JOURNAL OF SMALL BUSINESS STRATEGY

# STAKEHOLDER THEORY AND THE ENTREPRENEURIAL FIRM

Ronald K. Mitchell
Texas Tech University
rmitchell@ba.ttu.edu

Boyd Cohen
University of Victoria
bcohen@business.uvic.ca

## ABSTRACT

*This paper offers a typology of a stakeholder theory of the entrepreneurial firm, such that a new lens for entrepreneurial management emerges. We (1) generated a list of purported "theories of the firm" from the literature; (2) applied qualifying criteria; (3) analyzed the list according to two dimensions—stakeholder inclusion and stakeholder equilibration strength—to categorize these theories of the firm into a typology revealing gaps in the theory-of-the-firm literature; and (4) identified research questions for a stakeholder theory of the entrepreneurial firm that raises entrepreneurial management issues.*

## INTRODUCTION

The purpose of this paper is to offer a typology that suggests the need for and situates a stakeholder theory of the entrepreneurial firm such that a new lens for entrepreneurial management emerges. This task is necessary because there is reason to suppose that: (1) the distinctive nature of the entrepreneurial firm (Venkataraman, 1997) is directly impacted by stakeholder relationships (Mitchell, 2002a; Stinchcombe, 1965); (2) the contribution of stakeholders to firm value is connected to the entrepreneurial process (Venkataraman, 2002); (3) the individual-directed nature of early-stage companies makes entrepreneurs particularly likely to create more broadly inclusive stakeholder-based firms instead of more narrowly inclusive stockholder-based firms;and (4) the tendency of new firms, through a higher propensity to contain disruptive technologies (Christensen, 1997), will be to mobilize stakeholders that enact revolutionary verses evolutionary change.

We proceed to accomplish our objectives in the following manner. First, we briefly present the theoretical background that gives rise to the opportunity for the introduction of a stakeholder theory of the entrepreneurial firm. Second, we identify a representative set of theories of the firm that emerges from our review of the literature. Third, we further examine two key dimensions that we suggest will distinguish a stakeholder theory of the entrepreneurial firm: extent of stakeholder inclusion (from broad to narrow); and level of stakeholder equilibration strength (from weak to strong). Fourth, we review the various implicit and explicit positions of each theory according to both dimensions and the extent of stakeholder inclusion and stakeholder equilibration strength, situating these theories in a typology implied by these two constructs. Finally, we set forth some of the research questions and evaluate the ever-present "so what" question.

## BACKGROUND

For the past several years, the distinctive domain of entrepreneurship research has increasingly centered on investigation of the question: "How, in the absence of current markets for future goods and service, (do) these goods and services manage to come into existence?" (Venkataraman, 1997, p.120). An entrepreneurial theory of the firm is, therefore, expected to explain how the entrepreneur, as an individual, recognizes opportunity in an uncertain environment and, by persuading relevant stakeholders to supply their resources, creates a firm to exploit such opportunity (Dew, Velamuri, & Venkataraman, 2003, p.1). It follows that the success of new firms in overcoming their liability of newness is strongly associated with the extent and quality of stakeholder relationships (Stinchcombe, 1965). Recognition of the importance of variations in extent of stakeholder inclusion suggests "recasting the central purpose of the firm as serving the interest of stockholders to one where it serves the stakeholders" (Venkataraman, 2002, p.54). According to this argument variations in the extent of inclusion (narrowness verses breadth) of stakeholder relationships are therefore likely to be of interest in the suggestion and situation of a stakeholder theory of the entrepreneurial firm.

Furthermore, gathering and aligning the contributions of all stakeholders to increase overall firm value (Venkataraman, 2002, p.51; Vesper, 1996, p.4) is a critical part of the entrepreneurial process. As distinct from mainstream conceptions of the perfectly competitive "market process," the term "entrepreneurial process" has come to be deliberately used by theory-of-the-firm scholars to denote a transacting process that: (1) is at best tending toward equilibrium, but never really in equilibrium; (2) is populated by economic actors who make errors, are sometimes ignorant, sometimes ignorant about their ignorance, sometimes brilliant but mostly prosaic, sometimes knowingly deceitful but mostly well-intentioned, and boundedly rational; (3) has scope for genuine discovery, genuine disappointment, or pleasant surprise; and (4) exists in stark contrast to the neoclassical conception of transacting among instantaneously optimizing actors who are exceptionally well-informed, never commit an error, and, thereby, operate in instantly clearing markets (Venkataraman, 2002, p.55).

This entrepreneurial process is well-characterized by Schumpeterian notions of creative destruction (Schumpeter, 1934) that is accomplished by the forces of both weak equilibration, and strong equilibration. Weak equilibration forces are those that result in a more evolutionary - or incremental - process of developing new goods and services (akin to "rebuilding a stakeholder ship plank by plank while it still remains afloat"), while strong equilibration forces of "stakeholder innovation" result in the more revolutionary processes of creative destruction (sinking "the unfair and inefficient corporate ship while evacuating all stakeholders to the safety of a new vessel that is better than the old") (Venkataraman, 2002, p.54). According to this logic, variations in the strength of stakeholder equilibration are also likely to be useful in the suggestion and situation of a stakeholder theory of the entrepreneurial firm.

