

Living in Agreement with a Contract: The Management of Moral and Viable Firm–Stakeholder Relationships

Kalle Pajunen

ABSTRACT. In a contractual firm–stakeholder relationship the participants are expected to act according to the agreement and for mutual benefit. By acting against the agreement at the expense of the other participant, however, may result in higher individual profits within a short period of time. Building on the unlocked iterated prisoner’s dilemma (PD) setting, Scanlon’s [Scanlon, T. M.: 1998, *What We Owe to Each Other* (Belknap Press of Harvard University Press, Cambridge, Mass)] version of contractualism, and the social dilemma literature, this article considers what types of behaviors should be followed by both parties in an established firm–stakeholder relationship in order to reach an outcome that is defensible both in terms of morality and viability. It is argued that a normative foundation, which advises firms and stakeholders to ground their behavior on principles that could not reasonably be rejected by others, forms a basis for moral and viable behavior that can be expressed in the form of a strategic rule that excludes defection and utilizes the option to exit in response to the other participant’s defection. Then, a set of testable propositions is developed that describe how a firm and its stakeholders can further promote moral and viable relationships.

KEY WORDS: contractualism, stakeholder theory, moral, ethics, dilemmas, viability, cooperation, strategic management

Introduction

Recent research in stakeholder management has established a perspective considering firm–stake-

holder relationships in contractualist terms (e.g., Boatright, 2002; Donaldson and Dunfee, 1994, 1999; Heugens and van Oosterhout, 2002; Heugens et al., 2004; Hill and Jones, 1992). One of the main appeals of this approach is the idea of voluntary action and association that may be seen underlying the basic assumptions of both stakeholder management and contractualism. Specifically, from the contractualist point of view, firm–stakeholder relationships are based on explicit or implicit agreement including a set of mutually acknowledged future rights and obligations in order to achieve mutual benefit or prevent some harm (Heugens and van Oosterhout, 2002). The basic motivation for participation in such relationships is that they offer a possibility for an advantage the participants cannot realize on their own (Heugens et al., 2004).

After participants in a firm–stakeholder relationship have accepted a contractual commitment, they are expected to act according to the agreement and for mutual benefit. This can also be seen as a morally acceptable situation in an established relationship. However, the autonomous participants may realize that by acting against the agreement, at the expense of the other participant in the relationship, can result in higher individual profits within a short period of time. This is possible even if the contractual interests of the participants are alignable and they have the ability to live up to the terms of agreement (cf. Heugens and van Oosterhout, 2002). Indeed, due to bounded rationality (Simon, 1957), it is impossible to foresee all the emerging contingencies that may encourage participants for opportunism that collides with the agreement and mutual benefit (Williamson, 1985). In other words, if contrary to the agreement behavior provides an opportunity for individual profits that exceed the expected profits provided by

Kalle Pajunen received his Ph.D. in strategic management. His current research interests include research methodologies, turnaround processes, stakeholder theory, strategic leadership, and business ethics. His recent articles appear (or are forthcoming) for instance in Advances in Strategic Management, Human Relations, Journal of Management Studies, and Leadership.

the agreement, an established firm–stakeholder relationship can be considered as a modification of a prisoner’s dilemma (PD) setting, in which individually rational behavior may lead to a collective irrationality, “in which everyone is worse off than they might have been otherwise” (Kollock, 1998, p. 183).

Related to this dilemma, Jones and Wicks (1999, p. 216) proposed the principles of convergent stakeholder theory in order to address the question: “What kinds of stakeholder relationships are both morally sound and practicable?” These researchers argue that this form of theory is invalid unless it includes not only a normative component, stating that both the means and the ends of an action in a firm–stakeholder relationship should be morally sound and to be defended in moral terms, but also an instrumental component, stating that the means–ends chain must be logically convincing and theoretically consistent, as well as practically feasible. Thus, firm–stakeholder contracts and convergent stakeholder theory share the underlying idea that stakeholder management should at least be a zero-sum game and by choice a positive-sum game where it is possible for all players to increase the size of the benefits they receive in playing the game in the limits of some normative standard. However, an explicit answer to the question – what types of behaviors should be followed by both parties in an established firm–stakeholder relationship in order to reach an outcome that is defensible both in terms of morality and viability – still remains unsettled. This article, building on the unlocked iterated PD setting, Scanlon’s (1998) version of contractualism, and the social dilemma literature, tries to provide a solution to this question.

The proposed theory of moral and viable firm–stakeholder relationships in the unlocked iterated PD setting follows the logic summarized in Figure 1. Altogether, the article offers three interrelated contributions to stakeholder and contractarian business ethics literatures. First, the moral standards for behavior in established, contractual, firm–stakeholder relationships are defined. Second, drawing on the unlocked iterated PD literature, the instrumentality of the suggested normative foundation is confirmed by showing how it can lead to viable outcomes when taking the form of a strategic rule. Third, the article incorporates findings from the

social dilemma literature to the question of morality in firm–stakeholder relationships and in so doing proposes a set of structural and motivational solutions that further support the development and maintenance of moral and viable relationships. A discussion of the contributions and limitations of the propositions concludes the article. Finally, considerations regarding future research are given.

