambiguity or unusual situations, show self-control, and tolerate of deviant persons and ideas (Hofstede, 2011). People in low uncertainty avoidance cultures are good at confronting the unknown or are considered risk-takers (Licht, Goldschmidt, & Schwartz, 2005). People in this culture can maintain a relationship even after a conflict and confrontation (Treven et al., 2008). According to Eisenhardt (1989), the risk

aversion of agents is negatively related to the outcome-based contract. As such, we propose the following:

Proposition 2: High uncertainty avoidance cultures will react positively to the behavior-based contract, whereas low uncertainty avoidance cultures will react positively to outcome-based contracts.

Individualism/Collectivism

Individualism and Collectivism are two polar dimensions of a single scale that show the degree to which members are integrated into society or a collective entity (Hofstede, 2011). Brislin (1993) extended the definition of the dimension as the preferred way for members to deal with the issues in society. Because employees focus on personal achievements, they tend to have weaker relationships at work in which the task is more important than a relationship. That implies emotional detachment of agents from principals (Putnam, 2002). Agent decisions would be based on personal objectives that lead to goal conflict between agents and principals (Tajfel, 1981). Individualistic cultures do not shy away from confrontation and situations involving threats and accusations (Leung, Au, Fernández-Dols, & Iwawaki, 1992). In an individualistic society, people are more likely to do things their own way and maximize personal achievement (Brislin, 1993; Kohn & Schooler, 1969; Triandis, 2004). The goal conflict between agents and principals is likely to be higher in an individualism culture. According to Eisenhardt's proposition 7 (see appendix A), the goal conflict between principal and agent is positively related to the need for an outcome-based contract (Eisenhardt, 1989).

From the lens of Collectivism, social capital also plays an important role in culture. People seem to have emotional ties and a sense of belonging to the group (Tajfel, 1981). It is shown in the form of a 'we' consciousness, such that opinions are predetermined by the in-group, extended family relationships, and the notion that a relationship is more important than a task. Furthermore, transgression from norms leads to feelings of shame, and harmony is almost always maintained (Hofstede, 2011). Collectivism is concerned more with the social perceptions of their actions and how their actions affect society as a whole (Leung et al., 1992). The organization's growth is the basic motivation for agents in this type of culture, such that they would want to see their organization dominate the industry (Donaldson & Lorsch, 1983). Kotter (2010) also supported this notion, in that the executive in this type of culture enjoyed strong financial success of their organization more than their own benefits, and they behave ethically even without monitoring.

Those characteristics of a collectivist culture imply the natural alignment of goals between principals and agents, so the behavior-based contract is likely to be preferred and sufficient. The harmony and in-group relationship will also show strong alignment between agents and principals. Eisenhardt stated that the more engagement in the relationship between agents and principals, the more attractive behavior-based contracts appear, since principals have likely known the agents long enough to determine their behavior (Eisenhardt, 1989). As such, we propose the following.

Proposition 3: An individualistic culture will react positively to the outcome-based contract, whereas a collectivist culture will react positively to the behavior-based contract.

Masculinity/Femininity

Masculinity and Femininity are two polar ends of the dimension, which illustrates the dominant values in society. Masculinity values assertiveness, performance, success and competition over the quality of life, care for the weak, and warm personal relationship (Hofstede, 1994). Vitell and Festervand (1987) showed that people in a masculine culture were concerned more about their personal gains, so they tended to behave more unethically compared to people in a feminine culture. Employees in this culture prefer monetary or status-oriented rewards (Hofstede, 1997). Hence, the outcome-based contract is likely to be preferred in a highly masculine culture.

On the other hand, individuals in a feminine culture prefer a friendly atmosphere, position security, and cooperation (Taras et al., 2010). Femininity is associated with compassion and emotional openness (Treven et al., 2008). Strong feminine cultures can be indicated by the balance between family and work, and sympathy for the weak. For instance, both boys and girls may cry but neither should fight, the dominant religion focuses on fellow human beings, and both fathers and mothers deal with facts and feelings (Hofstede, 1983). Employees in this culture appreciate the symbolic rewards such as time off and offering materialistic rewards could be de-motivating in this culture (Hofstede, 1997; Treven et al., 2008). As such, we propose the following:

Proposition 4: A highly masculine culture is more likely to respond positively to the outcome-based contract whereas a highly feminine culture is more likely to respond positively to the behavior-based contract.

Discussion

In the globalized world, multinational corporations must deal with an array of challenges in a variety of cultural environments, including agency problems. We argue that agency theory is not universally applicable to all organizations in all countries, but rather we propose that consideration must be given to the cultural dimensions of a host country when applying agency theory. The paper expresses a framework for selecting an appropriate agency contract across culture dimensions, arguing that there are differences in agent motivational factors across cultures.

In collectivist and highly feminist cultures, such as Southeastern Asian countries, agents naturally have emotional ties to the organization. They tend to behave congruently with actions that benefit the principal. Motivation interventions should be non-monetary, subjective rewards. Management direction and close monitoring are preferred by persons in collectivist and feminine cultures. The behavior-based contract is considered an effective mechanism in these cultures. In low power distance and low uncertainty avoidance cultures, employees tend to be aggressive and independent. The chance of conflict between agents and principals is relatively high. The outcome-based contract may be more likely to control agent behavior in these cultures. This paper proposes that organizations carefully consider the proper agency theory control mechanisms relative cultural diversity.

Despite our review of major works as they relate to agency theory, we acknowledge that the above review is limited. As noted by Pandey and Leepsa (2017), three recognized agency problems; principal-agent problem, principal-principal problem, and principal-creditor problem; exist. This paper only focuses on the first type of agency problem between the principals or owners and agents or managers. The analysis might be different in other types of agency configurations, limiting the generalizability of our propositions.

Hofstede's cultural dimensions with regard to within-nation differences in culture as a result of globalization have been critiqued (Crozier & Thoenig, 1976; Yun, 2008). The world is changing fast. Culture dimensions can be more complex than in 1983 because culture develops over time. Some would argue that globalization tends to create homogeneous cultures (O'Reilly, 1991; Ohmae, 1985). Further, many people experience more cultures than that of their birth; hence, it is difficult to define the dimensions of people who are from mixed backgrounds which may lead to less predictable behavior.

The Globalization Index might also be helpful in future research. The Globalization Index (KOF index) considers social, political, and economic dimensions that flow among worldwide networks (Gozgor, 2018). It is more sophisticated in that it takes into account the variety of capital, culture, ideas, and information that affect people's values and norms (Dreher, Gaston, & Martens, 2008). Future research should consider using the KOF index as one important variable in cultural studies of this nature.

According to contingency theory, there are no one-size-fits all solution to all circumstances. Much managerial decision making depends on the situation and context. This paper proposes one type of agency theory contract over another, relative to four cultural dimensions and does not consider the mixed dimensions of multiple cultures in one country. For example, Hofstede (1980) found that Sweden had a high individualism index (71) but was also low on the masculinity index (5). Those two dimensions are posited to prefer different agency contracts and cannot be explained by these proposed propositions. Rather than choosing between two contract types, future research should focus on integrating both contracts to address agency problems in some mixed culture societies.

Conclusion

This manuscript provides plausible and grounded propositions for considering varying types of agency theory controls. We build on the work of Eisenhardt (1989) and Hofstede (1983) using four culture profiles. In addition, we propose methods for testing these propositions with secondary data. Further research of these propositions will provide a better understanding of the role culture plays on the principal-agent relationship and could help multinational organizations better navigate some of the challenges they are facing in an increasingly diverse and global marketplace.

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