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# The Firm as a Subsociety: Purpose, Justice, and the Theory of the Firm

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**Abstract.** Research in the “theory of the firm” tradition has often characterized firms as subeconomies, in which economic exchange is shaped by a central authority. We propose an expanded view of firms as subsocieties, in which authority is also responsible for establishing principles that shape cooperation among members. We draw on insights from political theory, sociology, and, to a lesser degree, legal theory to discuss how employees become members of subsocieties by exchanging rights, such as formal control over their work, for the benefits of membership. With this rights exchange, subsociety members develop expectations that those in positions of authority will use their control to define and sustain principles of justice and common purpose consistent with members’ moral sentiments. This view suggests expanded roles for authority and firm boundaries from what are incorporated into standard theories of the firm. These expanded roles have implications both for internal governance and for the boundary itself: When considering boundary changes, leaders must weigh both the economic and the social consequences of their decision.



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In his treatise *The Wealth of Nations*, Adam Smith advances the insightful thesis that “well-governed societies”—societies that elicit “the cooperation and assistance of great multitudes” and propagate a nation’s wealth (Smith 1776, p. 378)—are built on principles of justice, beneficence, and purpose, as established by a central architect. Of course, Smith is primarily remembered for very different ideas—that a society’s economy is shaped by the market’s invisible hand and by production’s increased specialization, or what he termed a division of labor. Explaining the economy’s consequent separation into conscious, authority-directed cooperation in firms and autonomous price-directed (or contract-directed) cooperation in markets emerged as the framing question for the theory of the firm. But in focusing on this firm-market dichotomy, juxtaposing authority and prices, economics largely ignored Smith’s parallel thesis regarding how society-level principles, particularly the alignment of “moral sentiments,” shape cooperation within society. Today’s theory of the firm says remarkably little about how such nonmonetary sentiments and values, including a desire for purpose and meaning in work

(Frankl 1949, Rosso et al. 2010, Grant 2012), or preferences for justice in dealings with others (Ouchi 1980, Fehr and Schmidt 1999, Greenberg and Colquitt 2013), shape cooperative activity and define the composition of a society’s economy, including its firm-market separation.

Our aim in this paper is to articulate a theory of the firm that places these society-level constructs of purpose and justice at center stage. Our theory views firms (and other organizations) as subsocieties that are more than a collection of economic exchanges shaped by authority, but also more than an aggregation of social relations that operate independently of firm boundaries and the authority with which these boundaries coincide. In our theory, authority, boundaries, purpose, and justice all feature prominently. We argue that firms are subsocieties circumscribed by firm boundaries and populated by employees who have entered into a rights exchange—granting authority to a central actor in exchange for an expectation that this authority will be used in ways consistent with espoused principles of purpose and justice. We employ the term “subsociety” to contrast with “subeconomy,” a label that Holmstrom

(1999) used to characterize firms. In his formulation, a subeconomy is one in which the principal—as social planner—uses authority to structure incentives, decision rights, and job design. These tools then shape productive exchange within the firm’s boundaries that can outperform markets within the larger economy.

Our argument is built analogously, but focuses on the expanded nature of sociality and preferences among members of a society versus an economy. Members of societies, in addition to economic preferences, also possess moral sentiments (to use Adam Smith’s term) that lead to evaluations of “right versus wrong” and “good versus bad” (Sidgwick 1874). Firms’ principals, and their choices, therefore, inhabit a broader role in our theory than in the traditional theories of the firm. In addition to their capacity to structure incentives and decision rights, they also have the authority to enact societal principles, particularly those pertaining to justice and purpose, that are vital to generating (or destroying) the identification of members within the firm and the sociality that results. Our theory is thus neither an economic theory that ignores these moral sentiments and the corresponding sociality that emerges within firms, nor a social theory that ignores the role of firm boundaries and authority. Instead, we take our lead from Smith, Durkheim, and Rawls, as well as organizational sociologists, such as Chester Barnard and Philip Selznick. In their (and our) conception, principles of purpose and justice, and the authority that shapes them, all feature prominently. Moreover, although our focus in this paper is on firms, we see application to other types of formal organizations, including government agencies, military, religious institutions, and nonprofit organizations.

Our theory suggests several insights and implications for the theory of the firm. First, the boundary of the firm does more than empower an authority to shape incentives and decision rights. It circumscribes a social domain or subsociety, in which the actions of this authority undergo enhanced moral scrutiny, thereby amplifying the positive and negative social consequences of these actions for those within the subsociety, relative to those outside it. Second, the amplified response to purpose- and justice-related actions for those within the firm boundaries highlights an important additional cost-benefit dimension that those designing organizations must incorporate into decisions about optimal or efficient firm boundaries. Third, as a consequence of the above, our theory provides insight into why we may frequently observe boundary choices that seemingly violate standard economic logic emerging from existing theories of the firm.

We organize the development of our theory as follows. We begin with (1) a very brief review of traditional economic (or subeconomy) theories of the firm, as well as related social theories of organization. We then (2) introduce the concept of a society, in contrast to that of an economy, as well as the role of authority in

ordering societies. We next (3) discuss what constitutes a well-governed society and how it is central to producing cooperation. As part of this discussion, we describe a fundamental responsibility of authority to promote a well-governed subsociety—the establishment of clear and credible principles of purpose and justice that apply across the society. We then (4) extend this discussion to firms and discuss how the legal form of a corporation generates principals with authority to shape purpose and justice. We conclude (5) with a discussion of the implications of our theory, advancing a short set of propositions that incorporate our prior argument into theories of the firm and firm boundaries.

## Firms as Authority-Enabled Subeconomies

Since Coase (1937), research in the theory-of-the-firm tradition has generally viewed firms and markets as distinct governance modes for organizing economic production, with the choice between them based on which mode most efficiently supports the desired exchange. In this tradition, firms emerge from sequenced decisions about how to efficiently organize exchanges, “[becoming] larger as additional transactions are organised by the entrepreneur and [becoming] smaller as [the entrepreneur] abandons the organisation of such transactions” (Coase 1937, p. 393). A firm therefore simply serves as an alternative to a market, providing an organizational setting in which employees specialize and cooperate, in what Holmstrom (1999) has labeled a subeconomy. What distinguishes firms from markets is that exchange is actively managed, consistent with Robertson’s (1923) characterization of organizations as islands of conscious power within a larger economy shaped by markets and prices.

Distinct theories of the firm highlight different applications of this authoritative control. In what Gibbons (2005) calls the “rent seeking theory of the firm” (Williamson 1971, Klein et al. 1978, Williamson 1979, 1985b), access to fiat available within the firm provides a more efficient resolution to haggling over uniquely generated value (appropriable quasi-rents). In the “adaptation theory of the firm” (Gibbons 2005), authority efficiently facilitates adaptive coordination and cooperation among multiple actors, particularly for those tasks that fall into Barnard’s “zone of indifference” for employees (Williamson 1971, 1973, 1985a; Klein and Murphy 1988; Williamson 1991; Klein 1996). Authority’s role in facilitating knowledge sharing critical to coordinating complex tasks is similarly highlighted in knowledge-based theories of the firm (Demsetz 1988, Kogut and Zander 1992, Conner and Prahalad 1996, Grant 1996, Nickerson and Zenger 2004). In property-rights theory, authority accompanies taking ownership of assets (Grossman and Hart 1986, Hart and Moore 1990)—control rights allow owners to dictate how assets are used and shape the incentives of employees.