Unlocked iterated prisoner’s dilemma setting

In the basic version of the PD, there are two players, each of whom has only two choices: to cooperate or defect. A player has to make the choice without knowing what the other will do next. The choices intersect at four possible outcomes, each with a designated payoff. The dilemma is that if both players defect, both do worse than if they had cooperated. Mutual cooperators do fairly well and score the reward (R). In the case that one player cooperates but the other defects, the cooperating player gets the “sucker’s payoff” (S), while the defecting player gets the “temptation to defect” (T). Finally, in the case that both defect, both receive the “punishment for mutual defection” (P). According to the dilemma, player 1 has the choice to cooperate or defect, though the payoff from the choice is dependent on the choice made by player 2. If the game is played only once, it is profitable for player 1 to defect if player 2 cooperates; however, player 2 is unlikely to cooperate if he knows that player 1 is able to defect. As a result, provided that $T > R > P > S$, defecting is the only equilibrium strategy leading to payoff P. That is, however, worse than the R that both could get if they would cooperate. Although the payoffs need not be symmetric, the payoff parameters should be ordered as presented above. Thus, rational behavior leads to the unfortunate situation where each player would be better off with mutual cooperation.

The PD setting as such, however, does not provide an appropriate basis for modeling firm–stakeholder interactions in contractualist terms. First, the contractual relationships are not restricted to one-shot games, but usually include several interactions. This means that the present choices not only determine the outcome of that particular move, but

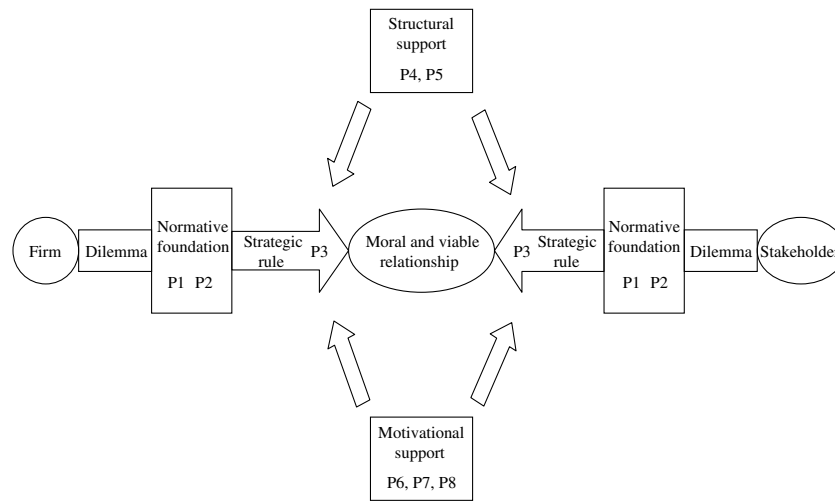


Figure 1. The logic of moral and practical firm–stakeholder relationships.

can also influence later choices made by the players. Thus, in the form of the iterated PD, the future can “cast a shadow back upon the present and thereby affect the current strategic situation” (Axelrod, 1984, p. 12). This prospect of future interaction also allows the possibility of mutual cooperation to emerge among the players, since they have a stake in the partner’s future behavior.

Second, the regular (iterated) PD involves a setting of forced interactions, and this is not in line with the realities of free market economies in liberal democratic societies. Firms and stakeholders are not prisoners, but have the possibility of refusing to play the game. Thus, not until “unlocking” the game by allowing the players an exit option brings this important analytical tool in line with the assumption of voluntary association that underlies the entire corpus of contractualist thought, and thus makes it an adequate tool for the analysis of voluntary firm–stakeholder interactions. Accordingly, participants in firm–stakeholder relationship can abandon an undesirable partner (see also Boone and Macy, 1999; Orbell and Dawes, 1993). Basically, the firm does not need to be in a relationship with a particular stakeholder if other similar support is available, nor is the stakeholder restricted to choosing that particular firm.

The option to exit leads to modification of the original payoff structure of PD (see Figure 2). Similarly as in the original one-shot dilemma, the nature of the game depends on the ordinal rankings of expected payoffs. The inclusion of the exit option

covers the assumption that the payoffs from choosing the withdrawal (N) alternative are lower than those expected under mutual cooperation, and higher than under mutual defection. Moreover, it is assumed that if one of the players withdraws, both of them maintain what they had before the other player’s exit. As a result, the payoffs rankings can be presented in the form $T > R > N > P > S$. Both of these modifications, iteration and the option to exit, change the true nature of the original dilemma, being as such illegitimate contributions to the technical discussion of the PD (Vanberg and Congleton, 1992). However, from the standpoint of this article, to consider firm–stakeholder relationships in contractualist terms, these changes are clearly legitimate and necessary in order to enable the emergence of relationships that capture morality and viability in their most basic nature.

The third adjustment to the original PD setting concerns the levels issue (e.g., Klein et al., 1994). While the dilemmas are traditionally conducted at the individual level, the discussion of firm–stakeholder relationships typically occurs at the organizational level. To be exact, although the *de facto* relationship between the firm and its stakeholder may consist of several interactions between different members of both groups, it is assumed that all members of a group are sufficiently similar to allow their classification as a group. In fact, there exists an extensive body of literature applying individual level dilemmas to organizational or institutional level issues (see Zeng and Chen, 2003).

