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Managing for Stakeholders, Stakeholder Utility Functions, and Competitive Advantage

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MANAGING FOR STAKEHOLDERS, STAKEHOLDER UTILITY FUNCTIONS AND COMPETITIVE ADVANTAGE

Keywords: stakeholder management, competitive advantage, stakeholder utility

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ABSTRACT

A firm that manages for stakeholders allocates more resources to satisfying the needs and demands of its legitimate stakeholders than what is necessary to simply retain their willful participation in the productive activities of the firm. Firms that exhibit this sort of behavior develop trusting relationships with stakeholders based on principles of distributional, procedural and interactional justice. Under these conditions, stakeholders are more likely to share nuanced information regarding their utility functions, which increases the ability of the firm to allocate its resources to areas that will best satisfy them (thus increasing demand for business transactions with the firm). In addition, this information can spur innovation, as well as allowing the firm to deal better with changes in the environment. Competitive advantages stemming from a managing-for-stakeholders approach are argued to be sustainable because they are associated with path dependence and causal ambiguity. These explanations provide a strong rationale for including stakeholder theory in the discussion of firm competitiveness and performance.

One of the primary objectives of the strategic management literature is to explain why some firms outperform other firms (Rumelt, Schendel and Teece, 1994). Stakeholder concepts played an important role in this discussion during the early development of the field. For example, Taylor (1971), in a review of corporate strategy practices, suggested that the importance of stockholders would eventually give way to a planning approach that incorporated a broader group of stakeholder interests. As modern strategic management emerged, many other authors incorporated a stakeholder perspective into their strategic management models and ideas (i.e., Dill, 1975; Mitroff and Emshoff, 1979; Newman, 1979; Taylor and Sparkes, 1977; Wommack, 1979). The common denominator among all these early works was the argument that to achieve high performance firms should adopt a broad strategy-making perspective that incorporates the needs and demands of multiple stakeholder groups.

Through the 1980s and early 1990s stakeholder theory did not play a prominent role in the strategic management literature, but continued to be developed by a small group of management scholars (Freeman, et al., 2009). Recently stakeholder theory has increased in importance in the strategy/performance discussion (i.e., de Luque *et al.*, 2008; Godfrey, 2005; Harrison and Freeman, 1999; Hillman and Keim, 2001; Sisodia, Wolfe and Sheth, 2007; Walsh, 2005). The increase in attention to stakeholder theory may be partly a result of heightened interest in theories that are considered to be ethically based, in light of increases in corporate wrongdoing. Moreover, the increase in interest is also likely to be due to recognition of the importance of stakeholder relationships to the acquisition and development of competitive resources (Dyer and Singh, 1998; Gulati, 1999).

The stakeholder position that seems to raise the most controversy regards the degree to which firms should allocate firm value to satisfying the needs and demands of a broad group of

stakeholders beyond what is necessary to simply maintain their willful participation in the workings of the firm (i.e. Harrison and Freeman, 1999; Jensen, 2001). Some firms allocate both value and decision-making influence widely across their stakeholder networks (Sisodia *et al.*, 2007). In this paper, we refer to this sort of firm behavior as "managing for stakeholders" (Freeman, Harrison and Wicks, 2007). This management approach is in contrast to what a more direct shareholder wealth maximization objective function might otherwise prescribe (cf. Friedman, 1962; Jensen, 2001). As Sisodia *et al*. (2007: 17) express it, "How is it that these companies can be so generous to everyone who costs them money (customers, employees, suppliers, communities) and still deliver superior…returns to investors?"

Most studies that have made use of comprehensive stakeholder models are supportive of a positive relationship between managing for stakeholders and firm performance (i.e., Berman et *al.*, 1999; Hillman and Keim, 2001; Preston and Sapienza, 1990; Sisodia *et al*., 2007; Waddock and Graves, 1997). Sometimes studies that demonstrate a positive relationship between corporate social responsibility and firm performance are also cited in defense of stakeholder theory (Orlitzky, Schmitdt and Rynes, 2003). However, these studies tend to focus on social issues like the environment or adherence to government regulations. *From its early development, the stakeholder concept has emphasized effective management of a broad group of stakeholders rather than social responsibility* (Freeman, 1984; Walsh, 2005). Over-emphasis on society (broadly defined) as a stakeholder seems to have led some strategic management scholars to believe that stakeholder theory is about managing social interests responsibly rather than managing a firm effectively. Moreover, such an emphasis may have actually undermined the rigor of the theory in explaining competitive performance (Hillman and Keim, 2001).

