

For Whom Does the Well Bankroll?

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Abstract

Many of the strategic management theories and frameworks are geared largely to a simple world where the firm is a unitary actor seeking to maximize the owners' residual. They are not designed to address a complex setting where value is created through a web of interconnected stakeholders with complementary capabilities. This whitepaper explores how theories or frameworks that treat firms as unitary actors (e.g., five forces, transaction cost economics alliance networks, or competitive dynamics) may offer misleading or incorrect conclusions in the absence of a stakeholder approach.

In a simple world where, for example, an oil well can be a key rent-generating asset and the gains from any advantage would accrue to the well's owners. Other factors of production would be traded in competitive markets and compensated according to their marginal contributions leaving the residual to owners. Agency theory concludes that shareholders are the only residual claimants because factors of production are assumed to be generic and traded in perfectly competitive markets (Asher, Mahoney, & Mahoney, 2005; Jensen & Meckling, 1976).

Many of the strategic management theories and frameworks are geared largely to this simple world where the firm is a unitary actor seeking to maximize the owners' residual. They are not designed to address a complex setting where value is created through a web of interconnected stakeholders with unique complementarities. Theories or frameworks that treat firms as unitary actors, such as five forces, transaction cost economics, alliance networks, or competitive dynamics, are ultimately grounded in this simple world.

Yet, there is also a strong acknowledgment, particularly in the context of the resource-based view, that value creation depends on idiosyncratic co-specialized resources and capabilities (Barney, 1991). These cannot be easily traded separately in competitive markets, so their external value is not reflective of their marginal contributions. Human capital theory, for example, tends to assume that workers with idiosyncratic skills only need to be compensated for their value in the next best use (Becker, 1964). The remainder would be captured by other stakeholders. However, stakeholders must cooperate closely to create value so fairness requirements dictate how value must be allocated. For this reason, the resource-based view has incorporated a stakeholder perspective more than other frameworks or theories in strategic management (Barney, 2018; Coff, 1999; Mahoney, 2006).

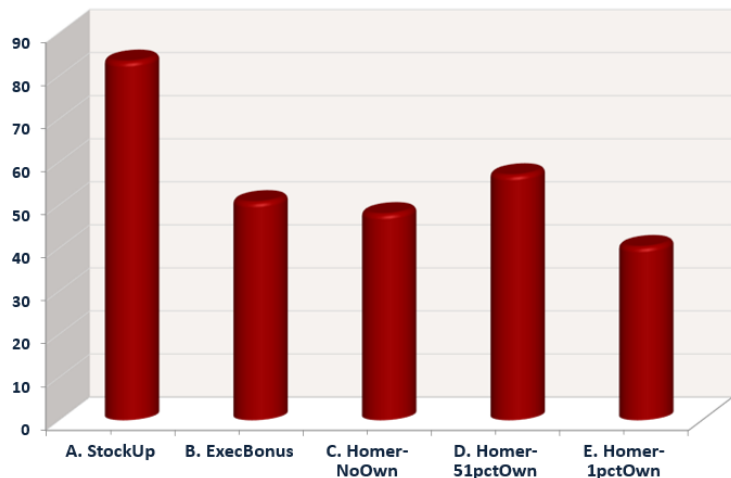
As mentioned, many theories still treat the firm as a monolithic entity aligned with the simple oil well example above. This does not reflect the contexts that are most often assumed in strategy formulation where stakeholders with unique complementary capabilities may value distinct strategic goals. That is, maximizing a simple goal like overall value creation may be quite misleading when stakeholders may consider an array of possible outcomes and value them differently. This whitepaper explores a few examples of theories or frameworks that could be augmented with a stakeholder perspective, and it would improve their predictive validity.

Misplaced Conclusions on Competitive Advantage

A key reason to be concerned is that consumers and users of the frameworks may make incorrect attributions. For example, imagine a series of scenarios where a firm and scientist have complementary capabilities that, when combined, would be superior to all rivals. Survey respondents are asked if each scenario is likely to result in a competitive advantage. The only difference between the scenarios was who captured value (investors, executives, or the scientist/Homer). In all cases, the key

resources are combined and retained over time since other firms lack the requisite complementary resources. However, the first graph to the right shows that many students perceive that there can