Finally, by the very act of creating a firm, entrepreneurs occupy the unique position of being most at liberty to shape stakeholder relationships, with respect to both stakeholder inclusion and stakeholder equilibration strength. The latitude to create a firm is essential to the entrepreneur "because it is through the firm that the opportunity-pursuing entrepreneur can coalesce and keep the myriad stakeholders together" (Venkataraman, 2002, p.55). Thus, it is at firm inception that entrepreneurs identify their stakeholders and assess the relative salience of each (Agle, Mitchell, & Sonnenfeld, 1999; Mitchell, Agle, & Wood, 1997), because successful founding is dependent upon stakeholder support (Stinchcombe, 1965). Furthermore, it is at or near inception that start-up firms are less bound by the institutional constraints of the financing and the regulatory establishment (for example, venture capitalist growth norms or security regulations) or by technological constraints (such as a dependence on existing technologies). Additionally, because near the time of startup entrepreneurs and their firms are inextricably linked, it appears likely to be more difficult for them to avoid the impacts of their firm on their stakeholders and, therefore, to be more likely to take stakeholder relationships into full account during the process of firm formation. Thus, it is not surprising that entrepreneurs have, for example, been found to be significantly less likely than managers to sacrifice personal ethics to attain business objectives (Bucar & Hisrich, 2001) or to be more likely to take stakeholders into account to overcome liabilities of newness (Stinchcombe, 1965). It might, therefore, be expected that due to: (1) the centrality of stakeholder relationships in entrepreneurial firms; (2) the unique contribution to value creation of stakeholder equilibration in the entrepreneurial process; and (3) the distinctive position of the entrepreneurial firm in the organizing life cycle, that the suggestion of a stakeholder theory of the entrepreneurial firm and its situation within the theory-of-the-firm literature, is warranted.

## REPRESENTATIVE THEORIES OF THE FIRM

The literature presently lacks a systematic summary of representative theories of the firm. A more comprehensive analysis would: (1) sift out from the many articles using theory-of-the-firm language, those that actually present a theory of the firm that contains a threshold level of specification; (2) identify relative strength among representative theories; (3) facilitate comparison and contrast; and (4) identify gaps wherein the literature might further develop. Management and entrepreneurship research has utilized theories from decision sciences, economics, management, sociology, and psychology (Amit, Glosten, & Muller, 1993). This broad range of theoretical foundations has enabled management and entrepreneurship researchers to explore management and entrepreneurship questions from many diverse lenses and has resulted in the application of a multitude of theoretical frameworks within management and entrepreneurship research. However, while, perhaps, hundreds of theories have been used in management and entrepreneurship research, relatively few theories are proffered as theories of the firm.

In the task of reliably identifying justifiable theories of the firm, we accept and utilize the logic developed by Dew, Velamuri, & Venkataraman (2003) who suggest three criteria. According to these authors, a theory of the firm must be capable of addressing three central questions: Why do firms exist? What are the determinants of their scale and scope? Why do certain firms persist over time while others do not? Under this logic, theories that do not address all three questions would not be considered to be theories of the firm (Dew, Velamuri, & Venkataraman, 2003, p.4).

Utilizing ABI Inform, we reviewed 255 peer-reviewed articles published between January 1986 and February 2003 that contained "theory-of-the-firm" language. We identified within that group of articles, 27 theories that are presented as "theories of the firm" (Table 1). We then examined each theory to assess the extent to which the theory as presented successfully answers the three central qualifying questions noted above. However, we did not assess the extent to which the proposed theories of the firm have been received or thoroughly tested and developed (Grandstrand, 1998) but only their comportment with the three foregoing criteria. As reported in Table 1 (and (Figure 1) that situates received theories of the firm

### Table 1 – Representative Theories of the Firm (A-Narrow/ Incremental)

| Theory | Purpose of Theory — The purpose of this theory is to: | Reason for Existence (⇒ I v. R) — Firms exist: | Scale & Scope (⇒ B v. N) — Scale & Scope are determined by: | Persistence (⇒ I v. R) — Firms persist because: |
|---|---|---|---|---|
| Agency (Jensen & Meckling, 1976) | Develop a theory of the ownership structure of the firm (Jensen & Meckling, 1976: 305). | As a nexus for contracting relationships, which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals (1976: 311) | The point at which the gross increment in (firm) value is just offset by the incremental loss involved in the consumption of additional fringe benefits due to (managers') declining fractional interest in the firm (1976: 323) | Given strong incentives for individuals to minimize agency costs, given many competing alternatives, and given its shortcomings, the corporate form has survived the market test against potential alternatives (1976: 357). |
| Customer Value (Slater, 1997) | Suggest that firms' customer value should be the focus of business activities and to propose a marketing based view of the theory of the firm (Slater:, 1997: 162) | To satisfy the customer (1997: 164 and Drucker, 1973) | The customer value strategy which dictates the size of the target market and the value proposition (1997: 164) | They possess a customer value-based organizational culture (organized around customer value delivery) complemented with a skill to learn about customers changing needs (1997: 164) |
| Evolutionary (Nelson & Winter, 1982) | Expand our understanding of economic change (Nelson & Winter, 1982) | Because a set of capabilities and decision rules combine and evolve based on the inheritance of acquired characteristics and the timely appearance of variation under the stimulus of adversity (Nelson & Winter, 1982). | The joint action of search and selection "routines" (Nelson & Winter, 1982) | They are "selected for" within a market environment, through a process of economic natural selection of routines (Nelson & Winter, 1982) |
| Exchange (Boulding, 1950) | Construct a classical type of macroeconomic distribution theory to distinguish between exchange process contributions to wealth creation and the processes of production (Boulding, 1950; Canterbery, 1994, p. 1227) | To both exchange (where existing assets including money are circulated among various owners), and to produce (where assets are created, destroyed, and accumulated) (1994: 1227) | The personal income distribution (PID), where PID as a key determinant of output is effected by potentially volatile financial transfers item (T) (Boulding, 1950; 1994: 1227) | The combination of money flows and production processes provides leveraged financial incentives (Boulding, 1950; 1994: 1227) |
| Industrial Organization (Caves, 1980: 88; Porter, 1980; Porter, 1984) | To explain how competitive forces within an industry shape the specific responses of firms within that industry to the small numbers bargaining power of rivals, suppliers, buyers, imitators, and substitutes (Porter, 1980) | Because they are portfolios of activities (Porter, 1984: 423) composed of the tangible or intangible semi-fixed assets or skills necessary for the conduct of these activities in the marketplace<br>(Caves, 1980: 64). | Market structure: " . . . certain stable attributes of the market that influence the firm's conduct in the marketplace" including size (Caves 1980: 64) | They compete effectively within an industry (Porter, 1980) |