Consequently, we want to say from the outset that the focus of this paper is on stakeholder theory as originally defined (Freeman, 1984) and *not* on corporate social responsibility.

In spite of the volume of literature on the topic of stakeholder management and performance, there is not much in the research literature that systematically describes, at the level of a firm's relationship with a stakeholder, how a particular type of stakeholder treatment leads to competitive advantage. The predominant arguments focus on attraction of stakeholders to a firm or its products (i.e., Turban and Greening, 1996; Jones, 1995) or on increasing a firm's ability to plan through coordinating multiple stakeholder contracts over time (Freeman and Evan, 1990). Other explanations focus on reducing the potential for loss of value, such as expenses associated with adverse legislation, regulatory penalties, or consumer retaliation (i.e., Godfrey, 2005; Graves and Waddock, 1994; Spicer, 1978).

The literature on trust is helpful in understanding why a particular type of stakeholder treatment may lead to competitive advantage. Mayer, Davis and Schoorman (1995) suggest that trust can lead a party to be "vulnerable to the actions of another party (712)." Consequently, stakeholders that trust a firm may be willing to reveal sensitive or private information because of a belief that it will not be used in a manner that is contrary to their best interests. Information that is gained through trusting relationships can be used to create value (Barney and Hansen, 1994). However, trustworthiness is only one element (albeit an essential one) to unlocking this sort of knowledge. A firm can be trustworthy yet not allocate value and decision making influence broadly across its stakeholders. From a rational perspective, simply trusting someone probably is not sufficient cause to divulge sensitive or private information. We explain how distributional, procedural, and interactional justice, with their accompanying concepts salience, reciprocity, and generalized exchange, facilitate the acquisition of knowledge about stakeholder utility functions.

After examining the factors that facilitate acquisition of knowledge about stakeholder utility functions, we explain how this knowledge allows a firm to take advantage of market imperfections giving rise, in turn, to value creation opportunities (Barney and Hansen, 1994). Utility functions include both factors that drive utility for stakeholders and the weightings stakeholders assign to these factors. We explain how nuanced knowledge of factors and their weightings can lead to fine tuning of firm tactics, resource allocations and strategies. Such knowledge may also lead to product and process innovations and an enhanced ability to deal with unexpected changes in the environment. These arguments are developed in light of theory regarding how economic rents are distributed among stakeholders (Blyler and Coff, 2003; Coff, 1999).

After establishing (1) how managing for stakeholders unlocks knowledge about stakeholder utility functions and (2) how this knowledge can lead to value creation opportunities, we then examine whether this type of stakeholder management behavior is likely to lead to a competitive advantage and whether the advantage is sustainable. As we make these arguments we extend the concepts developed herein to the level of multiple stakeholders, exploring the issue of whether firms are better off if they provide the same sort of treatment to all of their primary stakeholders or if they "pick and choose" the stakeholders and contexts in which to manage for stakeholders. We conclude that a consistent management approach is more likely to provide the advantages explored in this paper.

This paper integrates some of the central concepts of stakeholder theory with the literatures on organizational justice and trust to explain firm competitiveness. It provides a detailed exploration of factors that facilitate acquisition of knowledge about stakeholder utility functions. In addition, it offers a knowledge-based analysis of how firms that manage for

stakeholders can enjoy sustainable competitive benefits. These explanations provide a strong rationale for including stakeholder theory in the discussion of firm competitiveness and performance.