Finally, in Holmstrom's (1999, p. 76) expanded articulation of agency theory, firms are "Subeconomy[ies] in which the executive office has the power to regulate trade by assigning tasks, delegating authority, and delineating principles for how explicit and implicit incentives are to be structured"—a capacity to authoritatively shape the "rules of the game" in ways particularly advantageous when multitasking and other informational asymmetries exist (Holmstrom and Milgrom 1991, 1994).<sup>1</sup>

These theories, although differing in their underlying mechanisms, are united in their focus on articulating the circumstances under which authority enables a more efficient exchange that drives the firm-market distinction. As such, although the foundations of these theories differ, they share the subeconomy underpinning introduced by Coase (1937), in the sense that boundary decisions are determined by the most efficient organization of transactions that vary in their complexity, uncertainty, and costs to manage.

## From Subeconomy to Subsociety

But firms are more than loci of transactions distinguished by their access to authority or subeconomies with dispersed knowledge. They are collectives of individuals, and as collectives, they are subject to the range of social forces and moral sentiments that characterize human interaction. These social forces and sentiments do not appear randomly, but instead in patterns shaped by the boundaries of firms and the choices of those granted authority. In this sense, firms may be both subeconomies and social collectives shaped by a range of sentiments—an argument in Selznick's (1948, pp. 25–26) observation that: "Organization may be viewed from two standpoints which are ... empirically united .... On the one hand, any concrete organizational system is *an economy*; at the same time, it is *an adaptive social structure*."

Of course, literature on organizations outside economics strongly critiques these depictions of the firm, particularly their sharp distinction between firms and markets. As Granovetter (1985, p. 487) claims, within markets, "actors do not behave or decide as atoms outside a social context," and within firms, they do not "adhere slavishly to a script written for them." Accordingly, these social perspectives seldom articulate why firms exist, or why boundary choices matter, suggesting, instead, that organizational boundaries are of rather little consequence in shaping the sociality that emerges (e.g., Granovetter 1985 and Uzzi 1996).<sup>2</sup> One exception is literature on the role of identity in organizations (e.g., Kogut and Zander 1996, Kogut 2000, Anthony and Trippas 2016, Ravasi et al. 2020). This work builds off the idea that socialization within firms creates a unique sense of "we" rather than an "I" that, in the words of Simon (1991, p. 36), "allows individuals to experience satisfactions (to gain utility) from successes of the [business]."

However, as Marx (1867) noted long ago, organizations are as well known for fostering alienation as identification. Therefore, any theory of the firm that appeals to identification must explain why firm boundaries sometimes foster identification and robust cooperation and at other times foster alienation and complete noncooperation (Freeland and Zuckerman Sivan 2018).

We present a theory in which firms are subsocieties, rather than simply subeconomies, with the term "society" defining a fundamentally more expansive construct than an "economy." In developing this view, although we echo the social critiques of economic theories of the firm by highlighting the substantive role that sociality and identification play in shaping economic outcomes, our aim is to develop a *societal theory of the firm*, where both authority and organizational boundaries remain central. In our theory, organizational boundaries circumscribe a domain wherein value-related choices by leaders face amplified scrutiny, thereby generating patterns of sociality and identification that emerge differently within and outside the firm. From our theory, we draw implications for the theory of the firm and selection of firm boundaries.

We proceed by first defining a society as (1) an ordered community formed for a particular purpose or activity, (2) composed of individuals who possess moral values or sentiments alongside standard preferences rooted in self-interest, (3) in which authority plays a key role. We then distinguish a well-governed society, adopting Smith's term, labeling it as a society in which (4) authority implements clear and consistent principles of purpose and justice. We then link these concepts to firms, discussing firms as subsocieties that are well-governed or poorly governed. We then consider several implications of this perspective for theories of the firm, and organizations more generally.

## The Notion of a Society Revisited

Although the term society derives from the Latin *societas*, meaning "union for a common purpose," modern usage defines society as an "aggregate of people living together in a more or less ordered community" or "an organization or club formed for a particular purpose or activity" (Oxford English Dictionary). We combine these to define societies as *an ordered community of individuals formed for a particular purpose or common aim*, and emphasize three features as central to societies and a fourth as central to a well-governed one.

First, societies are ordered communities—an idea advanced by political philosophers Hobbes, Locke, and Hegel. Society members enter a social contract, whereby they accede to political authority in exchange for various rights granted in return. The resulting order enabled by this social contract contrasts with a "state of nature" that emerges absent it—a state that, in its extreme form, Hobbes characterized as a "war of all against all" (Hobbes 1651).

Second, as Adam Smith emphasized, societies are composed of individuals who possess moral sentiments—moral assessments of their own and others' actions. Smith viewed these moral sentiments as central to how humans make sense of the world and choose whether to cooperate. They reflect “preferences” (Akerlof and Kranton 2005) and values (Barnard 1938; Selznick 1994; Bénabou and Tirole 2011, 2016) that shape two broad categories of moral assessment: assessments of right versus wrong and assessments of good versus bad (Sidgwick 1874). Societal members are drawn to join with others who share their values and sentiments and act in ways that realize them. When members sense support for their values within their communities, they respond with greater identification and cooperation (Akerlof and Kranton 2005, Bénabou and Tirole 2011), and the opposite when these values are contravened.

Third, as Comte, Weber, and other classic sociologists suggest, authority provides the foundational structure for any ordered society, whether political, religious, or cultural (Nisbet 1993, Selznick 1994). Those granted authority set direction, resolve disputes, and establish the rules by which a society operates—rules that may be either reasonable or capricious and may either resonate with or violate the moral sentiments of those in the society. When authority is used to uphold the society's moral sentiments, it provides the basis for order that enables members to cooperate and achieve their collective aims.

Fourth, societies can be either well or poorly governed, depending on how authority is deployed. The challenge to craft a well-governed society lies at the core of political theory from Thomas Hobbes to modern scholars. Solutions to generating well-governed societies have generally focused on the establishment of rules-based orders, where the rules and principles that guide them resonate with the moral values of members, such that members seek out, join, and willingly participate in the society (Nisbet 1993). Thus, in a well-governed society, leaders articulate societal principles and credibly commit to uphold them. Through these principles and the choice of actions consistent with them, leaders both shape the values of their members and attract individuals who hold values with which the leaders' espoused principles are consistent. Akerlof and Kranton (2005) discuss how this occurs in the context of the military. Military training emphasizes the principle of “service before self,” thereby both attracting those who value this principle and inculcating it among its personnel.

When leaders make choices that are consistent with these principles, then, societal members respond with identification. By contrast, leaders' inconsistent choices undermine identification. Using Akerlof and Kranton's military example, when leaders make choices that exemplify country and duty above self-interest, those choices

reinforce the society's values and lead to greater identification. If, on the other hand, military leaders use their authority to, say, enrich themselves and undermine security, their actions violate those same values and erode subordinates' identification. It follows, therefore, that those granted authority must not only evaluate their choices based on technical efficiency, but also on the principles that they wish to uphold and the associated values underlying them. If those with authority enact principles that support these principles and values, the result is a well-governed society that elicits identification and cooperation. We argue that two broad categories of principles and values, aligned with Sidgwick's (1874) categories of “doing what is right” or just and “doing what is good” or purposeful, define the focus of society's members.