## B-Broad/ Incremental

| Theory | Purpose of Theory — The purpose of this theory is to: | Reason for Existence (⇒ I v. R) — Firms exist: | Scale & Scope (⇒ B v. N) — Scale & Scope are determined by: | Persistence (⇒ I v. R) — Firms persist because: |
|---|---|---|---|---|
| Behavioral (Cyert & March, 1963) | Develop an empirically relevant, process-oriented, theory of economic decision making (Cyert & March, 1963: 3) which predicts firm behavior (1963: 19) | To form coalitions of individuals in order to attain collective objectives (p.28) through decision-making processes (1963: 290) | Temporal or functional coalitions of participants formed to make decisions (1963: 27) | Because they are an adaptively rational system: successful adaptations to firm behavior and resource allocation by coalitions (1963: 99) |
| Game Theory (Kogut & Zander, 1996) | To provide an alternative theory of the firm which accounts for ownership, incentives, and self-interest (Kogut & Zander, 1996: 502). | To reduce the costs of communication and coordination of embedded social knowledge (1996: 503) | Qualitative changes in the reservoir of social knowledge available to economic agents (1996: 503). | Through the recombination of knowledge. Firms evolve through the opportunities and influences of the external environment (1996: 503). |
| Resource dependence (Pfeffer & Salancik, 1978) | Include the role of external control of organizations in organization theory (Pfeffer & Salancik, 1978) | Because bridging and buffering mechanisms around a technological core create organization (Pfeffer & Salancik, 1978: 106, 108; Scott, 1987: 182-198). | The effectiveness of bridging and buffering mechanisms (Scott, 1987) | They effectively manage resource-dependent power relationships (Pfeffer & Salancik, 1978) |
| Stakeholder (Brenner & Cochran, 1991) | Describe how organizations operate and to help predict organizational behavior (Brenner & Cochran, 1991: 452) | To fulfill some set of their various stakeholders' needs (Brenner & Cochran, 1991: 453) | The structuring and choice processes of the firm's management (Brenner & Cochran, 1991: 455) | They effectively manage the stakeholder value matrix of the firm (Brenner & Cochran, 1991: 455, 465) |
| Transaction Cognition (Mitchell, 2001) | Generalize and extend transaction cost economic theory to demonstrate how entrepreneurial cognitions (planning, promise, and competition) create new value at multiple levels of analysis, through the reduction of cross-level transaction costs (Mitchell, 2001) | Because they are bundles of transactions which aggregate because together they minimize transaction costs (2001: 83) | The size of the cumulated value networks that must be assembled to serve stakeholders at minimum transaction cost (2001: 88) | They economize on multi-level transaction costs: Lower-level markets fail (thus firms form per Coase, 1937); and higher-level aggregations (hierarchies) do not yet form (Mitchell, 2001) |
| Transaction Cost Economics (Coase, 1937) | Explain why firms form as an alternative to the market | To economize on transaction costs through substitution at the margin (Coase, 1937; Williamson, 1985) | First-order economizing (Williamson, 1991) | They are relatively more efficient than markets (firms form when markets fail) (Coase, 1937) |

## C-Narrow/ Revolutionary

| Theory | Purpose of Theory — The purpose of this theory is to: | Reason for Existence (⇒ I v. R) — Firms exist: | Scale & Scope (⇒ B v. N) — Scale & Scope are determined by: | Persistence (⇒ I v. R) — Firms persist because: |
|---|---|---|---|---|
| Entrepreneurial (Casson, 1996; Witt, 1998) | Set out a general framework within which all the key questions in the theory of the firm can be brought together at once (Casson, 1996: 55) | To improve coordination by structuring information flow, which requires that it be endowed with legal privileges, including indefinite life (1996: 56) | Factors supporting entrepreneurial insight, e.g., level of information synthesis (to make price and production decisions), necessary sunk costs to permit necessary customization, level of desire to appropriate the value of profit opportunities (Casson, 1996) | Entrepreneurs monitor the environment and effect changes to respond to change as dictated by the environment (Casson, 1996) |
| **D-Broad/ Revolutionary** | | **NONE** | **NONE** | **NONE** |