		Player 1		
		Cooperate	Defect	Withdraw
Player 2	Cooperate	R = 1 R = 1	S = -2 T = 2	N = 0 N = 0
	Defect	T = 2 S = -2	P = -1 P = -1	N = 0 N = 0
Withdraw		N = 0 N = 0	N = 0 N = 0	N = 0 N = 0

Figure 2. The payoff matrix of the unlocked prisoner's dilemma.

Moral standards in contractual firm–stakeholder relationships

The premises of convergent stakeholder theory establish a straightforward condition that a moral and practically feasible theory should always have an explicit normative foundation that defines the basis for the organizational behavior and its acceptable outcomes. The quality of the normative foundation is not predefined with regard to any broader moral view. As a clear restriction, however, it should not function against the viability of the firm (Jones and Wicks, 1999). A stakeholder theory suggesting anything else would be anti-business. Yet, managers cannot choose to be ethical only when it would seem to be profitable, since then the moral path would only represent a device and not an end. Indeed, it would be impossible to morally defend business activity based on a normative foundation that enables the firm to freely choose whether to be moral or not in order to maximize profits. This does not mean that managers should pay equal attention to all stakeholders all the time. It only urges that different ethical rules cannot be used with different stakeholders.

Scanlon's contractualism

In order to construct such a satisfactory normative foundation, that considers the relationship from both

the firm's and the stakeholders' perspectives, morality can be perceived as the standard of right and wrong in our dealings with other persons. Scanlon's (1998) contractualist moral theory of the right and wrong in human relations provides us with a plausible approach, though probably not the only one, for considering the moral standards of behavior in established firm–stakeholder relationships. The leading thesis of Scanlon's theory is concerned with what we can justify to other people on the basis of what we might expect them to accept under certain conditions, or as he describes:

“Judgments of right and wrong ... are judgments about what would be permitted by principle that could not reasonably be rejected, by people who were moved to find principles for the general regulation of behavior that others, similarly motivated, could not reasonably reject” (1998, p. 4).

Scanlon distinguishes his view from other contractualist accounts (i.e., how moral ideas can be explicated using the device of an agreement) by its notion of the motivational basis of the agreement (cf. Gauthier, 1986; Rawls, 1971). Using the terms of stakeholder management, both firms and stakeholders “whose agreement is in question are assumed not merely to be seeking some kind of advantage but also to be moved by the aim of finding principles that others, similarly motivated, could not reasonably reject” (Scanlon, 1998, p. 5). Therefore, an action in an established firm–stakeholder

relationship is wrong if the principle that permitted it would be one that someone could reasonably reject. The search for conditions of mutual justification using the idea of reasonable rejection will then itself lead us to the right standards of behavior.

According to Scanlon, “Principles are general conclusions about the status of various kinds of reasons for action ... they may rule out some actions by ruling out the reasons on which they would be based, but they also leave wide room for interpretation and judgment” (1998, p. 199). Thus, principles are not simple rules that can be applied without appeals to judgment. Whether a principle could reasonably be rejected depends on a comparison of the reasons that can be proposed against it with those that can be proposed in its favor from the viewpoints of the people occupying various positions in a situation of the kind to which the principle relates. The reasonable grounds for rejecting a principle thus come from the viewpoints of distinct individuals rather than any impersonal perspective. Moreover, what is reasonable and, accordingly, reasonable to reject, always depends on the context, the range of relevant reasons in this context, and how their weights have been specified. However, since we cannot precisely know which individuals will occupy these positions, our assessment of reasonable rejection cannot be based on particular characteristics of actual individuals. Instead, we have to rely on “generic reasons,” that is, general information about reasons that people would have when being in such positions.

Although this short description, certainly, does not do full justice to Scanlon’s intricate argumentation, it still provides an explicit basis for considering what it is required for moral firm–stakeholder relationships in the iterated PD setting with an option to exit. Examining the morality of behavior in such a clearly specified context may undervalue the complexity of firm–stakeholder relationships as well as the possibilities of Scanlon’s theory. However, as a counterbalance, it provides explicit boundaries for the notion of reasonableness and, as a result, the parsimony needed in theorization (Bacharach, 1989). Moreover, the PD captures important aspects of morality as they are commonly understood (Gauthier, 1986; Vanberg and Congleton, 1992). Scanlon did not construct his theory directly to be applied in the context of business organizations, but this is equally true in

the case of Kant, Rawls, and other moral theorists, whose works form the foundation of the modern business ethics literature. Although Scanlon’s theory is seen as the most powerful version of contractualism (Ashford, 2003), it also has its inherent weaknesses (for further discussion see Wallace, 2002) in the same way as have other moral theories. As a result, by noticing its limitations and restrictions, the application and modification of Scanlon’s theory in the established firm–stakeholder interactions provides a welcome advancement in the business ethics literature.

Moral behavior in the unlocked iterated PD setting

Building of Scanlon’s core thought, the main or only aim in the established firm–stakeholder relationships should not be the goal-oriented and rational maximization of total benefit, rather each action in the relationships should also be such that it would not be rejected by others and, in particular, by the counterpart in the relationship. As a result, in terms of the unlocked iterated PD, defective behavior (i.e., behavior that violates the agreement at the expense of the other participant; e.g., breaking a promise) can reasonably be rejected by any of the participants in these relationships. Although it might be rational for the other party, in terms of short-term profit maximization, defective behavior intentionally weakens the position of the other party, and is always unjustifiable from the viewpoint of discrete individuals in contractual relationships. In short, actions in contractual firm–stakeholder relationships that embody the principle of defection are morally wrong.