**Justice in Well-Governed Societies.** A primary attribute of a well-governed society is the maintenance of a “public conception of justice,” what Rawls elsewhere calls “the first virtue of social institutions” (Rawls 1971, p. 3). This moral virtue is a broader construct than fairness or equity, and it encompasses “the distribution of rights and privileges, powers and opportunities, and the command over material resources” (Barry 1989, p. 292). Even Adam Smith, one of the original advocates of free markets, recognized the importance of justice in society, viewing it as “the main pillar that upholds the whole edifice” (*Theory of Moral Sentiments*, chapter 3, para. 4).

Although justice tends to be valued universally, the specific principles that are applied vary across settings. In other words, what is considered right, fair, and equitable can vary from one society to the next. Moreover, the maintenance of justice within collectives involves assessments of a wide range of both procedural and distributional factors and the management of conflicting claims and interests. Given this contingent nature and the importance of justice in well-governed societies, it follows that one of the primary responsibilities of those in authority is to define and uphold consistent principles of justice that apply to their specific societal context.

**Purpose in Well-Governed Societies.** Justice alone is insufficient to compose a well-governed society. Even Rawls, a key figure in modern theories of justice, recognized that societies should possess “a vision of the way in which the aims and purposes of social cooperation are to be understood” (Rawls 1971, p. 8). Thus, in addition to shared principles of justice, well-governed societies also share a common aim or purpose. The seeds of this idea also extend back at least to Adam Smith (1758, pp. 233–234), who argued that each actor within a society possesses “a principle of motion of its own, altogether different from that which the [designer] might

choose to impress upon it." For Smith, if the societal architect can align principles so that they "coincide and act in the same direction ... society will go on easily and harmoniously, and is very likely to be happy and successful ... ", but if not "society must be at all times in the highest degree of disorder." Durkheim took this idea further by conceiving of purpose as underpinning authority and a key to solving this problem of moral disorganization. In his view, if individuals feel part of a larger moral purpose, they will feel connected to the broader society, and that identification thereby becomes an important basis for order.

As Durkheim (1897) noted, purpose plays a unifying role across all types of societies. Societies in political contexts can embody social aims, albeit aims that are more abstract than those within special-purpose organizations. As examples, the ideal of self-determination as set forth in the U.S. Declaration of Independence or the ideals of "Liberte, Egalite, Fraternite" in postmonarchy France represent social aims of a political nature, however imperfectly realized they may be in practice. Benjamin Disraeli, the U.K. Prime Minister during the mid-19<sup>th</sup> century, reflected this idea when he stated:

There is no community in England; there is aggregation, but aggregation under circumstances which make it rather a dissociating than a uniting principle... It is a community of purpose that constitutes society... Without that, men may be drawn into contiguity, but they still continue virtually isolated. (Disraeli 1845, book 2, chapter 5)

In summary, the principles of justice and purpose underpin a well-governed society. For Selznick (1994, p. 431), purpose and justice provide the "ends and means" to address "the universal problem of social organization," using such moral reasoning as a complement to technical logic. Purpose addresses "to what end is the community ordered?", whereas justice addresses "by what means?" Societies ordered by those in authority according to principles of justice and purpose that resonate with the moral sentiments of members are more likely to generate a sense of identification that motivates members in a common direction, and, hence, can be understood to be well-governed.

### Firms as Well-Governed Subsocieties

We argue below that firms and formal organizations possess these same societal properties. They are (1) ordered communities formed for a particular purpose, (2) composed of individuals who possess moral values or sentiments, and (3) shaped by those granted authority. Firms are therefore subsocieties that, when (4) well-governed by those in authority through choices and actions that resonate with members' purpose- and justice-related moral sentiments, generate identification and cooperation.

First, like societies, firms are ordered communities with definite aims, albeit commercial in nature, that may range from pedestrian to lofty. Firm boundaries delineate social communities, rather than mere collections of individuals involved in coproduction—an argument that can be extended to formal organizations more broadly, including religious organizations, universities, nonprofits, and public-sector institutions, insofar as they have definitive aims and rely on ordered communities to meet those aims. This argument, of course, has a long tradition in the organizations literature and is well captured by Barnard's (1968, p. 2) observation that "every formal organization is a social system, something much broader than a bare economic or political instrumentality or the fictional legal entity implicit in corporation law."

Second, firms, like subsocieties, are composed of employees with moral sentiments—sentiments about what is right versus wrong and good versus bad. Employees are inclined to support and join others in supporting aims and values that are consistent with their moral sentiments. When employees find support for their values within organizations, they respond with cooperation and identification. This insight has been affirmed across decades of research on firm culture that highlights the unique expression of values and assumptions that develops within firm boundaries (e.g., Schein 2010, Chatman and O'Reilly 2016, and Corritore et al. 2020). As Barnard (1968, p. 2) describes, "to a large extent management decisions are concerned with moral issues" with "organizations [giving] expression to or [reflecting] mores, patterns of culture, implicit assumptions as to the world, deep convictions, unconscious beliefs that make them largely autonomous moral institutions ...." That organizations "give expression to or reflect" the worldviews held by members underscores that firms are not only technical systems of production, but are also "autonomous moral institutions"—a channel through which the values of their constituent members are instantiated. For Barnard, individuals do not leave their values at the organizational boundary, but, instead, organizations as subsocieties both reflect and shape the values of their members.

Third, authority plays a critical role in ordering firms and organizations as subsocieties. By articulating the meaning of the organization's work; defining the central activities it performs; voicing aspirations; and choosing which members to allow in, whom to remove, and whom and how to reward and punish, they first articulate and then make tangible the principles by which decisions are made. As a community, members assess both the principles espoused by leaders and the consistency of their decisions with these principles. These assessments will, in turn, shape the subsocieties. Principles that resonate with the underlying values of the community and that are consistently reinforced by leaders

will lead to identification by members, and those that do not will lead to alienation.

The legal underpinnings of authority influence how it is deployed to shape these subsocieties. These underpinnings vary as a function of the organization, whether for-profit corporations, benefit corporations, nonprofits, public agencies, schools, churches, military, or other types of organizations. In each of these cases, a rights exchange defines the organization's boundary and demarcates members of the subsociety from nonmembers. Although the nature of this rights exchange differs by the type of organization, it is precisely this exchange that empowers leaders with authority to effectively shape the principles by which the subsociety operates.

Within corporations, three legal rights provide leaders with power and responsibility to shape societal principles of purpose and justice. First, employers have the power to direct not only the output of work, but also how the work is performed.<sup>3</sup> Employees accept a duty of loyalty to the firm, to "yield obedience to all reasonable rules, orders, and instructions of the employer" (53 American Jurisprudence, as cited in Masten 1988, p. 185). Second, employers have power to determine compensation and rewards and, perhaps most importantly, to resolve disputes.<sup>4</sup> Third, employers assume control of voice rights for the firm (Robé 2011). In other words, leaders have the authority to set the "rules of the game" and be the judge, jury, and executioner of internal disputes. Moreover, they speak for and within the firm, setting the mission and articulating the values that drive choices. Through this rights exchange, therefore, leaders are conferred the power to shape perceptions of purpose and justice among employees. Importantly, these rights do not extend beyond the boundaries of firms, except as explicitly detailed in a contract. Consequently, leadership does not have the equivalent wide latitude with suppliers as they do with employees to dictate how to perform work, enforce loyalty, or exercise voice to speak for suppliers.