STAKEHOLDER THEORY AND MANAGING FOR STAKEHOLDERS

In this paper we define stakeholders as groups and individuals who can affect, or are affected by, the strategic outcomes of a firm (Freeman, 1984; Jones and Wicks, 1999). Of course, this definition can be defined so broadly as to render the stakeholder concept meaningless (Donaldson and Preston, 1995; Phillips, 2003). As Mitchell, Agle and Wood (1997) point out, "the broad concept of stakeholder management must be better defined in order to serve the narrower interests of legitimate stakeholders. Otherwise, influencing groups with power over the firm can disrupt operations so severely that *legitimate* claims cannot be met and the firm may not survive (122)." Consistent with our interest in competitive performance, we include in our conceptualization those stakeholders that are most closely associated with the firm's operations or objectives. These include primary organizational stakeholders such as employees and managers, customers, suppliers, and the firm's owners (i.e., shareholders, partners and/or members). We acknowledge that the concepts we are discussing may apply to other key stakeholders which will vary from firm to firm. However, we have selected a group for discussion that is likely to be highly salient to practically all firms. We have deliberately excluded stakeholders whose objectives are not closely tied to the firm's operations or objectives (i.e., Hillman and Keim, 2001; Walsh, 2005).

The stakeholder perspective envisions a firm at the center of a network of stakeholders (Rowley, 1997), a complex system for exchanging goods, services, information, technology, talent, influence, money, and other resources (Freeman, 1984). Freeman (1984) and the authors

of subsequent developments in stakeholder theory (e.g., Post, Preston and Sachs, 2002; Phillips, 2003) build their logic from an assumption of an efficient market while giving the welfare of the firm top priority. In an efficient market, for-profit business firms that serve stakeholders purely for altruistic purposes are not likely to prosper or even survive. Stakeholder theory argues that firm welfare is optimized by meeting the needs of the firm's important stakeholders in a win-win fashion (Walsh, 2005). This instrumental view of stakeholder theory suggests that firms that attend to the interests of a broad group of stakeholders enjoy higher levels of performance than firms that focus primarily on one or a few stakeholders (Donaldson and Preston, 1995; Jones, 1995).

As we mentioned previously, we use the term "managing for stakeholders" to describe firms that allocate both value and decision-making influence widely across their primary stakeholders (Freeman *et al.*, 2007). Jones, Felps and Bigley (2007) distinguish between firms that "always regard the interests of legitimate stakeholders as at least moderately salient (152)" and those that are willing to violate their standards for treatment of stakeholders "whenever it is economically *advantageous* to do so (149)." The firms we are describing in this paper tend to be consistent in their treatment of stakeholders. They may do so because they believe (1) it is the right way to treat stakeholders (normative view), (2) it is economically advantageous (instrumental view) or (3) both of these. We do not mean to imply that the differences in motivation are trivial; however, the focus of this paper is on the possible outcomes of a particular type of behavior rather than on the motivations for the behavior. Even within a firm that manages for stakeholders, there is likely to be a range of perspectives among individual employees and managers regarding the reasons the firm pursues such an approach.

Firms that manage for stakeholders allocate more value than what is necessary simply to maintain their willful participation in the workings of the firm. This statement implies that, from a traditional microeconomic perspective, firms overinvest in some stakeholders (Freeman *et al.*, 2007). For instance, in the case of customers, traditional microeconomic theory suggests that (absent perfect price discrimination) the only customer that is not receiving a surplus is the last customer served (the price point at which supply meets demand) and that a firm might ask a price that is lower than necessary because of uncertainty with regard to demand characteristics. The primary difference between this traditional view and our perspective is *intentionality*. The firms we are describing intentionally allocate more value to stakeholders than what the market might otherwise require. Consider, for example, a chain of coffee houses that provides health benefits to their part-time employees even though doing so is not industry practice. That same company pays its suppliers more for its coffee beans than the market requires. Companies like this are intentional in their efforts to optimize the value of their relationships with stakeholders. In contrast, “satisficers” may attempt to offer jobs that are barely sufficient to retain employees or offer products that are just good enough. One of our contentions in this paper is that such firms are missing opportunities for value creation that might otherwise be available to them.