In reality, however, behavior based on the principle of defection, though morally unjustified, is common in contractual relationships. What, then, would be a reasonable reaction against action that is motivated by defection? Although a cooperative action in the unlocked iterated PD setting is the only reasonable response to another cooperative action, it cannot be justified as a response to defection. In fact, if such behavior were followed, besides diminishing the benefit, it would also reinforce the behavior motivated by the principle of defection and therefore be just as morally wrong. Thus, cooperation may take either the form of right or wrong, depending on the action that motivates it.

Defective action as a retribution against other defective action cannot be justified to others in an unlocked PD setting. First, it is based on a reason that supports further defective behavior, which may even lead to the spiral of retaliations. Second, it produces a payoff that is not optimal in the situation. As a result, the only principle that could not be reasonably rejected as a response to defective action is withdrawal from the relationship – to use the option to exit.

The option to exit, however, also has a two-fold nature in contractual relationship. Namely, from the cooperator's point of view, withdrawal embodies the principle of defection and can be reasonably rejected because the cooperator has not given any reason for the other to leave the relationship. Moreover, it will prevent the cooperator receiving the payoff it is seeking. Altogether, the following normative propositions consolidate the above arguments about the established, contractual, firm–stakeholder relationships with an explicitly moral basis.

Proposition 1. In moral firm–stakeholder relationships in the unlocked iterated PD setting all actions that are based on or provide support for the principle of defection should be ruled out.

Proposition 2. The morality of cooperation and opting out responses in the unlocked iterated PD setting can be defined only through the action motivating the response and the subsequent actions that logically should be motivated by the response.

Viability of the moral relationships

As discussed earlier, a normative foundation for behavior should not function against the viability of the firm. The question arises then as to how the moral standards outlined above, which explicitly limit the possible choices in the established firm–stakeholder relationship, might lead to and provide support for the behavior that would also be feasible. Proving that a moral behavioral pattern would be viable involves showing that in comparison with alternative behavioral patterns, whether they are moral or not, it is more than or at least as successful as any other (Vanberg and Congleton, 1992).

The main question examined by Axelrod (1984) concerned determining which types of strategies are the most successful (i.e., winning) in the iterated PD situation. In order to resolve this question, a two-round computer tournament was arranged. The result was that, in both rounds, the winner had the simplest strategy: tit-for-tat (TFT). The TFT strategy simply opens each interaction with a cooperative move and then mirrors the other player's last move by cooperating with cooperators and defecting with defectors. Players following the TFT strategy are never the first to defect. However, as its trademark, the strategy follows the rule of “an eye for an eye” by immediately reciprocating a defect with another corresponding defect (Kollock, 1993). It can be interpreted that being clear in its aims, it discourages the other side from defecting (Au and Komorita, 2002), though it is more likely that the TFT encourages conflict spirals (Brett et al., 1998). Nevertheless, by including the principle of defection in the repertoire of choices, the TFT directly contradicts the above-described moral basis. Thus, it cannot form an acceptable behavioral foundation for established firm–stakeholder relationships.

The exclusion of the TFT strategy does not mean that we also abandon the possibility of behaving in a feasible manner. On the contrary, Axelrod's results of the TFT's superiority in the iterated PD setting have been called into question by several researchers (e.g., Bendor and Swistak, 1997; Kollock, 1993; Lomborg, 1996; Macy, 1995) and when the option to exit is included, other strategies are found to systematically outperform it (Boone and Macy, 1999; Congleton and Vanberg, 2001; Hayashi and Yamagishi, 1998; Schuessler, 1989; Vanberg and Congleton, 1992; Yamagishi and Hayashi, 1996).

In the spirit of Axelrod's computer tournaments, Vanberg and Congleton (1992) showed in their computer simulation that in the iterated PD game with the exit option, a strategy called a prudent moral strategy is highly viable. It never defects, but uses the option to exit in response to an opponent's defection. The results from the series of tournaments demonstrate how the prudent moral strategy out-scores among others TFT and opportunistic, always defect, strategies when there are moderately numerous pairings with other players. Thus, it has been proposed as a behavioral pattern that is reasonable also in terms of profitability. A computer

simulation of Schuessler (1989) produced similar results. A strategy called conditional cooperation (CONCO) that starts by cooperative action, never defects, and quits interaction at once if the other defects performed particularly well.

The third PD computer tournament with an option to exit organized by Hayashi (1993; see also Hayashi and Yamagishi, 1998) also demonstrated the effectiveness of a similar strategy as described above. The most viable strategy in the tournament, called out-for-tat (OFT), follows a parallel behavioral pattern as that in the prudent moral and the CONCO strategies but offers an additional element of forgiveness by allowing the defected player to return to the group of potential players after three periods of interactions. Again, this strategy outperformed other strategies including the TFT strategy.