Within other types of formal organizations, authority may derive from sources other than traditional corporate law. Within employee-owned cooperatives, for example, the principals are the employees themselves. Leaders to whom employees delegate authority will therefore run the organizations, according to principles that account for this relationship. Similarly, within benefit corporations, leaders must run the organization to meet the publicly stated beneficial objective, and their authority derives from this responsibility. In both cases, employee expectations of leaders will be shaped by this legal form, and leaders will respond accordingly. Other organizations, like religious institutions and professional societies, may utilize other forms of private ordering to empower those with authority. The provisions of how authority is granted and what rights are exchanged for membership will necessarily mean that the tools

available to shape these subsocieties differ across these contexts. Common across all, however, is that those in authority roles possess the power, and corresponding responsibility, to establish the principles that determine whether societies are well-governed (using Adam Smith's term). This is the final component that characterizes a society, to which we now turn.

Fourth, the degree to which firms—as subsocieties—are well-governed depends on how those in authority wield their control to uphold purpose and justice within the organization. Barnard (1968, pp. 42–43) emphasized the role of purpose in ordering organizations of all types, stating that any "formal system of cooperation requires an objective, a purpose, and aim"—one that members find consistent with their own moral sentiments. In his view, it was the role of leadership to provide that purpose to organizations (Barnard 1938, pp. 283–284):

Leadership ... is the indispensable social essence that gives common meaning to common purpose, that creates the incentive that makes other incentives effective ... Executive responsibility, then, is that capacity of leaders by which, reflecting attitudes, ideals, hopes, derived largely from without themselves, they are compelled to bind the wills of men to the accomplishment of purposes beyond their immediate ends, beyond their times.

In other words, effective leaders use their authority to create common purpose within organizations, one that will inspire and unify members. Selznick (1957, p. 62) also held this view with two of his four core responsibilities of leaders focused on purpose: defining the "institutional mission and role" and ensuring an "institutional embodiment of purpose"; one concerned with justice: "ordering of internal conflict"; and the last one spanning both: ensuring the "defense of institutional integrity."<sup>5</sup>

Building off these insights, Ghoshal and Moran (1996, p. 33) proposed that "purposive adaptation" constitutes the primary differentiator of firms over markets, enabling firms to coordinate in new directions, even in the absence of price signals and existing markets. In this view, purpose not only directs workers' discretionary behavior, but also motivates workers, especially when they share the organization's values, goals, and aspirations. More recent research on positive leadership supports the idea of leaders as the primary meaning-makers within the organization, inspiring their members to achieve more than is feasible under formal incentives contracts alone (Podolny et al. 2004, Carton 2018).

Instilling justice has also been shown as vital to the effective function of organizations. A large literature on various forms of justice—procedural, distributive, and interactional—links perceptions of each to team and organizational outcomes (e.g., Colquitt et al. 2001 and Blader and Tyler 2013). This is particularly the case because organizational boundaries demarcate social referent groups,

within which social comparisons are rife (Nickerson and Zenger 2008). This alignment of referent groups and organizational boundaries reflects the fact that those within the organization (unlike those without it) have granted rights to a common authority to shape procedural, distributive, and interactional justice. Employees within the same organization therefore consider each other as “similar others”—individuals who fill like positions and compete for promotions, resources, and opportunities, controlled by a shared central authority (Festinger 1954, Kulik and Ambrose 1992, Gartenberg and Wulf 2017, Obloj and Zenger 2017). In response, leadership may alter compensation arrangements (Gartenberg and Wulf 2017, 2020) and restrict organizational boundaries to eliminate activities that prompt perceptions of injustice (Nickerson and Zenger 2008, Feldman et al. 2018).

This ability of leaders to establish principles of purpose and justice within firms derives directly from the legal allocation of rights within a corporation. The firm’s control over employee inputs—such as loyalty and behavior—and not merely employee outputs allows principals and their delegates to promote activities consistent with a stated purpose. Voice rights provide a vehicle to articulate a firm’s purpose and to further reinforce consistent behaviors. The authority to determine the distribution of power, resources, and rewards largely unfettered by the intervention of the courts provides a broad capacity to manage justice within the firm. Moreover, the fact that these rights have been ceded by employees to employers elevates the employer’s responsibility to wield these rights in responsible ways that build a well-governed subsociety. Extending this discussion beyond firms to organizations more generally, as the nature of the authority varies, so, too, will the principles enacted and the resulting character of the subsociety.

In summary, firms—and formal organizations as a whole—meet the definition of subsocieties: They are (1) ordered communities formed for a particular purpose, (2) composed of individuals with moral values, and (3) governed by a central authority. Moreover, well-governed firms are those in which (4) principles of purpose and justice that guide leaders’ actions resonate with subsociety members. As such, firms can reasonably be conceived both as subeconomies and as subsocieties, subject to the same social considerations that influence societies more generally. These considerations have implications for the theory of the firm, particularly its boundaries—a topic to which we now turn.

## Implications for Organizational Boundaries

Although our theory has implications that extend to formal organizations of all types, we focus here specifically on firms, in order to contrast and relate our “firms as subsocieties” perspective to standard economic theories

of firms and their boundaries. In contrast to many social theories of organization and exchange that tend to ignore or undersell the importance of firm boundaries, in our theory, the firm boundary performs two vital functions. First, the boundary circumscribes subsociety membership, among which social responses to the authority’s moral choices are amplified. Second, firm boundaries are often in and of themselves decisions subject to social responses. This section discusses each of these two functions in turn.

### The Boundary as Social Amplifier

Leaders’ choices provide demonstrable manifestations of societal principles in practice. Absent observable actions, principles of purpose and justice are, by construction, abstract ideals. They move beyond “cheap talk” when they are the basis of concrete decision making and a visible exercise of authority within firms. These exercises of authority are assessed by members against leaders’ articulated principles to determine both how credible the principles are and what they actually mean in practice. This process reflects the act of meaning-making within organizations, as discussed by Podolny et al. (2004). These “agentic actions” create particular meaning in organizations, precisely because they can be “ascribed to an individual [the leader]” rather than “taken for granted” as part of the firm’s established routines (Podolny et al. 2004, p. 26). These visible, discretionary, and non-routine exercises of authority can either reinforce or undermine intangible moral principles that define purpose and justice within organizations, depending on how others assess their consistency with espoused principles.

Firm boundaries influence how those who interact with the firm perceive and respond to agentic actions by its leaders. As discussed above, unlike nonemployee stakeholders, employees cede substantial rights to the firm, including control over their daily work, duty of loyalty, compensation structure, dispute resolution, and voice. The resulting authority of leadership over employees leads to heightened expectations that this authority will be used responsibly. Actions and decisions deemed unjust or inconsistent with purpose therefore have social consequences that ripple through a firm, undermining identification and cooperation. Actions and decisions that are deemed fair and consistent with purpose also have social consequences, but in the opposite direction.

The range of choices and actions that will undergo moral scrutiny by subsociety members for their consistency with purpose and justice is, of course, expansive, but may relate to the allocation of resources, including pay, or decisions about the scope of the firm. For instance, if a leader chooses to internalize a particular activity within the firm, that activity becomes, to the employees, part of “what we do.” For that reason, if the activity is inconsistent with the principles of purpose or

justice of the firm, it will call into question the credibility of those principles, and employees' basis for identification with the organization. Consider the hypothetical examples of a hospital chain branching into cigarette manufacturing, a girls' empowerment magazine selling weight-loss drugs, a company committed to racial equity agreeing to be acquired by a company with a history of discrimination, or a patriotic defense contractor selling products to the home country's adversaries. In light of such actions, any speech by leaders about the company's principles now rings hollow, and the basis for identification with the organization is undermined.