## Non-Theories of the Firm

| | | | | |
|---|---|---|---|---|
| Competence-based (Hodgeson, 1998) | Set out a general form alternative to contractarian (e.g., Coase) theories of the firm (Hodgeson, 1998: 25). Competence-based theories are an omnibus grouping rather than a specific theory (Hodgeson, 1998) | N/A | N/A | N/A |
| Computational (Barr & Saraceno, 2002) | Present a framework for analyzing the information processing (learning) behavior of firms, where firms are viewed as an artificial neural network (Barr, 2002: 345). | N/A: This theory assumes the existence of firms. | A collection of information processing units (2002: 345). Optimal firm size changes as the environment changes (2002: 346). | Repetition of successful activities and recognition patterns through learning algorithms (2002: 351). |
| Economic Development (Lamoreaux, 1998) | Use business history, in particular the contractual choices made by 19th-century entrepreneurs to organize their businesses, to reflect on the nature of the firm (1998: 66) | To bring together producers and investors in response to incomplete contracts and market power (1998: 70) | The attainment of sustained capabilities (1998: 70) | They provide protection from economic holdup (1998: 70) |

## Non-Theories of the Firm (cont'd)

| **Theory** | **Purpose of Theory — The purpose of this theory is to:** | **Reason for Existence (⇒ I v. R) — Firms exist:** | **Scale & Scope (⇒ B v. N) —Scale & Scope are determined by:** | **Persistence (⇒ I v. R) — Firms persist because:** |
|---|---|---|---|---|
| Knowledge-Based (Kogut & Zander, 1992) | Explain knowledge creation, sharing and transfer within a firm (Kogut & Zander, 1992: 383) | Knowledge-based view does not explain why firms exist in lieu of opportunism or moral hazard (Foss, 1996) | What the firm makes and what it buys (1992: 385) | Combinative capabilities in the creation of difficult to codify and highly complex embedded knowledge (1992: 385-388). |
| Managerial (Bartlett & Ghoshal, 1993) | Describe a "new" organizational form characterized by radical decentralization in the creation of self-contained units and frontline entrepreneurship (Bartlett & Ghoshal, 1993). | N/A: This theory assumes the existence of firms. | The clustering of roles amongst three distinct organizational groups (front-line, middle management, and top management) which work across decentralized units (1993: 41) | They successfully decentralize decision making and renew continuously while establishing stabilizing mechanisms which reduce complexity and guide action (1993: 36) |
| Neoinstitutional (Furubotn, 2001) | To provide an explanation of management decision making where profit maximization is not cost-effective given transaction costs and bounded rationality (Furubotn, 2001: 143) | To attain constrained profit maximization (2001: 151). | N/A: Does not address firm boundaries. | The use of alternative decision making (without knowledge of optimal solutions) to attain profits through efficiency relative to industry competitors (2001: 144). |
| Neoclassical (Smith, 1937) | Justify laissez-faire economics (Lerner, 1937: viii) with respect to firm activity that is motivated by profit seeking and is guided by an invisible hand (Smith, 1937: 423). | Only for the sake of profit that any man employees a capital in the support of industry (Smith, 1937: 423). However, this is a theory of markets in which firms are important actors (Jensen & Meckling, 1976: 306); profit maximization is one of many goals or not a goal at all (Cyert & March, 1963: 8) | N/A: Neoclassical economics has no positive theory to determine the bounds of the firm (Coase, 1937; 1963: 15) | They are important actors in markets (1976: 306) |
| Political (Muller & Warneryd, 2001) | To define the role of outside ownership in minimizing the risk of opportunistic behavior arising from imperfect formal enforcement (Muller & Warneryd, 2001: 527) | N/A: This theory assumes the existence of firms (2001: 527) | N/A: Inside versus outside ownership is not associated with scale and scope. | They reduce rent-seeking costs through optimal level of outside ownership (2001: 529) |
| Property Rights (Grossman & Hart, 1986) | To predict the acquisition of assets by one firm from another and to explain the costs and benefits of integration (1986: 695). | N/A: This theory assumes the existence of firms (1986: 692) | The assets owned by the firm (1986: 692) | They identify the optimal ownership structure to minimize loss due to investment distortions (1986: 710). |
| Resource-learning (Mahoney, 1995) | To suggest a theory that integrates constructs from resource-based, dynamic capabilities, &learning theory (1995: 91). | N/A: This theory assumes the existence of firms. | Bundles of unique resources (Mahoney, 1995) | Of the accumulation of unique and valuable resources through the development of competitive mental models (1995: 97). |

relative to the foregoing dimensions.

Interestingly, in our analysis we noticed that the scale and scope theory-of-the-firm criterion (Table 1 – column 4) speaks to the extent of inclusion or exclusion of stakeholders; and we also noticed that the existence and persistence theory-of-the-firm criteria (Table 1 – columns 3 and 5) speak to equilibration strength. An examination of the map created using these criteria (Figure 1) suggests that a stakeholder theory of the entrepreneurial firm might fill in an under-researched area of theory development, thereby, fulfilling a needed function in the theory-of-the-firm literature which, as more fully explained in the final section, would explain firms with broadly inclusive/ revolutionary (strong equilibration) stakeholders (Quadrant D). Could this analysis presage recognition of the emergence of a new type of entrepreneurial firm?