In sum, in each of the experimental studies conducted in the iterated PD setting with the option to exit, the most viable strategy fulfilled the standards of moral behavior defined in the normative foundation. In each case, the possibility of defection is completely ruled out and withdrawing is only used as a response to defection. Although the results of the computer simulations cannot provide a universal verification of strategies that will be most viable in certain situations, they strongly support the idea that the suggested moral standards for established, contractual, firm–stakeholder relationships can form the basis for viable business activity. Thus, the proposed strategic rule for firm–stakeholder interaction can be presented as follows:

Proposition 3. The behavior in contractual firm–stakeholder relationships in the unlocked iterated PD setting is moral and viable when it is based on a strategic rule that disallows defections and uses the option to exit in response to the other participant's defection.

Solutions supporting the viability of moral relationships

Although morality and viability could be combined following the above strategic rule, the realization of such a behavioral standard in actual firm–stakeholder relationships is more complicated. Short-term incentives for defection and a limited knowledge of the relationship's nature, among other things, may

still encourage behavior that can be considered unethical and, at least in the long run, unviable. Thus, both a firm and stakeholders should intentionally support the development and maintenance of moral and viable relationships that rely on the strategic rule and will, therefore, be realized in the form of mutual cooperation.

The extensive body of experimental and empirical research, particularly in social psychology, but also in economics, management, sociology, and the political sciences has examined possible solutions to social dilemmas and, accordingly, how to promote mutual cooperative behavior (for a review see Dawes, 1980; Komorita and Parks, 1996; Kopelman et al., 2002; Messick and Brewer, 1983; Pruitt and Kimmel, 1977). Following a classification presented by Kollock (1998), the solutions can be divided into three broad categories according to whether the solution is sought through the strategies of the actors, by affecting the structural parameters of the situation, or by affecting the motivation of the actors.

Research focused on the iterated PD setting has primarily concentrated on strategies and actions that players should choose in order to succeed in the game (e.g., Axelrod, 1984; Baker and Rachlin, 2002; Bendor et al., 1991; Vanberg and Congleton, 1992). This article has shown how the strategic rule provides a morally defensible solution to this question. Therefore, the supporting constructs are selected from the structural and motivational solutions.

Four conditions are applied in order to identify the solutions that can be used to support the development and maintaining of moral and viable relationships. First, the suggested supportive constructs should not work against the normative foundation so that someone could reasonably reject them. Thus, they should have direct implications for reasonable cooperative behavior. Second, the solutions should be directly applicable in two-person dilemmas. Solutions suggested exclusively for N-person dilemmas or solutions that change the payoff rankings are not considered. Third, while the solutions should be conceptually distinct from one another, they should not be contradictory. Finally, each solution should have sufficient theoretical and empirical support in the literature. These tests focused the discussion to the influence of payoff structure and sanctioning systems under the category of structural solutions and the influence of

communication, identification, and long-term orientation under the category of motivational solutions. The causal relationships suggested are intrinsically probabilistic. Accordingly, the activation of a proposed solution makes the suggested outcome more likely.

Structural solutions

Payoff structure

The basic requirement for the development of mutual cooperation necessitates that the payoff of cooperation for both participants in the relationship is greater than zero and higher than it would be in mutual defection. This is not, however, always a sufficient condition for ensuring cooperation. As a result, an extensive body of literature has focused on examining how changes in the payoff structure affect the level of mutual cooperation (e.g., Cable and Shane, 1997; Komorita, 1976; Komorita et al., 1980; Parkhe, 1993; Zeng and Chen, 2003). Uniformly, it is suggested that the greater the profits from cooperation and the lower the profits from defecting, the higher the levels of cooperation. It is also argued that cooperation rates increase as the profits to others from one's cooperation increase (Kollock, 1998; Komorita et al., 1980) and that even a relatively small change in the payoffs may often be enough to make the cooperative relationship more stable (Axelrod, 1984).

Both the firm and the stakeholder can make mutual cooperation more attractive by explicitly changing the payoff structure. A creditor, for example, can offer better interest rates, and the firm can concentrate more on loans to the creditor. Likewise, the firm can offer better compensation for employees, or the employees can educate themselves for more demanding assignments. In terms of morality, neither a firm nor its stakeholders can reasonably reject a change that is based on a morally acceptable foundation and does not reduce the benefit gained from the relationship. Therefore, intentionally enlarging the difference between the payoffs from mutual cooperation and the payoffs from defection clearly supports the development of moral and viable behavior. Altogether, in a testable form:

Proposition 4. The higher the payoff from mutual cooperation and the lower the payoff from mutual defecting, the more likely that the behavior in the firm–stakeholder relationship will be moral and viable.

Sanctioning system

Several researchers have found strong support for the view that sanctioning and monitoring have both direct and indirect effects on behavior in social dilemma situations. However, the results are conflicting in terms of whether a sanctioning system promotes or decreases cooperation. For example, the findings of Yamagishi (1986, 1988) as well as McCusker and Carnevale (1995) suggest that sanctioning systems produce greater cooperation, whereas Tenbrunsel and Messick (1999) found that in some situations sanctioning and monitoring systems could actually considerably reduce the possibility of mutual cooperation.