Our focus on employees as subsociety members does not imply that actors external to the firm are indifferent to these actions. These external actors may also recognize when choices violate espoused principles of purpose and justice and may react negatively, particularly if personally impacted. Suppliers may care whether the firm's leaders negotiate fair contractual terms relative to those that others receive. Using our hypothetical expansion decisions above, customers may also care that the hospital chain makes cigarettes or that their favorite magazine sells weight-loss drugs. Our claim is not that nonemployee stakeholders are indifferent to the consistency of the firm's decisions with purpose and justice, but, instead, that employees will, in general, care more. They will scrutinize more carefully and respond more vigorously to actions that violate or reinforce purpose and justice, precisely because employees have ceded rights that empower subsociety leaders in ways that nonemployee stakeholders have not.<sup>6</sup> Stated from a different perspective, the employees of a focal firm may be appalled by purpose- and justice-violating actions taken by suppliers to their firm and may even react negatively toward their own leaders for choosing to contract with such suppliers. But the employees of the focal firm can only blame their leader for poor contracting judgment, and not for the supplier's purpose- and justice-violating actions themselves. Just as the noble or morally resonant actions of a supplier don't redound to the leaders of the focal firm, the purpose and justice violations of the supplier are not directly pinned on the leaders of the focal firm and, thereby, have a more muted social effect on the focal firm's subsociety members.

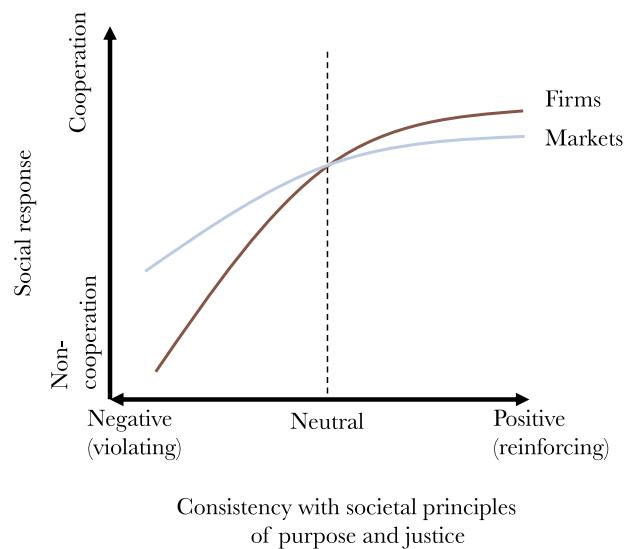
Figure 1 depicts this logic. The figure represents the cooperation-enhancing or cooperation-destroying social response within a focal firm or subsociety to an agentic action taken by leadership, as a function of its consistency with the societal principles of the firm. The x-axis depicts this consistency, with the center representing the indifference point at which the action is neither consistent nor inconsistent with the underlying purpose and justice of the firm, while the y-axis depicts the cooperation-enhancing or cooperation-destroying social

response of subsociety members to the action in terms of identification or alienation.

Two observations arise from this figure. First, and directly to our core argument, the steeper slope of the firm curve relative to the market curve depicts the heightened scrutiny and resulting social amplification that define the cooperative social response within firm boundaries. Starting at the indifference point in the center of the x-axis and moving right, the figure depicts that, when the agentic action reinforces principles of purpose and justice, the positive social response within the firm is amplified relative to the outside response. Conversely, on the left of the figure, where actions violate these principles, the negative social response is, again, more pronounced within firms. Engaging in actions that reinforce justice and purpose, therefore, is associated with higher effectiveness inside firms, whereas the opposite is the case for actions that violate these principles.

Second, the degree to which societal principles govern leaders' actions is, itself, a choice. The absolute steepness of the response curves will depend on the degree to which those in authority actively promote principles of purpose and justice. An organization that has, through its past actions, defined and reinforced a clear purpose and sustained a pattern of justice will have a steeper curve, rewarded more for actions that reinforce these principles and punished more for those that violate them. Religious institutions, nonprofits, the military, and many corporations with deep commitments to social missions likely fall into this category of steeply sloped response curves. By contrast, an organization with a pattern of past actions that has neither defined nor sustained principles of purpose or justice may see a more muted response, as reflected in a flatter

**Figure 1.** (Color online) Firms vs. Markets as a Function of Social Consistency



response curve. In this case, because no real purpose or principles of justice have been established, there is little basis for identification with the firm, and employment will be based on more instrumental logic. Using our hypotheticals above, employees of a defense contractor with no patriotic mission will likely have a more muted response to doing business with adversaries than employees of a contractor with a strong mission. Many corporations and other types of associations may fall into this category.

In this manner, the boundary of the firm functions to amplify the social response to agentic actions. The agentic actions taken by leaders within a focal firm prompt more scrutiny and a more robust response than actions taken by leaders of firms outside the focal firm, and these actions also prompt more scrutiny and a more robust response from employees of the focal firm than nonemployee stakeholders.

### The Boundary as an Outcome

We now consider the second function of boundaries in our theory, as the outcome of important agentic choices by leaders—choices that are themselves scrutinized for consistency with purpose and justice. Thus, although existing theories of firm boundaries evaluate the relative efficiency of governance modes, we suggest that there are comparative social benefits or costs of boundary decisions that must also be evaluated. Boundary decisions are, therefore, a joint function of efficiency effects covered in standard theories of the firm and the social spillover effects that arise from our subsociety perspective.

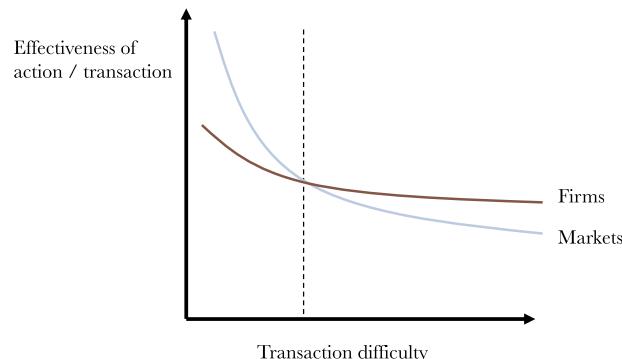
The intuition for the firm-market boundary choice in subeconomy theories is that firms internalize transactions when they are more difficult to execute, often because they demand specific forms of investment. Figure 2, reproduced from Gibbons (2005), illustrates this idea. The *y*-axis represents the effectiveness of the transaction, while the *x*-axis represents the difficulty of managing that transaction. Transaction difficulty is a general term that encompasses several theoretical ideas, including asset specificity, effort noncontractibility, and difficult measurement. In general, we observe that simpler transactions can be more effectively managed, regardless of whether they are located within or outside firms. The central insight is comparative: Markets generally outperform firms when transaction execution is easy, an advantage that gradually erodes and then reverses as difficulty increases.

