

Corporate Culture as a Resource for Management

Comment

by

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1 Introduction

According to Donald C. LANGEVOORT [2006, p. 83], corporate culture is a means of communication and coordination in organizations that, as such, reduces uncertainties, resolves ambiguities, and can offset agency costs. We agree. We are finding it particularly helpful how Langevoort adapts the sociological term *sense making* to rational-choice analysis, by reading corporate culture as a device (a) to coordinate the perceptions of individual organization members when collective action is required, (b) to avoid uncertainty and ambiguity caused by not knowing the reactions of other organization members, and (c) to induce aligned motivations and emotions as often expressed by organizational/corporate identity or firm loyalty.

This clearly sheds some light into the “black box” of corporate culture. But is there empirical evidence for what this “black box” is claimed to contain? In this comment, we cull some of the evidence from the literature. And we offer a formal model for an element central to Langevoort’s analysis: the risk of management crowding out beneficial corporate culture by engaging in explicit monitoring.

2 Some Empirical Evidence

Support for the corporate-culture hypothesis seems to be provided by experiments employing a *minimal-group paradigm* (see, for instance, TAJFEL [1970], and the discussion by GÜTH, LEVATI, AND PLONER [2005]). Rather artificial ways of separating one group of participants from another suffice to induce in-group favoritism and out-group discrimination. The emotional and cognitive links and ties of corporate culture are, of course, much stronger than those purely due to labels. Due to such bonding, other organization members will usually do what serves the agreed-upon task of the corporation. This avoids the need of coordinating behavior to some extent, and can render formal rules unnecessary.

When considering “corporate identity” of firms one is, of course, confronted with the agency problem. Although principal–agent theory (see, for instance, HOLMSTROM AND TIROLE [1989]) predicts shirking without incentive pay, many German

professors prove the contrary (though there are, of course, opportunists). Actually, principal–agent experiments show that trust of principals (by paying high salaries) and reciprocity of agents (by working rather than shirking) can be as efficient as or even more efficient than incentive schemes. This, however, may change with experience (see GÜTH *et al.* [1998]).

More importantly, principal–agent theory suffers from a serious shortcoming in neglecting hiring competition. Assume that the shareholder is the principal and the chief executive officer (CEO) his agent. Incentive contracts would imply a significant positive correlation of firm performance and CEO earnings. Following JENSEN AND MURPHY [1990], there is a large econometric literature on this subject, which usually finds zero correlation of firm performance and managerial remuneration. In an experiment involving hiring competition among firms, firm loyalty was found to be surprisingly low. In only 22 of altogether 346 cases where a higher wage was offered by another employer did the employees stay with their former employer, in spite of the firm specificity of human capital and labor (BERNINGHAUS, GONZÁLEZ, AND GÜTH [2004]).

The author claims that in a firm facing severe competition, even bankruptcy, “the group has a strong incentive toward cohesion in order to survive” (LANGEVOORT [2006, p. 85]. Actually, it was once the usual belief (see, for instance, BEWLEY [1995], [1997]) that one cannot reduce wages in ongoing employment relationships. But nowadays, when there is a threat of bankruptcy, employees, partly via their (trade union) representatives, accept substantial wage cuts and the loss of other benefits.

What we conclude from this rather cursory and eclectic review of evidence for the corporate-culture hypothesis is that (1) there are strong and reliable indicators of corporate-culture effects but (2) these effects are fragile in the sense of being highly situation-sensitive, especially when the organization is seriously endangered.

Another research strategy could be not to discuss corporate culture in isolation, but rather to investigate corporate culture as it interacts with formal institutions, be they monetary incentives or the formal legal structure of the firm. Put differently, we would not expect formal and informal intrafirm institutions to be independent of each other. Rather their relationship might be one of complementarity, of substitution, or of conflict. *Efficiency wages*, *i.e.*, paying employees above-market prices, would be an instance of complementarity. The additional monetary incentive also serves as a tool for strengthening firm identity and for building stronger emotional ties with the firm. Substitution effects are not infrequent between elements of the formal and the informal governance structure of the firm. While most firms nowadays rely on a formal works council for representing worker interests, in some firms the workforce eschews the formal right to set up a council, and instead relies on informal interaction with management or the owners of the firm. Finally, formal interventions may crowd out a preexisting corporate culture. If workers must sign in and sign out at the factory entrance, they usually are much less inclined to work overtime if necessary. This latter effect is explicitly mentioned in Langevoort’s paper.

