Contract Theory and Strategic Management: Balancing Expectations and Actions

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Abstract

Business firms as well as each of their subunits can be thought of as a set of contracts in which participating agents seek their own goals. Participants contribute resources, expecting to receive in exchange more than the opportunity cost of their contributions. For this system to work, the expectations of each individual must be in balance with what he/she is expected to contribute. In addition, the production technology of the firm must be capable of fulfilling such expectations in aggregate. Changes in factor and product markets continually alter the expectations and actions of individuals, nudge them out of balance, and threaten the feasibility of the contract set. A strategic manager scans the relevant markets for incipient changes in environment, and redesigns and implements new contracts which balance the self-interest of individuals with their changing expectations. Redesign and renegotiation of contracts is complicated because people protect their self-interest. Many firms collapse when the managers fail to recognize and act upon the changes in business environment in a timely fashion. Some redesign efforts fail because managers do not elicit the cooperation of those who have the necessary knowledge and expertise and expect to be adversely affected by the proposed changes. The contract model of the firm provides a framework and perspective to reduce such failures.

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