Our subsociety view of firms suggests a different mechanism influencing firm boundary decisions. Boundary decisions, in addition to their efficiency effects discussed above, have social effects on the subsociety that relate to how these decisions reinforce or violate principles of justice and purpose. Our subsociety view of firms also has implications for scope decisions, more broadly, that are

interdependent with the boundary choice. To structure our logic, we acknowledge that, in regard to any proposed scope expansion of the firm, leaders face one of the three choices: (i) to internalize access to the identified activity, (ii) to outsource access to the identified activity, or (iii) to limit the scope of the firm altogether and not access the activity, either through contract or integration.

When the nature of the activity itself (or the actions of those who implement it) violates the focal subsociety principles, the associated loss of cooperation or other social costs may prompt those who lead the firm to outsource or disengage from an otherwise-valuable activity. Consider the decision by many energy firms to trade derivatives after power and natural gas markets were deregulated in the United States and Europe. As these derivatives markets boomed, top traders in these organizations were richly compensated to match Wall Street-style practices. This integration decision was perceived by many within the firms as violating principles of justice, as “20-something college boys” were perceived as making millions of dollars off the hard work of the core business. These trading units were eventually largely shuttered or sold to financial institutions, and the trading functions were outsourced to those same institutions. Although the companies explained their decisions as derisking their operations, in private, many executives expressed an alternate explanation—the need to eliminate the large compensation differentials, and associated discord, within the company. Or consider Google’s 2017 decision to enter a partnership with the U.S. Department of Defense and develop an internal business line focused on “algorithmic warfare.” The initiative was projected to earn Google an estimated \$250 million over the medium term. Word quickly spread throughout the company and set off an “existential crisis,” with more than 4,000 employees signing a petition that demanded Google commit to a policy of never building warfare technology (Shane et al. 2018). Protests reached such levels that Google’s management withdrew from the initiative at

**Figure 2.** (Color online) Firms vs. Markets as a Function of Transaction Difficulty (Gibbons 2005)



the time. In both of these cases, the activity violated core principles of the focal firm, resulting in outsourcing (energy firms) and disengagement (Google).

Alternately, in cases when activities support subsociety principles, the increased cooperation and other associated social benefits may encourage expanded boundaries. Consider the example of New York law firms that, in the wake of the September 11 terror attacks, noticed that their staff began to question their career paths (Carnahan et al. 2017). Firm departures—particularly to careers outside of law—substantially increased in the years after the attack. However, those firms that performed pro bono work in-house saw noticeably lower turnover rates, with their attorneys reporting “greater satisfaction from promoting social reform or helping a disadvantaged client” (Rhode 2003, p. 447, as quoted in Carnahan et al. 2017). In this instance, the choice to provide pro bono services in-house was not made because these activities were especially difficult to contractually manage. Instead, the decision to internalize pro bono work infused the firms as a whole with enhanced purpose, particularly valuable after a devastating tragedy.

In these illustrations, boundary choices were influenced by the social response of employees as members of a subsociety—negative in the case of Google and energy firms and positive in the case of the law firms. Whether the response is negative or positive in terms of identification and cooperation is determined by whether the boundary choices undermine principles of purpose and justice within the subsociety or whether they reinforce them.

Returning to Figure 2, we can see how the figure depicts not only the social amplifying role of boundaries, as discussed in the prior section, but also how this amplified scrutiny and social response shape the boundary choice itself. From the discussion in this section, we can reconceptualize this figure as denoting the boundary choice associated with the social consistency of a given activity with the subsociety principles. All else equal, firms will internalize activities if their consistency with purpose and justice is situated in the region in which the line demarking “firm” lies above the line demarking “market.” In other words, when an activity reinforces principles of purpose and justice within the firm (e.g., law firms and pro bono work), leaders will be more likely to internalize them. When an activity undermines these principles (e.g., Google or energy firms), leaders are more likely to outsource it (or, as we elaborate below, disengage altogether). This leads us to the proposition:

**Proposition 1.** *All else equal, firms are more likely to internalize activities that reinforce principles of purpose and justice, and less likely to internalize activities that violate these principles.*

Note that this logic—and consequent predictions—are distinct from subeconomy logic and predictions. In our case, the relative costs and benefits are driven by

employees’ social response to an activity, independent of the relative technical effectiveness that underpins standard theories.

Our focus leading up to Proposition 1 has been on the decision to internalize an activity. But, of course, firms also face the decision of whether to access an activity in any form, either internally or through outsourcing. Our theory addresses this choice as well. As discussed above, employees of a firm as members of a subsociety will assess the social consistency of all activities accessed by the firm, regardless of whether they are performed by employees or by other firms. However, for reasons highlighted above, subsociety members will give heightened scrutiny to activities under the control of their own leadership, prompting an elevated social response. To recall this logic, the nature of authority within firms provides leaders with more power to shape purpose and justice within their own organizations than supplier organizations. Employees therefore hold leaders responsible for the purpose- and justice-related choices that they are empowered to make—for instance, the choice to contract with a partner or supplier who makes choices that violate the focal firm’s sense of purpose and justice. However, the focal subsociety is less likely to hold its leaders directly responsible for the purpose- and justice-related choices of these suppliers. For example, Google’s employees would likely still have reacted negatively to a Google decision to partner with a third party who was the primary supplier to the Department of Defense (DOD), rather than working directly with the DOD as it chose to do. Their reaction under this counterfactual, however, would likely have been more muted. Not surprisingly, after employee protests over its DOD contract, the company chose to step back from the contract altogether, rather than restructure the activity to be at arm’s length. In this case, the negative social response associated with violating Google’s sense of purpose was too high, even if managed through a contract. Moreover, any effort to contract after the fact, once employees had protested the initiative, would likely have been perceived as an unprincipled effort to evade responsibility and prompted further backlash.

This response and choice contrast with our example of energy firms, many of which chose to outsource their trading operations to financial institutions once they closed their internal units, rather than disengage from them entirely. In this case, the negative social response from contracting with entities that offered such high employee pay did not trigger violations of justice that overwhelmed the benefits of accessing this activity through outsourcing. This logic leads to our second proposition, which speaks to the broader scope of a firm’s activities, whether accessed internally or externally:

**Proposition 2.** *All else equal, firms will likely not engage with an activity, even by outsourcing, if the negative social*

response of violating principles of purpose and justice by doing so are higher than any potential financial benefits.

**The Boundary as a Function of Both Transaction Costs and Social Consistency.** We now consider an integrated view of the subeconomy and subsociety theories of firms. One simple interpretation of the subeconomy theories depicted in Figure 2 is that the transactions being governed are simply “neutral” in their social consistency with the existing firm. Although this may be true in some instances, it need not be the case, as our illustrations suggest. Transactions performed to access activities, therefore, should be assessed both on their effectiveness and social consistency together.

This joint assessment is depicted in Figure 3. Along the vertical axis is transaction difficulty, the key determinant of boundaries under the subeconomy view. Along the horizontal axis is consistency with societal principles of purpose and justice, the key determinant of boundary choices under the subsociety view. Each quadrant represents predictions of the governance mode as a function of the magnitude of each factor. The diagonal quadrants contain the straightforward predictions: If the activity both demands high transaction costs to govern and is consistent with the societal principles of the firm, it is likely to be internalized (upper right quadrant). Similarly, if the activity demands low transaction costs and is inconsistent with the firm’s principles, it is likely to remain external to the firm.