**Figure 1 - A Theory of the firm Typology**

| | | Stakeholder | Inclusion |
|---|---|---|---|
| | | Narrow | Broad |
| Stakeholder Equilibration | Revolutionary | C<br>Narrow/Revolutionary: 1 | D<br>Broad/Revolutionary: 0 |
| Strength | Incremental | A<br>Narrow/ Incremental: 10 | B<br>Broad/Incremental: 6 |

**Extent of Stakeholder Inclusion**

The scale and scope theory-of-the-firm criterion in the definition of a firm defines the extent of inclusion or exclusion of stakeholders. Extent of stakeholder inclusion can be conceptualized as being broad (to include a great many stakeholders) or as being narrow (to exclude most potential stakeholders, leaving a very limited set of actual stakeholders). In the stakeholder literature, the broad definitions attempt to specify the empirical reality that virtually anyone can affect or be affected by an organization's actions, while the narrow definitions attempt to specify the pragmatic reality that firms simply cannot attend to all actual or potential claims and must, therefore, employ some prioritizing system to limit the extent of inclusion in the firm (Mitchell et al., 1997, p.854). As anchor points in our analysis we have used, at the broad end of the spectrum, Freeman's (1984) definition of stakeholders, which includes "any group or individual who can affect or is affected by the achievement of the organization's objectives" (Freeman, 1984, p.46). As an anchor point for the narrow end, we have used Clarkson's (1995) definition of primary stakeholders: those without whose continuing participation the firm cannot survive as a going concern (Clarkson, 1995, p.106).

**Stakeholder Equilibration Strength**

Both the existence and persistence theory-of-the-firm criteria may be used to define the strength of stakeholder equilibration in the definition of a firm. Accordingly, stakeholder equilibration strength is defined to be the degree of impact that stakeholder actions have upon the existence and persistence of a firm. The level of stakeholder equilibration strength is relevant to an examination of theories of the firm that seeks to situate a stakeholder theory of the *entrepreneurial* firm, because the role of the entrepreneur in relationship to stakeholders is catalytic: firm ownership: "set at the point at which the new combinations of resources to produce new value (Schumpeter, 1934). Weak equilibration entrepreneurial processes occur all the time in a market economy, where entrepreneurs merely realize or conjecture (either through genuine insight and knowledge, or through mere luck) that some resources are underutilized in their current occupation (i.e., there is disequilibrium) and recombine them - through incremental adjustments to existing stakeholder relationships - into a potentially more useful and fruitful combination (Venkataraman, 2002). Strong stakeholder equilibration entrepreneurial processes take place where the distribution of value to its creators becomes so inequitable under normal market conditions that a change is necessary in the economic order - through the revolution of creative destruction (Schumpeter, 1934) engineered by entrepreneurs who effectuate, in reality, (Sarasvathy, 2001) the unfailing power of innovations in goods and services to produce among relevant stakeholders the insistence upon change (Venkataraman, 2002). In either case (weak or strong), the nature of the entrepreneur/stakeholder interface affects the existence and persistence of the firm.

**Implied Typology**

In our analysis, we sought to gain a seminal view of each of the theories of the firm included therein by reviewing the first introduction or an influential publication of the theory, as well as (where helpful) subsequently published research utilizing or critiquing the respective theories. We, as authors, then engaged in a series of analytical discussions regarding the "plotting" of each of the theories of the firm across the two foregoing analytical dimensions (Figure 1). Each author presented her/his own interpretation of the theory's relationship to the dimensions based on the review of the relevant publications for each theory. When a disagreement arose, the authors redoubled their dialog, each explaining the rationale for their interpretation. Discussion continued until we were able to reach agreement for how to situate each of the 17 theories of the firm within the 2 x 2 framework suggested by the analytical dimensions utilized. The results of this analysis are presented as the first four sections[1] in Table 1, and are also reported in Figure 1. Based on the foregoing two dimensions, we identified the four distinct theory-of-the-firm quadrants shown. A brief description of each quadrant follows, which presents sample theory from each quadrant.[2]

***Quadrant A***

Theories considered to be both narrow in their orientation towards stakeholder inclusion, and incremental with respect to stakeholder equilibration strength appear in quadrant A. As Figure 1 indicates, the majority of the theories of the firm under consideration (10 of 17) fall into this category, and include (in alphabetical order): agency, customer value, evolutionary, exchange, industrial organization, institutional, population ecology, real entity, resource-based, and strategic theories of the firm. Theories in this quadrant tend to be focused on the most constricted set of conditions, by which we mean exclusive verses inclusive, and constrained to explain only incremental change.

For example, agency theory appears to belong in this quadrant because, with respect to stakeholder inclusion, agency theory is primarily concerned with principal/owner and agent relationships that are manifest in a firm boundary (for purposes of the theory) that is tightly focused. As reported in Table 1, Jensen and Meckling (1976, p.323) suggest that firm scale and scope, as considered by agency theory, is bounded by

[1] The fifth section of Table 1 contains the ten theories that did not qualify in our analysis under all three criteria.

[2] The reader is invited to further utilize Table 1 as a means to more fully elaborate each quadrant.

firm ownership: "set at the point at which the gross increment in (firm) value is just offset by the incremental loss involved in the consumption of additional fringe benefits due to (managers') declining fractional interest in the firm," which we take to imply a narrow set of firm stakeholders. With respect to stakeholder equilibration strength, agency theory describes how agents of a firm act on behalf of the owner depending upon the proper alignment of incentives. Incentive alignments are fundamentally incremental in their equilibration strength because they are a nexus for contracting relationships that is characterized by the existence of divisible residual claims on the assets and cash flows of the organization that can generally be sold without permission of the other contracting individuals (p.311). Furthermore, given strong incentives for individuals to minimize agency costs, the many competing alternatives and the shortcomings of the corporate form, the corporate form has survived the market test against potential alternatives (p.357), indicating a low susceptibility to strong stakeholder equilibrating forces, and a greater likelihood that a weak-equilibration characterization is most apt.