The research of Tenbrunsel and Messick (1999) indicates that whether a sanctioning system produces mutual cooperation or increases the probability of defection depends, first of all, on the decision frame that is adopted and, second, on the strength of the sanctioning system. Their findings from an environmental dilemma situation show that the presence of a sanctioning system changed the participants' perception of the situation, thus promoting the adoption of "business frame" (i.e., their mindset), whereas in the absence of sanctions so called "ethical frame" was more likely to be adopted as a prevailing mindset and the dilemma understood in ethical terms.

When the business frame was evoked, the researchers found that the strength of sanctions (fines) had a considerable effect on cooperation. The presence of strong sanctions induced cooperation, but when a sanctioning system was weak, participants were more likely to defect. Conversely, when an ethical frame was evoked, the researchers found that cooperation became the prevailing choice, independent of the strength of the sanctions. Accordingly, in the situation without sanctions, participants cooperated because it was morally right, though when strong sanctions were present, a business frame was perceived, and

cooperation was chosen because it was egoistically rational to do so.

Other researchers have found similar results vis-à-vis the effects of how people act in response to differently framed situations. For example, Pillutla and Chen (1999) found that people cooperated less in social dilemmas when the situation was perceived as economic than when it was perceived as non-economic, whereas Batson and Moran (1999) noted that participants cooperated more in a PD when it was framed as a social exchange than when it was framed as a business transaction. Malhotra and Murnighan (2002), in turn, showed that binding contracts led participants to cooperate due to the constraints imposed, whereas non-binding contracts, although producing a smaller initial increase in cooperation, led to an immediate rise in mutual trust and cooperation because of the participants' own free will to cooperate. In fact, parties with a history of binding contracts trusted each other less than did those who had never met.

The effects of a sanctioning system have direct implications for the development and maintenance of moral and viable firm-stakeholder relationships. The existence of a sanctioning and monitoring system, as such, is not morally wrong as long as it is not used against the normative standards. However, in firm-stakeholder relationships, it can unintentionally promote unethical behavior by creating an atmosphere of mistrust. For example, Kruglanski (1970) found that a repeatedly monitored employee might interpret the supervisor's surveillance as showing distrust. In the business frame, incentives for the defective behavior also increase if participants in the relationship uncover deficiencies in the monitoring system or find the sanctions to be weak (Cialdini, 1996; Pfeffer, 1994). A sanctioning system could drive the firm-stakeholder relationship into a situation that supports the principle of defection, thereby operating against the normative foundation. Moreover, the costs of maintaining a strong monitoring and sanctioning system can be substantial (Kollock, 1998). Altogether, the above considerations can be presented in a testable form as follows:

Proposition 5. Moral and viable firm-stakeholder relationships will be more likely without a sanctioning system in an ethical frame than with a sanctioning system in a business frame.

Motivational solutions

Since the implementation of structural solutions may be impossible or are considerably expensive (cf. payoffs), motivational solutions are suggested as another or a complementary way to promote moral and viable relationships.

Communication. Findings in past social dilemma and cooperation literature unanimously indicate that improving communication has positive effects on interpersonal as well as interorganizational cooperation (e.g., Braver and Wilson, 1986; Buskens and Weesie, 2000; Dawes et al., 1977; Kerr and Kaufman-Gilliland, 1994; Miller et al., 2002; Valley et al., 2002; van de Kragt et al., 1983). For example, in Majeski and Shanes's (1995) study of the effects of communication on groups' ability to cooperate in the unlocked iterated PD setting, the researchers found that when groups were not able to communicate, they made cooperative choices between 35% and 45% of the time and accomplished mutual cooperative outcomes about only 25% of the time. In the case when groups could communicate, cooperative choices increased to over 70% of the time, and mutual cooperative outcomes were achieved about 70% of the time.

Reciprocated face-to-face communication enables both sides to realize the benefits and payoffs that follow from the mutual cooperative behavior (Valley et al., 1998). A viable relationship between a firm and a supplier, for example, necessitates that the firm already beforehand knows what it can expect from the future in terms of raw materials, prices, or time schedules of deliveries. For instance, as shown by Takeishi (2002), automakers often need deep knowledge sharing with suppliers about the components in order to achieve better results. A clear dialogue with creditors and stockholders regarding future investments, in turn, assures mutual understanding in decision-making. This is especially necessary in order to avoid disagreements about the distribution of possible risks.

Communication as such, however, is not a sufficient solution. Rather, it is seen as a necessary tool or mediator that enables the process ultimately generating the outcomes that may more directly support moral and viable behavior. Thus, advancement of communication can be seen as an essential precondition for the development and maintenance of

moral and viable firm–stakeholder relationships. Therefore, the following proposition is suggested:

Proposition 6. The higher the level of communication in a firm–stakeholder relationship, the more likely the behavior will be moral and viable.

Identification

One possible outcome of a communication process in a firm–stakeholder relationship is mutual identification and identity building. Dutton et al. (1994, p. 242) defined organizational identification as “psychological attachment that occurs when members adopt the defining characteristics of the organization as defining characteristics for themselves.” While most of the research in organizational identification has focused on intraorganizational issues, it has been noted that organizational identity is created by interactions that are both intraorganizational and interorganizational (Gioia, 1998) as well as at individual and collective levels (Scott and Lane, 2000). In fact, Scott and Lane carefully described how organizational identity emerges specifically in iterative interactions between managers and stakeholders. Thus, the identification does not need to be a one-way process but more preferably a result of dyadic interaction between a firm and a stakeholder so that both participants would perceive their common interests as their own.