The off-diagonal quadrants depict divergent subeconomy and subsociety effects. When the activity demands high transaction costs, but is societally inconsistent (upper left quadrant), managers must weigh the efficiency gains from internalizing the activity against the

**Figure 3.** Firm Boundaries as a Function of Social and Economic Logic

		Negative (violating)	Positive (reinforcing)
		Firm if costs from social contract violations lower than efficiency gains	Firm
Transaction difficulty	High		
	Low	Market	Firm if benefits from social contract reinforcement greater than efficiency losses

Consistency with societal principles of existing firm

costs of a negative social response. The Google AI illustration above, for example, falls into this quadrant and represents the managerial challenge of weighing potentially attractive market opportunity against the potentially harmful impact of violating societal principles. The flip side of this situation arises when the activity involves low transaction costs and, thus, is easy to contractually access, but it reinforces societal principles of the firm (lower right quadrant). The expansion by legal firms into pro bono work is an example of this condition, whereby the pro bono work itself did not represent a transaction particularly difficult to outsource, but it did reinforce a sense of purpose within these firms. This latter condition presents management with the need to weigh the potential inefficiency of internalizing these activities with the potential social benefits of their agentic actions. Their decisions, therefore, will depend on whether the social benefits (costs) outweigh the associated transaction costs (benefits) of a given option. They must, therefore, incorporate the full set of transaction and social costs and benefits all together when choosing their actions. This discussion above suggests the following pair of propositions:

**Proposition 3(a).** *When transaction-cost considerations suggest that an activity should be outsourced, firms may nonetheless choose to integrate if the benefits of reinforcing principles of purpose and justice outweigh the added transaction costs of integration.*

**Proposition 3(b).** *When transaction-cost considerations suggest that an activity should be internalized, firms may nonetheless choose not to internalize if the costs of violating principles of purpose and justice outweigh the reduced transaction costs of integration.*

## Discussion

Our aim in this paper has been to propose that firms are not mere subeconomies—aggregations of internally managed and sequentially assembled transactions—but also subsocieties, circumscribed by their boundaries and subject to the same divergent moral sentiments and social forces as the larger societies in which they are embedded. Within these boundaries, leaders possess authority to align moral sentiments, but also receive elevated scrutiny of purpose- and justice-related decisions, thereby prompting an amplified social response within firm boundaries that either elevates or undermines cooperation and identification. This view is not merely a relabeling of existing economic theories of the firm or a relabeling of social theories of organization that focus on identification. Relative to economic theories of the firm, our theory highlights principles of purpose and justice as central to characterizing firms and their boundaries and the accompanying role of authority in establishing these principles. Relative to social theories, our theory

highlights the central role of boundaries and authority in shaping identification and promoting the social health of the subsociety. In the process, our theory addresses the challenge articulated by Freeland and Zuckerman Sivan (2018)—that theories of the firm must explain why sometimes the sociality within organizations results in identification and cooperation, whereas at other times it results in alienation and discord.

Our theory provides an alternative explanation for firm boundary choices, as well as broader decisions about contracting and scope. In addition to transaction-cost considerations, leaders must contemplate the social spillovers related to upholding or violating principles of purpose and justice in decisions about organizational boundaries and scope. In some cases, activities that have no transaction-cost basis for integration are better integrated due to the positive social spillovers, whereas in other cases, activities that transaction-cost logic suggest merit integration, are best outsourced because their integration would violate principles of purpose and justice. Finally, in some cases, even outsourcing activities that violate purpose or justice may be insufficient to avoid substantial negative social spillovers and, as a consequence, may warrant limiting the scope of a firm's exchanges, and not just its boundaries.

Our theory most closely relates to several recent social approaches to the theory of the firm and boundaries. Nickerson and Zenger (2008) have focused on the effects of envy and social comparison on firm scope. In their view, firm boundaries demarcate social reference groups, within which individuals compare their own standing and performance along salient dimensions. These social reference groups can induce comparison costs within firms, particularly when the comparisons are perceived as inequitable. Our work echoes theirs in the sense that social comparison is an important dimension along which justice is assessed by individuals. Our focus, however, is on broader principles of justice—as well as purpose—that leaders must account for when making boundary choices and on the specific role of authority in shaping these principles. Our effort is also related to recent work by Freeland and Zuckerman Sivan (Freeland and Zuckerman Sivan 2018). Both approaches place the role of legal boundaries and allocation of rights within the firm hierarchy as foundational in differentiating firms and markets. The approaches differ, however, in the implications drawn. Whereas Freeland and Zuckerman Sivan focus on voice rights and how these are affected by boundaries, we focus on societal expectations and obligations that result from the legal structure and boundaries.

One potential critique of our work is that our arguments around purpose and justice could simply reflect additional factors to incorporate into the broad concept of transaction difficulty, along the lines of other transaction-specific factors, such as asset specificity, adaptability, and

contractibility (Gibbons 2005). On the one hand, we acknowledge the possibility of this simple additive approach. A transaction's consistency with purpose and justice could be just another transaction difficulty to factor into some joint optimization logic, along the lines of Figure 1. On the other hand, we see value in isolating these effects in order to understand how they operate, in much the same way that alternative theories of the firm have been composed that focus on asset specificity, adaptability, and contractibility (Gibbons 2005). Moreover, we view our theory of the firm as addressing more than simple boundary decisions. It is unique in highlighting the empowering role that firm boundaries play in allowing managers to broadly shape an organization's social function.

Our theory of firms as subsocieties relates to, but is conceptually distinct from, literature on organizational culture (Guiso et al. 2015, Chatman and O'Reilly 2016). Similar to organizational culture research, we are focused on what Pettigrew references as a "system of publicly and collectively accepted meanings" (Pettigrew 1979, p. 574) and the normative expectations that these prescribe (Schein 2010, Corritore et al. 2020). But we are particularly focused on those publicly and collectively accepted beliefs and sentiments related to purpose and justice. Similar to organizational culture research, we are interested in how shared beliefs and meanings form and then shape the behavior of subsociety members. Yet, our primary focus is on how leaders of a subsociety compose these shared beliefs through the use of authority and how the expectations of subsociety members then constrain leaders to take actions consistent with them. We recognize that the processes by which this alignment is achieved are vital to a theory of firms as subsocieties and are not fully developed in our theory. We speculate that leaders can facilitate alignment through several different means (Gibbons et al. 2021). First, in the spirit of Hofstede (1984), leaders may attract and select subsociety members with values and moral sentiments that align with those that the leaders seek to instill. Second, in the spirit of Schein (1996), leaders can actively change or shape purpose- and justice-related values and sentiments to appropriately align. Third, and finally, leaders can shape expectations of the firm's commitment to these values through a pattern of historic adherence to them. Of course, leaders may use all three mechanisms to compose a well-governed subsociety that promotes identification. Organization-culture research provides insights into these processes, but how these relate to our theory of firms as subsocieties and the role of firm boundaries awaits future work.

We recognize that our focus on purpose and justice as the principal's primary levers to shape identification in a subsociety may miss other important social levers and determinants of a well-functioning subsociety—in particular, those that appeal to deeply held values that

are shared (or potentially conflict) among members of the organization. We make no claim that our two categories of principles—purpose and justice—represent an exhaustive list. However, we deem them to be of particular importance or salience, as they roughly map to the two categories of moral evaluation—namely, “what is good” (purpose) and “what is right” (justice)—that are highlighted in moral philosophy.