3 Modeling the Risk of Crowding Out Beneficial Corporate Culture

Since the risk of crowding out seems crucial to Donald Langevoort's analysis, we want to elaborate on it formally. At t_0 , nature N selects workers of two types. Type S seizes any opportunity for maximizing utility in the short run. Type L is more long-term-oriented. Such workers resist the temptation to act opportunistically if loyalty is beneficial for them in the long run. N 's move cannot be observed by management. At t_1 management decides whether to monitor workers. At t_2 workers decide whether to exercise effort. For simplicity, it is assumed that their (binary) choice is between the contracted and no effort, the latter yielding zero gross profit. At t_3 payoffs are paid out to management and the workers respectively.

Payoffs are as follows: If workers exercise effort, management receives gross profit Π . Out of this, management must pay wage W . If management engages in monitoring, its payoff is reduced by an additional cost parameter M . Workers receive gross income W when they are not monitored or monitored and working, and receive 0 otherwise. From this, disutility E is deducted if they exercise effort. An additional disutility A is deducted for the annoyance of being unduly monitored if they are of type L .

If management knew that a worker was of type L , the only equilibrium outcome would be no monitoring and exercising effort. If management knew that a worker was of type S , however, the only equilibrium outcome would be monitoring and exercising effort only if monitored. When not knowing the worker's type, one must specify the probability p of nature selecting workers of type L , and the corresponding probability $1 - p$ of type S being selected, which we assume to be commonly known. We must further distinguish according to the size of A . Provided $W - E - A > 0$, workers exercise effort in all cases and management expects $\Pi - W - M$ if it monitors. If management does not monitor, it expects $p\Pi - W$. Accordingly, in this set of cases, the equilibrium play is monitoring and effort if $\Pi - M > p\Pi$, *i.e.*, $(1 - p)\Pi > M$. Otherwise, the equilibrium outcome is no monitoring, and (no) effort by workers of type $L(S)$. If $W - E - A < 0 < W - E$, workers of type L do not exercise effort if monitored. Management's problem then shifts to comparing the following payoffs: if it monitors, it expects $(1 - p)\Pi - W - M$. If it does not monitor, it expects $p\Pi - W$. Consequently, management monitors if $(1 - p)\Pi - W - M > p\Pi - W$, or $(1 - 2p)\Pi > M$.

What are the implications for the crowding-out problem presented by Langevoort? If loyal workers are only weakly annoyed by being monitored, the two factors driving the decision to monitor are the cost of monitoring, and the profit increase $(1 - p)\Pi$ by inducing S -types to work. If monitoring is cheap, the share of loyal workers must be very high for management to forgo the opportunity of monitoring. If annoyance is strong, however, management also faces the opportunity cost that loyal workers no longer exercise effort. Empirically, this is not outlandish. For in reality, workers will not choose between full and no effort, but between high and low effort. The risk that loyal workers will react to monitoring by "internal emigration" is not unheard of. In reality, management's problem will typically be even more demanding. For

management will not know the percentage of loyal workers with certainty. It will therefore have to rely on its subjective probability p , and hence run the risk of taking an objectively inappropriate monitoring decision.

This has, of course, been an exercise in partial analysis. While workers have been allowed to deviate from short-term maximization, management has been assumed to be a strict (short-term) utility maximizer. Moreover, the share of a type of workers does not respond to management action; only their choices do. In reality, it is possible that worker loyalty hinges upon the perception that management is not a short-term maximizer either. Yet even in such an environment, it seems plausible that management considers whether a strategy of loyalty (*i.e.*, no monitoring) would pay. It would, if no monitoring and effort by loyal workers is an equilibrium in our game for parameters that are empirically plausible.

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