*Quadrant B*

Theories of the firm which are broad in their inclusion of stakeholders but remain incremental in their stakeholder equilibration strength, appear in quadrant B (Figure 1). Six theories of the firm appear to fit into this quadrant and include: behavioral, game, resource, stakeholder transaction cognition, and transaction cost economic theories of the firm. Transaction cost economics (TCE) provides an example of theories of the firm that reside in quadrant B.

As noted in Table 1, TCE is broad in its inclusion of stakeholders due to the nature of the first-order economizing process motivating transaction cost economizing (Williamson, 1991) which knows few boundaries but efficiency (Williamson 1985) and is, therefore, applicable to the coordination and alignment of activities among a wide range of stakeholders in the economic system. Nevertheless, TCE specifies only incremental stakeholder equilibration strength because, according to TCE, stakeholders exert relatively little direct influence on the firm but, instead, have incremental impacts as various stakeholders influence the costs of transactions that are manifest in substitutions at the margin (Coase, 1937). According to TCE theory, substitution at the margin consists of the transaction-by-transaction replacement of hierarchy for market that occurs "at the margin" (in an incremental manner based upon the most miniscule efficiency advantages), such that society becomes "not an organization, but an organism" (Coase, p.387) - by its organic nature destroyed by verses nourished by a strong equilibration process.

*Quadrant C*

Theories focused on only a narrow set of stakeholders but with a revolutionary view of stakeholder equilibration strength fall into Quadrant C. We were only able to identify one theory of the firm that appears to belong in this quadrant. This theory, the entrepreneurial theory of the firm, claims to set out a general framework within which all the key questions in the theory of the firm can be integrated (Casson, 1996, Witt, 1998).

However, somewhat surprisingly, we were constrained to assess the entrepreneurial theory of the firm to be narrow in its stakeholder inclusion because—as suggested in Table 1—it appears as to only be focused on a narrow set of environmental actors that can have a direct impact on the firm: those stakeholders implicated in generating and informing entrepreneurial insight (Casson, 1996). This is in contrast to theories which consider a broader set of internal and external stakeholders, such as stakeholder theory (and other such theories appearing in Quadrant B). Yet the entrepreneurial theory of the firm does have a revolutionary orientation towards stakeholder equilibration strength, suggesting that stakeholders external to the firm (e.g., environmental forces that dictate responses to change) bring to bear the full power of the environment on a firm that is reflexively adaptable: to reformulate itself to achieve indefinite life, thus, being subject to and responsive to strong equilibrating forces.

### *Quadrant D*

Theories of the firm which have a broad view of stakeholder inclusion and a revolutionary orientation towards stakeholder equilibration would be included in Quadrant D. However, as indicated in Figure 1, we found no theories of the firm that appeared to be likely inhabitants of this quadrant. Accordingly, we observe that given the lack of theoretical development associated with a combined orientation toward revolutionary equilibration strength and a broad view of stakeholder inclusion, there appears to be a need for such a theory. In the following section we inquire about the outlines of a potential theory that would fill this gap in the literature – what we term a stakeholder theory of the entrepreneurial firm – which we hope will address the deficiency in the extant theories of the firm.

## TOWARD A STAKEHOLDER THEORY OF THE ENTREPRENEURIAL FIRM

### Purpose of a Stakeholder Theory of the Entrepreneurial Firm

As illustrated in Figure 1 (which plots the typology suggested by our analysis in Table 1), the theory-of-the-firm literature is missing broad/revolutionary theories of the firm (Figure 1, Quadrant D). In this section of the paper, we suggest that a stakeholder theory of the entrepreneurial firm might fill this void. We therefore inquire: What purposes would such a theory serve that extant theories do not serve?

In our present assessment, we observe that presently extant theories mainly explain firms that form to manage incremental changes in the value creation process, which occur over some continuum of a relatively narrow to somewhat broad level of stakeholder inclusion. Stakeholder theory (Brenner & Cochran, 1991; Freeman, 1984; Mitchell et al. 1997) has developed to manage the inclusiveness dimension. What is missing within the stakeholder theory-of-the-firm literature is theory that explains broadly inclusive firm formation that is also revolutionary in nature. Such phenomena do exist, such as firms that produce so-called disruptive technologies (Christensen, 1997). The intended purpose of a stakeholder theory of the entrepreneurial firm then would be to advance theory that addresses the three requisite dimensions in our analysis: the emergence, growth/size, and persistence of broadly inclusive, revolutionary firms (Figure 1, Quadrant D).

### Reason for Firm Existence

A stakeholder theory of the entrepreneurial firm would explain why broadly inclusive revolutionary firms might be expected to exist in the first place. Theoretical justification abounds for firms that are incremental in their equilibration strength (Table 1; Figure 1, Quadrants A & B). We wonder at the paucity of theories of the firm that possess revolutionary equilibration strength. We are hopeful, in highlighting this paucity, that we will draw research attention to the investigation of such questions as: Are the forces in play so powerful that firms, as we know them, are simply inadequate to contain the socioeconomic energy generated? Are all entrepreneurial firms to be considered to be revolutionary or are there both incremental and revolutionary types of firms, necessitating theory that explains each and the distinction between them? Are there, within the coordination, bridging/buffering, decision-making, economizing, and other reasons for firm existence, those theories with a logic sufficiently compelling to explain the reasons for broad/revolutionary firms? Attention to these questions will contribute markedly to a better understanding of reasons for these firms' existence.