### Implications Beyond Firms

Although our discussion has focused primarily on firms, our logic applies equally to other types of organizations as well. For example, nongovernmental organizations may choose to target some causes, but not others, and some churches may choose to engage in political activities, whereas others may emphasize providing local social services. Universities have been roiled by debates regarding the benefits of elaborate sports operations that provide resources, but are perceived to detract from the educational mission of the institutions. Conversely, universities have also offered educational programs to local communities to further their educational mission, despite the cost of these measures to the universities. Across all types of organizations, the general insight is that activities are more likely to be internalized when they are consistent with the espoused principles of the subsociety, but are otherwise likely to be outsourced.

These subsociety forces may also manifest differently across different types of organizations. For example, purpose is, by construction, more salient in hybrid organizations than in many for-profit firms. These organizations will therefore likely draw a pool of employees that have stronger-than-average preferences for mission-oriented work and whose values are congruent with the espoused purpose of their chosen firm. This selection process may, in turn, lead to stronger social amplification within these types of organizations that may constrain and enable action differently than what is possible in a conventional firm. Different types of organizations may also manifest justice differently, depending on the pool of employees they draw and their associated expectations. For example, a global firm that operates across many countries and cultures may adopt a more pragmatic sense of right and wrong than a local organization that draws employees from a monocultural context. These differences in how subsocieties manifest arise across types of organizations and how these differently shape the social response to leaders’ actions and decisions should be probed further.

### Implications Beyond Boundaries

We focused our main discussion on the implications of a subsociety perspective on firm boundary decisions. However, in highlighting the role of firm boundaries as a border that amplifies the scrutiny received and social

consequences of decisions made by leaders, we point to implications well beyond these boundary choices. The identification and cooperation benefits to aligning choices along principles of purpose and justice have implications for how leaders select among multiple objectives, including conflicting objectives that relate to value creation and corporate social responsibility (Wry and York 2017, Obloj and Sengul 2020, Battilana et al. 2022). Similar alignment benefits may also apply to how leaders navigate intertemporal and intraorganizational tradeoffs (Helfat and Eisenhardt 2004), including the ability of leaders to defer financial rewards to pursue other meaningful or purpose-related goals, as well as to maintain principles of fairness across time and throughout the organization. Decision patterns that support purpose and justice principles may also focus creativity, guide discretionary behavior, and contribute to breakthrough innovations (Henderson 2021). A track record of adherence to purpose and justice may also help in recruiting and retaining a skilled workforce (Carnahan et al. 2012, Burbano 2016, Carnahan et al. 2017), particularly one that values the advocated principles of purpose and justice. This view also has implications for work on strategy and identity (Anthony and Tripsas 2016, Ravasi et al. 2020)—work that highlights how “who we are” (identity) influences and is reinforced or undermined by “what we do” (strategy). Bringing these two views together, “who we are,” in turn, is shaped not only by cognitive mechanisms, but also by moral sentiments, or shared beliefs in purpose and justice that are, in turn, shaped by leadership.

Beyond strategic considerations, the intersection of organization and society raises the important question of how principles and values at the broader society level relate to those adopted inside organizations. In other words, how are subsocieties shaped by the societies in which they are embedded, and vice versa? This interplay is likely complex. As noted above, leaders may shape the subsociety principles in ways that attract and retain workers with shared preferences for purpose and justice, and firms may differentiate themselves on this basis (e.g., Nardi et al. 2022). This idea is related to research by Burbano (2016), Burbano et al. (2018), and Carnahan et al. (2017) on how firms can use a commitment to pro bono and socially responsible work as screening tools and nonmonetary compensation. In this sense, firms can be understood as a channel through which social preferences are fulfilled and benefit from the “social assets” they provide (Bénabou and Tirole 2011).

On the other hand, this interplay of society and subsociety principles may impose stresses on organizations. The post-2020 U.S. election turmoil among Facebook employees highlights this phenomenon: The company was widely accused of degrading public discourse during the election cycle, with ramifications for public trust

in the electoral process. This public censure penetrated the firm, impacting the morale and commitment of employees. Also within the United States, social issues regarding racial justice, abortion rights, and political polarization have similarly penetrated firms, raising employee expectations for CEOs to take public stances on these issues (Chatterji and Toffel 2018). Our theory suggests that this evolution in employee expectations about their subsociety's purpose and justice principles demand that leaders reevaluate choices, including choices about their scope and boundaries.

## Conclusion

The overriding aim of this paper is to demonstrate how firms can be characterized as subsocieties, a fundamentally broader construct than subeconomies, with ramifications for boundaries and the theory of the firm more generally. Formal authority, as distinctly enabled by the legal entity and boundaries more generally, shapes the subsociety within the firm and, in doing so, induces social responses of its members to managerial decisions. It is our view that this characterization of firms as subsocieties—with the attendant impact on decisions within and about firm boundaries—can explain important empirical regularities not well characterized by existing theories of the firm. By doing so, we hope to inspire future work on societal factors and moral sentiments that influence the behavior of organizations both within and across formal boundaries.

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## Endnotes

<sup>1</sup> Another approach is based on evolutionary logic (Nelson and Winter 1982) and resource perspectives (Penrose 1959). This theory of the firm conceives of firms as superior governance mechanisms for establishing routines and tacit knowledge compared to markets. These routines and knowledge, in turn, enable firms, under certain conditions, to respond to external conditions more efficiently than markets (Amit and Shoemaker 1993, Teece et al. 1997, Jacobides and Winter 2005, Helfat et al. 2009).

<sup>2</sup> Although sociality is an uncommon term, we found it to be most encompassing of the phenomenon that we aim to capture. The Random House Unabridged Dictionary of American English (<https://www.wordreference.com/definition/sociality>, accessed December 6, 2022) defines it as the “social nature or tendencies as shown in the assembling of individuals in communities.” In our usage, sociality extends beyond cooperation to encompass the full nature of social behavior of individuals in groups, including the socialization of group members and related beliefs, preferences, and behaviors.

<sup>3</sup> In fact, the litmus test in the U.S. Tax Code that legally separates an employee from a contractor is “whether the alleged employer ... has the right to control ... the details of the alleged employee’s work” (Pitts v. Shell Oil Co., 463 F.2nd 331 (1972), as cited in Masten 1988, p. 186). Following similar logic, independent contractors represent employers “only as to results of [their] work and not as to the means whereby it is to be done” (56 Corpus Juris Secundum 45; Restatement of Agency (2nd), 2, 14, as cited in Masten 1988, p. 186).

<sup>4</sup> As Freeland and Zuckerman Sivan (2018) highlight, a firm’s legal structure generates a *rights hierarchy*, whereby disputes between members are adjudicated up the hierarchy, with the “firm” as a legal personage at the apex, holding power to wield, delegate, and revoke these rights. A central outcome of the rights employees cede to firms is the capacity to flexibly resolve disputes surrounding how work is performed, what behaviors are appropriate, and what distribution of rewards is equitable. Within hierarchies, the resolution of these disputes can be “justified through reference to what ‘ought’ to happen based on the larger social purpose by which such rights are justified.” (Freeland and Zuckerman Sivan 2018, p. 146, emphasis ours).

<sup>5</sup> “Institutional integrity” meant to Selznick the degree to which the organization was guided by principles that reflected underlying values.

<sup>6</sup> This logic is based on the degree of rights exchange and power granted to leaders. Of course, there may be situations in which outside stakeholders similarly ceded rights and power to firm principals—for example, Dorobantu et al. (2017). These would be cases in which we would expect outside stakeholder evaluations to be more similar to, or even more pronounced than, those of employees.

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