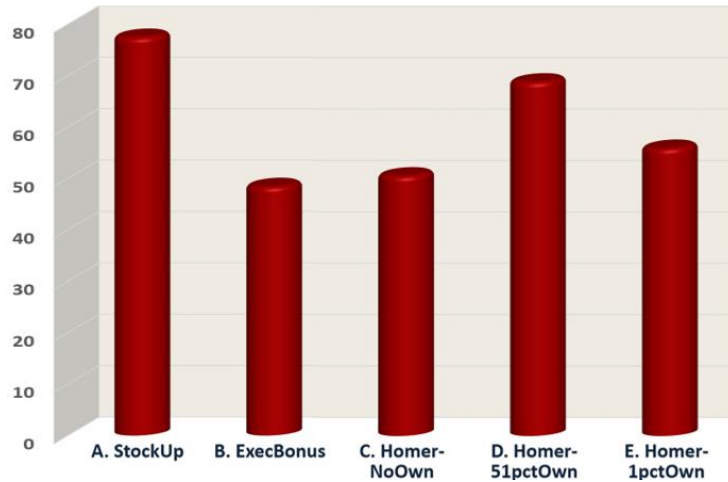
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only be a competitive advantage if the value is evident in stockholder returns (far left bar). The second graph shows a similar pattern for strategic human capital scholars. Interestingly, both

groups perceive a greater likelihood of a competitive advantage if the scientist owns a controlling interest in the company (4th bar in each chart). Nevertheless, in each case, the same unique complementary resources are combined (e.g., firm and scientist),

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retained, and continue to produce greater value than other firms in the industry.

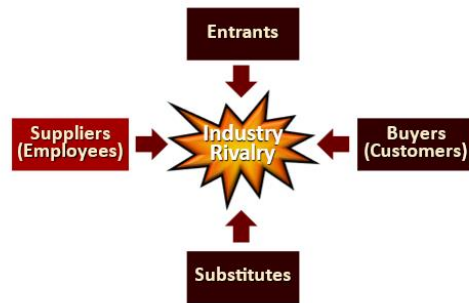
How Exclusion of Stakeholder Perspectives Limits Firm-Level Theory

In the following, we explore how the monolithic treatment of firms in various theories leads to incorrect conclusions within the context of those theories. That is, they do not correctly predict the intended outcomes. Admittedly, the stakeholder perspective pushes us toward microfoundations which have also been examined in the literature. While both encourage us to consider individual behavior, a distinction might be that a consideration of stakeholders also pushes us to explore differences in goals and outcomes for individuals. In this sense, it might be a subset of a broader scope of work on microfoundations.

The goal here is not to examine all monolithic theories, but rather to offer illustrative examples of how the lack of a stakeholder perspective may distort predictions in meaningful ways. Specifically, we examine Porter's Five Forces, Transaction Cost Economics, Alliance Networks, and Competitive Dynamics.

Porter's Five Forces: Employees are external suppliers?

The Five Forces framework (right) explicitly considers employees to be external suppliers (to the firm and the industry). This is somewhat at odds with the literature on internal labor markets which might suggest that employees



If employees aren't in the firm, who is?

are part of the firm as opposed to workers hired on a spot market (e.g., day laborers) (Baron, Davis, & Bielby, 1986; Bidwell, 2011; Lazear & Oyer, 2004; Williamson, 1975). If employees are not part of the firm, as suggested by this framework, who is part of the firm? The answer would seem to be only the investors or owners.

The framework implies that competitive advantage can (and should) be obtained by increasing bargaining power over employees and thereby appropriating value. From a stakeholder perspective, this might be considered to be a transfer of value within a firm and cannot be a source of competitive advantage between firms. The result might even be actions and policies that ultimately erode competitive advantage as the firm could lose (or choose not to invest in) critical resources. Indeed, since this framework is so widely taught, it may be a key reason why students and practitioners tie stock market returns so closely with competitive advantage.

Transaction Cost Economics (TCE) and Goals for Efficiency and Value Creation

Proponents of TCE would suggest that, in the search for efficiency, firms will optimize total value creation with the governance and production costs associated with different organizational forms (Nickerson, 1997; Williamson, 1991). However, a stakeholder approach may lead us to a

different process and perspective on how organizational forms are selected. For example, Coff (2010) describes how the organizational form selected for the iPod was driven more by rent capture concerns than it was by the goal of maximizing value creation. He notes that the entrepreneur, Tony Fadell, tried to develop the product on his own, eschewing the need for complementary assets, and when that was not possible, he chose not to work with firms that had the greatest complementary assets (Phillips and Real Networks). He chose instead to work with Apple Computers which had agreed in a lawsuit with Apple Records never to enter the music distribution business – streaming music was not part of their strategy at the time. Initially, Fadell joined Apple as an independent contractor and the design and production of iPods was outsourced to another company (PortalPlayer) under his direction.