Research in organization theory and social psychology has indicated several consequences of successful identification, including an increase in cooperation (Kramer and Brewer, 1984), motivation to reach common goals (Brewer and Gardner, 1986), stronger mutual commitment (Foreman and Whetten, 2002), and improved learning (Kogut and Zander, 1996). Recently, for example, by using data from physicians affiliated with three health care systems, Dukerich et al. (2002) found a positive relation between strength of organizational identification and physicians’ cooperative and organizational citizenship behavior. The lack of identification, in turn, may be realized in the form of mistrust and selfish profit maximizing (Scott and Lane, 2000).

Identification and constructing a shared identity provides a clear solution for promoting the development and maintenance of moral and viable firm–

stakeholder relationships. When both a firm and stakeholders share a common understanding of values and goals, they are more likely to trust each other and to learn from each other, thus decreasing the T and, in turn, strengthening the atmosphere of mutual cooperative behavior. Thus, the following proposition is suggested:

Proposition 7. The higher the level of identification in firm–stakeholder relationship, the more likely the behavior will be moral and viable.

Long-term orientation

Axelrod’s (1984) main advice for promoting mutual cooperation is to make interactions more durable by increasing “the shadow of the future.” In the context of a firm–stakeholder relationship, durability means simply that the stakeholder and the firm explicitly know that the relationship will extend long into the future. Therefore, neither the firm nor the stakeholders need worry that the other has a short-term incentive to defect. Indeed, creation of mutual long-term goals is suggested to be a robust solution for increasing cooperative behavior (Insko et al., 1998; Pruitt and Kimmel, 1977; Zeng and Chen, 2003).

Together with repeated interactions, long-term orientation allows parties to better signal consistent cooperation (Heide and Miner, 1992; Parkhe, 1993), to understand the dilemma nature of the relationship, and, accordingly, to develop mutual trust (Hosmer, 1995; Jones and George, 1998) and decrease any prevailing uncertainty (Boyle and Bonacich, 1970; Mayer et al., 1995). For example, employees should be able to negotiate permanent employment contracts with clear conditions, in order that both parties know what they can expect from each other. Moreover, regular face-to-face contacts between employees and management reinforce mutual understanding of values and norms. Owners’ frequent interest in the firm’s performance, in turn, encourages the firm to follow accepted plans and courses of action. Similarly, if a firm states explicitly that it will continue to use the products of a particular supplier in the future, the supplier is more likely to take greater care of the firm’s special demands or even offer special prices (cf. Valenzuela and Villacorta, 1999). At the same time, the supplier

benefits from not needing to constantly suffer from new transaction costs resulting from negotiations with other possible customers (Williamson, 1985). In short, long-term orientation and regular communication provides a way to motivate firms and stakeholders to develop and maintain moral and viable relationships. Therefore, in a testable form:

Proposition 8. Moral and viable firm–stakeholder relationships will be more likely when they are based on a long-term orientation rather than short-term orientation.

Discussion and conclusion

The understanding of the “ought” of moral and viable business practices has become dramatically acute as a result of recent corporate scandals. However, if we cannot find a satisfactory answer to the dilemma how the “ought” could lead to the “can” – that is, what is ethically right to do also implies what is reasonable from the profitability’s point of view – would at worst indicate that morality and viability are deemed to be separate discourses and that practicing managers should again reconsider the question of what they “ought” to do. Fortunately, recent stakeholder research has taken this dilemma seriously suggesting that these elements can and should be connected (Donaldson, 1999; Jones and Wicks, 1999).

Contributions to the theory

This article has contributed this discussion by describing an approach to how we could live in contractual firm–stakeholder relationships in the context of the unlocked iterated PD setting in a way that fulfills clear moral standards without forgetting the economic rationale of the relationships. First of all, grounding on Scanlon’s (1998) contractual moral theory, a normative foundation is offered that perceives actions in firm–stakeholder relationships to be morally wrong when they are based on or provide support for defection and suggests that the morality of cooperation and opting out responses can be defined only in terms of the action motivating these responses. On a

more general level, the normative foundation suggests avoiding actions that could not be justified to others and grounding behavior on principles that others, similarly motivated, could not reasonably reject.

Second, relying on the findings of the experimental studies conducted in an unlocked PD setting, this article has demonstrated how the normative foundation provides a basis for practical behavior when it takes the form of the strategic rule that excludes defection and utilizes the option to exit in response to the other participant’s defection. This suggestion also contributes to the extant theory of stakeholder strategies (Clarkson, 1995; Freeman, 1984; Frooman, 1999; Savage et al., 1991) by showing how ethically defensible stakeholder management that views relationships from both the perspective of the firm and the stakeholder can also provide a reasonable solution in terms of profitability.