**Scale & Scope**

A stakeholder theory of the entrepreneurial firm would also explain the scale and scope of a broadly inclusive revolutionary firm. This is an issue at present because, in its initial conceptualization, Schumpeterian entrepreneurship (the notion that new combinations follow processes of creative destruction) is applied to entrepreneurs as individuals, not to firms/organizations (Schumpeter, 1934). Progress toward the specification of a broad/revolutionary theory of the firm should explicitly lay out why and how organizations might become implicated in processes of revolutionary creative destruction, especially since it is commonly expected that most organizations will do just the opposite in the face of the emergence of disruptive technologies (Christensen, 1997). Scale and scope dynamics are also an issue because the motivation for stockholders (narrow) verses stakeholders (broad) has traditionally been financial. Thus, a credible reason for broad inclusion and the motive purpose for such inclusion must be identified and has only recently begun to be explored (Mitchell, 2002b).

**Persistence**

Lastly, a stakeholder theory of the entrepreneurial firm would explain the persistence of a broadly inclusive revolutionary firm. Even should we accept as given the reasons for existence and for the bounding of scale and scope, we would not have answered the question: Why couldn't the broadly inclusive/revolutionary firm simply be a transitory form that regularly precedes or is commonly attendant to the entrepreneurial event? If so, is such an explanation, no matter how ably it explains existence, scale, and scope, really never is destined to be a theory of the firm because it does not explain persistence? Furthermore, even if an argument can be made for the *persistence* of the phenomenon, is there a place in the theory-of-the-firm literature for such broadly inclusive, revolutionary but provisional systems (BIRPS)?

## DISCUSSION

Stakeholder thinking is essential in business. And knowing who or what really counts (Mitchell, et al., 1997) does matter. In this paper, we use two dimensions of "counting:" (1) making a stakeholder mistake that can tear apart your business – the "equilibration" problem; and (2) making a stakeholder mistake that can impair your business for lack of support – the *inclusion* problem.

The "so what?" implications of this type of analysis indicates that we can use these two dimensions to create a means to interpret a great many proposals for: (1) why firms come into existence in the first place; (2) how big they grow; and (3) when they become obsolete and fail to persist.

As practitioners in the arena of small business and entrepreneurship, having this analytical framework available to us would make it possible to see ourselves from multiple viewpoints and, thereby, better understand the kinds of decisions that are truly important. So-called "theories of the firm" have been a topic of discussion among thoughtful practitioners for many decades for just this reason: to answer the why, how, and when questions noted in the previous paragraph. While not every theory applies to every business, it is not unreasonable for low-change businesses in narrowly defined niches to utilize the theory-lenses in Figure 1 – Block A and for lower-change businesses in broadly defined niches to view themselves through the theory-lenses in Figure 1 – Block B. Perhaps of greater import is for people in businesses who are in high-change, broadly inclusive settings to be aware that there is very little research and documented understanding of this situation and to see this as a potential opportunity to explore the ways to incorporate stakeholders more broadly to better deal with high change and great uncertainty.

Thus, the purpose of this paper has been to suggest the need for and to situate a stakeholder theory of the entrepreneurial firm such that a new lens for entrepreneurial management emerges. It is our hope that our analysis, and the questions that arise therefrom, have been sufficiently stimulating and persuasive to instigate investigations that address the under-researched areas identified.

## REFERENCES


Agle, B. R., Mitchell, R. K., & Sonnenfeld, J. A. (1999). Who matters to CEOs? An investigation of stakeholder attributes and salience, corporate performance, and CEO values. *Academy of Management Journal* Special Research Forum on Stakeholder Theory, 42(5), 507-525.

Amit, R., Glosten, L., & Muller, E. (1993). Challenges to theory development in entrepreneurship research. *Journal of Management Studies*, 30(5), 815-834.

Barney, J. (1991). Firm resources and sustained competitive advantage. *Journal of Management*, 17(1), 99-120.

Barr, J. & Saraceno, F. (2002). A computational theory of the firm. *Journal of Economic Behavior and Organization*, 49(3), 345-361.

Bartlett, C. & Ghoshal, S. (1993). Beyond the M-form: Toward a managerial theory of the firm.. *Strategic Management Journal*. 14, 23-46.

Boulding, K. (1950). *A reconstruction of economics*. New York: John Wiley & Sons.

Brenner, S. & Cochran, P. L. (1991). The stakeholder model of the firm: Implications for business and society theory and research. *Proceedings of the International Association for Business and Society*, 449-467.

Bucar, B. & Hisrich, R. (2001). Ethics of business managers vs. entrepreneurs. *Journal of Developmental Entrepreneurship*, 6(1), 59-82.

Canterbery, (1994), Boulding's T, Kaleckian power, and Minsky's fragility hypothesis. *Journal of Economic Issues*, 28(4), 1227-1248.

Casson, M. (1996). The nature of the firm reconsidered: Information synthesis and entrepreneurial organization. *Management International Review*, 36(1), 55-94.

Caves, R. E. (1980). Industrial organization, corporate strategy and structure. *Journal of Economic Literature*, 18(March), 64-92.

Christensen, C. M. (1997). *The innovator's dilemma: When new technologies cause great firms to fail*. Boston, Mass.: Harvard Business School Press.

Clarkson, M. B. E. (1995). A stakeholder f ramework for analyzing and evaluating corporate social performance. *Academy of Management Review*, 20(1), 92-117.