The sequence of distinct governance structures in the iPod example illustrates how governance choices often cannot be predicted accurately using traditional TCE theory. Rather, value creation requires the assembly of distinct factors and resources where stakeholders weigh value capture regimes against the total value that could be created. However, the process is dynamic in that new resources are needed at different points in time. Each new stakeholder may disrupt the equilibrium and require new governance structures and/or value appropriation regimes.

Relatedly, central constructs in TCE, such as required asset specificity, are assumed to be easily observable by firms in order to select an optimal governance structure. However, asset specificity is notoriously difficult to observe or measure (Joskow, 1988) and recent work identifies that individuals' perceptions may be manipulated in negotiations to select the governance structure (Weber & Coff, 2023). Note that focusing on perceptions requires that we

explore how different stakeholders within and across firms may view these critical variables. For example, in the context of interfirm contracting, suppliers typically have an incentive to convince buyers that a given transaction requires greater asset specificity so they can increase the contract price. Consider the development of software solutions where the contractor has experience developing similar systems, but the buyer cannot easily observe the prior work. As such, a transaction may be framed as highly customized (requiring specific investments) that will increase the price. In the process, the governance structure may be distorted to support the higher price.

The sequence of distinct governance structures in the iPod example as well as the possible manipulation of perceptions in interfirm contracting illustrate how governance choices often cannot be predicted accurately using traditional TCE theory. Rather, governance structures are selected based on a consideration of stakeholders' value capture and their perceptions of the governance required by the context. This may require new governance structures and/or value appropriation regimes to obtain and deploy resources. Again, the need for diverse stakeholders with complementary capabilities means that TCE's governance logic is often missing important contextual elements.

Alliance Networks: Who makes connections?

Theory on strategic alliances draws on many different paradigms. Some of the work draws on TCE and thus carries some of the same challenges identified above (Reuer & Ariño, 2007; Somaya, Kim, & Vonortas, 2011). Other work draws on social networks and social capital theory to explain the emergence of alliances and their outcomes (Gulati, 1995; Yin, Wu, & Tsai, 2012). These theories typically draw on individual-level research on social networks to make predictions

in firm-level networks. That is, they treat each firm as a node in a network of alliance relationships. For example, a firm may occupy a structural hole and take advantage of brokerage opportunities (Ahuja, 2000; Walker, Kogut, & Shan, 1997).

However, alliances engender unique stakeholder relationships, and assuming that the individual-level theory extends to firms may leave out important context. For example, each alliance typically has one or more alliance managers. As such, exploiting brokerage opportunities may require that two different alliance managers within the focal firm are: 1) connected in the firm's internal network to identify the opportunity, and 2) motivated to cooperate to create the potential value. This may make them powerful stakeholders in the process but since theory treats the firm as a monolithic entity, this stakeholder management problem is not studied or addressed.

Competitive Dynamics: Individuals' Payoffs?

The competitive dynamics literature assumes firms select strategic moves based on a payoff structure that allows them to anticipate how rivals might respond to their moves (Dixit & Nalebuff, 1993; Gibbons, 1992). The broad assumption is that firms are unitary actors responding predictably to a set of incentives.

Returning to the points made about perception and TCE, the payoff structures are almost never known with any certainty and are therefore subject to the perception of various stakeholders within and across firms. Furthermore, the choice to pursue a given competitive action may be motivated as much by the potential payoff as how it might be allocated within the firm. Furthermore, the potential payoffs may be perceived differently by stakeholders within and across firms. Rather than having a simple payoff structure that a single actor responds to,

perceived payoff structures may result from framing contests among stakeholders within firms (Kaplan, 2008). Then the response to the perceived payoffs will likely reflect a balancing of distinct stakeholder objectives as opposed to a simple profit maximizing goal. While this makes prediction much more challenging, these internal stakeholder processes may be more representative of how competitive actions are ultimately selected.

Discussion and Conclusion

Here, we have explored just a few theories and frameworks that treat firms as monolithic actors. However, these are enriched by exploring how individual stakeholders may be incorporated into the process. Incorporating individuals in this way is a basic microfoundational approach. However, beyond this, incorporating stakeholder theory will push scholars to consider how the application of these theories affects different stakeholders' outcomes. This goes well beyond traditional microfoundational approaches.

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