Third, drawing from the social dilemma literature, the article has proposed a set of structural and motivational solutions that firms and stakeholders can apply in order to support the strategic rule and in this way the development of moral and viable firm–stakeholder relationships. Although recent research has greatly advanced our understanding of stakeholder relationships by applying different theoretical perspectives, such as network (Rowley, 1997), resource dependence (Frooman, 1999), prospect (Jawahar and McLaughlin, 2001), and agency (Hill and Jones, 1992) theories, none of these contributions, including Jones’s (1995) short discussion of PD, have explicitly and comprehensively considered the firm–stakeholder relationships from the dilemma perspective. Thus, the point of view offered by dilemma literature provides a valuable addition to theory by clarifying the dynamic nature of the contractual relationships between a firm and stakeholders.

In particular, by combining the social dilemma and stakeholder literatures helps us to understand how the different structural and motivational factors affect the firm–stakeholder interaction. For example, the propositions included provide a strong case for how advanced communication between firm and stakeholders functions as a mediator that can enhance the level of identification and promote long-term orientation, thus supporting moral and

practical behaviors. The understanding of the two-fold influence of sanctioning systems, in turn, may in some cases explain the way in which motivational solutions that were supposed to enhance mutual cooperation actually encouraged defection or, in a more optimistic case, will lead the relationship directly to the ethical frame. In all, by combining different literature streams the article opens new perspectives to a deeper understanding of firm–stakeholder relationships.

Regarding the recent discussion of contractarian business ethics and stakeholder management (Heugens and van Oosterhout, 2002; Heugens et al., 2004), these contributions add to the earlier research in particular by explicating how the behavior in established firm–stakeholder relationships (i.e., contractual relationships that fulfill the boundary conditions: autonomy, alignability, and ability) should be conducted. As a result, contractualism, as a fairly generic normative theory of ethics, is adapted to solve a concrete problem. Moreover, the supportive solutions concerning moral and viable firm–stakeholder interaction provide propositions how contractarian business ethics can be operationalized to real-life situations.

While the conclusions provided here are bounded to contractual relationships and the unlocked iterated PD setting, they seem to be fairly robust also over different normative claims and contextual settings. For example, from the perspective of virtue ethics (e.g., MacIntyre, 1985; Williams, 1985), where virtues are seen as traits, or dispositions to act in a certain manner, accepted as ethical in one's society, the suggested propositions can be considered as virtues of behavior in firm–stakeholder relationships. Of course, there are also other broadly accepted virtues, but the solutions suggested here can be used to supplement these. Most importantly, it is difficult to imagine a generally accepted virtue for behavior that would directly contradict the propositions. In the same way, if we consider other situations that do not involve PD setting, especially the propositions related to the supportive constructs seem to be relevant with the purpose of promoting moral and viable interaction between firms and stakeholders. Altogether, these are questions that in order to be fully resolved need to be submitted to further study.

Limitations and directions for future research

Regardless of the theoretical insights, there are some limitations that need to be addressed here. First, the abstract context of the unlocked iterated PD makes assumptions that simplify the contractual firm–stakeholder relationships. While these simplifications are necessary in order to capture the essence of the phenomenon (see Folger and Turillo, 1999), they also produce to some restrictions. Specifically, it is assumed that the members in dilemma have fully symmetric positions with identical possibilities regarding the choices and payoffs. However, in real-life situations the positions of the members can be asymmetric (see Wade-Benzoni et al., 1996), although they do have the same choices. The asymmetry problem, however, does not constrain the validity of the normative foundation and the strategic rule because their authority comes from the viewpoints of distinct individuals rather than any impersonal perspective.

Another open question is the quality and amount of forgiveness. Hayashi (1993) found that a version of OFT strategy that brought the defected player back into the group of potential players after three periods of interactions produced viable results. In the real world, however, constructing a moral and workable relationship is difficult if the members have a history of defective behavior. Nevertheless, researchers have also found that restoring mutual cooperation is not impossible (Bottom et al., 2002).

Regarding directions for future research three challenges are suggested. First, the normative element of the theory is not, obviously, dependent on empirical observations. However, the propositions concerning the supportive solutions need to be tested empirically and their validity in other settings than PD should be more carefully considered. One could also examine whether each of the supporting solutions is sufficient in enhancing moral and practical relationships, or whether the outcome is rather a consequence of a combination of necessary causes that together form a sufficient condition for moral and viable relationships (see, e.g., Ragin, 1987).

As a second challenge, in addition to simulations and experiments, longitudinal studies are especially needed to systematically investigate the development and different stages in contractual firm–stakeholder

relationships. This calls for the use of both quantitative and qualitative strategies. The time period for an accurate longitudinal study would extend over several years. Thus, research may need to exploit historical analyses and long-term field studies.

The third challenge for future research is to determine the boundary conditions of the propositions by examining how different contextual factors and environmental impulses can influence the development and maintenance of moral and viable firm-stakeholder relationships. For example, an interesting question is to examine how a financial crisis situation in a firm may affect its different stakeholder relationships, as well as the use of possible supporting solutions to promote mutual cooperation. Another research avenue would be to consider the network effects. Since stakeholders may have close connections to other stakeholders it is important to understand how inter-stakeholder relationships and stakeholder networks influence the development and maintenance of moral and viable relationships. On the whole, the conclusions of this article suggest that the contractarian framework provides an applicable basis for considering these important issues in the areas of business ethics in general and firm-stakeholder relationships in particular.

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*Department of Management Studies,
University of Tampere,
FI-33104M,
Tampere,
Finland
E-mail: kalle.pajunen@tut.fi*