Coase, R., H. (1937). The nature of the firm, Economica New Series 4. In G. J. Stigler & K. E. Boulding (Eds.), *Readings in Price Theory*, pp. 386-405. Homewood, IL: Irwin.

Cyert, R. M. & March, J. G. (1963). *The Behavioral Theory of the Firm*. Englewood Cliffs, NJ: Prentice-Hall.

Dew, N., Velamuri, S. R., & Venkataraman, S. (2004). Dispersed knowledge and an entrepreneurial theory of the firm. *Journal of Business Venturing*, 19 (5), 659-679.

DiMaggio, P. J. & Powell, W. W. (1983). The iron cage revisited: Institutional isomorphism and collective rationality in organizational fields.

*American Sociological Review*, 48(April), 147-160.

Drucker, P. F. (1973). *Management*. New York: Harper & Row.

Freeman, R. E. (1984). *Strategic Management: A Stakeholder Approach*. Boston, MA: Pitman.

Furubotn, E. (2001). The new institutional economics and the theory of the firm. *Journal of Economic Behavior* & Organization, 45(2), 133.

Grandstrand, O. (1998). Towards a theory of the technology-based firm. Research Policy, 27, 465-489.

Grossman, S. & Hart, O. (1986). The Costs and Benefits of Ownership: A theory of vertical and lateral integration. *The Journal of Political Economy*, 94(4), 691-719.

Hannan, M. T. & Freeman, J. (1989). *Organizational Ecology*. Cambridge, MA.: Harvard University Press.

Hodgson, G.M. (1998). Evolutionary and competence-based theories of the firm. *Journal of Economic Studies*, 25(1), 25-56.

Jensen, M. & Meckling, W. (1976). Theory of the firm: Managerial behavior, agency costs, and ownership structure. *Journal of Financial Economics*, 3, 305-360.

Kogut, B & Zander, U. (1992). Knowledge of the firm, combinative capabilities, and the replication of technology. *Organization Science* 3, 383-397.

Kogut, B. & Zander, U. (1996). What firms do? Coordination, identity, and learning. *Organization Science*, 7(5), 502-518.

Mitchell, R. K. (2001). *Transaction cognition theory and high performance economic results* Victoria, BC: International Centre for Venture Expertise.

Mitchell, R. K. (2002a). Entrepreneurship and stakeholder theory: Comment on Ruffin Lecture #2. *Business Ethics Quarterly: The Ruffin Series*, 3, 175- 196.

Mitchell, R. K. (2002b). Stakeholders of the world unite: Assessing progress on the path toward a stakeholder theory of the firm. In D. Windsor & S. A. Welcomer (Eds.), *Proceedings of the Thirteenth Annual Conference*, June 27-30, 2002, Victoria, BC, Canada: International Association for Business and Society. pp. 223-225.

Mitchell, R. K., Agle, B. R., & Wood, D. J. (1997). Toward a theory of stakeholder identification and salience: Defining the principle of who and what really counts. *Academy of Management Review*, 22(4), 853-886.

Muller, H. & Wareryd, K. (2001). Inside versus outside ownership: A political theory of the firm,. *The Rand Journal of Economics*, 32(3), 527-541.

Nelson, R. R. & Winter, S. G. (1982). *An evolutionary theory of economic change*. Cambridge, MA: Belknap Press of Harvard University Press.

Penrose, E. (1959). *The theory of the growth of the firm*, Chapter V: inherited resources and the direction of expansion, pp. 65-87. New York: Wiley.

Pfeffer, J. & Salancik, G. (1978). *The external control of organizations: A resource dependence perspective*. New York: Harper & Row.

Porter, M. E. (1980). Competitive Strategy: Techniques for Analyzing Industries and Competitors. New York: Free Press.

Porter, M. E. (1984). Strategic interaction: Some lessons from industry histories for theory and antitrust policy. In R. Lamb ( Ed.), *Competitive Strategic Management*, pp. 415-443. Don Mills, ON, Canada: Pearson Education Canada.

Sarasvathy, S. D. (2001). Causation and effectuation: Toward a theoretical shift from economic inevitability to entrepreneurial contingency. *Academy of Management Review*, 26(2), 243-264.

Schumpeter, J. (1934). *The Theory of Economic Development.* Boston, MA: Harvard University Press.

Slater, S. (1997). Developing a customer-value based theory of the firm. *Academy of Marketing* Science, 25(2), 162-167.

Smith, A. (1774/1937). *The wealth of nations*. New York: Modern Library.

Stinchcombe, A. L. (1965). Organizations and social structure. In J. G. March ( Ed.), *Handbook of Organizations*, pp. 142-193. Chicago: Rand-McNally.

Venkataraman, S. (1997). The distinctive domain of entrepreneurship research. In J. Katz (Ed.), *Advances in entrepreneurship, firm emergence and growth*, 3, 119-138. JAI Press.

Venkataraman, S. (2002). Stakeholder value equilibration and the entrepreneurial process. *Business Ethics Quarterly*: The Ruffin Series, 3, 45-58.

Vesper, K. H. (1996). *New Venture Experience.* Seattle, WA: Vector Books.

Wernerfelt, B. (1984). A resource-based view of the firm. *Strategic Management Journal*, 5, 171-180.

Williamson, O. E. (1985). *The Economic Institutions of Capitalism.* New York: The Free Press.

Williamson, O. E. (1991). Strategizing, economizing, and economic organization. *Strategic Management Journal*, 12(S), 75-94.

www.ronaldmitchell.org/publications

.