There is also an inherent assumption in our approach that suggests firms that manage-for-stakeholders have fairly accurate information regarding what the minimum requirements for stakeholder participation might be. The market can help to provide this information, as in our example of a company that knows it is providing benefits that are not normally provided in the industry. However, as we will discuss later, firms that manage-for-stakeholders are expected to be in a favorable position with regard to understanding stakeholders’ utility functions. This information allows for a better understanding of minimum stakeholder requirements.

The managing-for-stakeholders approach is in contrast to what might be called an "arms-length" approach to stakeholder management. From the arms-length perspective, stakeholders are considered interchangeable economic actors. Power is the primary criterion with regard to influence over both firm decisions and value distribution. Consequently, stakeholders are given voice only if it is obviously in the best interests of the firm to do so, and value is distributed according to negotiations in which each stakeholder must fight for their own interests.

At this point, three acknowledgements are in order. First, these two perspectives are intentionally stylized for purposes of our analysis. Few firms fall in perfect alignment with either perspective. Nevertheless, firms tend to favor one approach over the other, at least by degree, as indicated by numerous empirical studies (i.e., Berman, et al., 1999; Hillman and Keim, 2001; Preston and Sapienza, 1990; Waddock and Graves, 1997). Second, we should point out that investments in stakeholder relationships are neither a managerial panacea nor a "rule for riches". We do not argue that incremental investments in stakeholder relationships, as a resource, will *always* result in superior firm performance. Firms can invest unwisely in stakeholder relationships and effective stakeholder management, like all management, is a difficult and uncertain process. Finally, we do not assert that all sustainable competitive advantages stem from a managing-for-stakeholders approach, but rather that this approach is a potentially powerful source of such advantages. As such, we are attempting to explain one aspect of firm competitiveness.

We now further develop our perspective that managing for stakeholders allows a firm to acquire nuanced knowledge about stakeholder utility functions, which can lead to competitive advantage. Figure 1 provides a roadmap of these arguments and, thus, the remainder of this manuscript.

(Insert Figure 1 about here)

MANAGING FOR STAKEHOLDERS AND STAKEHOLDER UTILITY FUNCTIONS

A firm that manages for stakeholders seeks to identify and understand how the welfare of its stakeholders is affected by the actions it takes. It also seeks to act in a way that demonstrates to stakeholders that it understands and respects how their welfare is affected. Welfare refers to the well being of an individual or group and is often conceptualized by a utility function. In this paper the relevant "utility function" of a stakeholder specifies that stakeholder's preferences for different combinations of tangible and intangible outcomes resulting from actions taken by the firm. A stakeholder can refer to an individual (e.g., a resource broker), to a collection of individuals (e.g., a labor union), or to a firm (e.g., a business customer). A firm that seeks to understand a stakeholder's utility function is actually seeking two types of knowledge. First, it wants to know which factors are driving the utility of the stakeholder. Second, it is seeking knowledge about the relative weighting of each factor in determining total utility. For instance, a customer may value a number of features in a product it buys from the firm; however, those features are not of equal importance to the customer.

Stakeholder utility functions can change due to a number of factors, including innovations, new firms entering and incumbent firms exiting an industry, and social influences or trends. As a result, stakeholders continuously update their preferences and utility functions as the alternatives available to them change (Hayek, 1945). Still, at any point in time, most economic actors can articulate ways their welfare could be improved. The reason why their welfare (in one particular dimension) is not optimal is that the offers currently available in the market – their alternatives – do not match with the vector of factors that determine their utility and/or the relative weightings of those factors.

A stakeholder may reveal factors and weightings that comprise their utility function to a firm in the hope that the firm will either (1) present an existing offer (i.e., value proposition) of which the stakeholder is currently unaware or (2) design a new, innovative offer that improves their welfare. Arrow (1974) points out that assuming an individual agent knows all of the production possibility sets and prices of the goods she buys and sells is unrealistic. Missing markets for future goods continue to exist because agents do not have access to the same observations about the world (Arrow, 1974; Hayek, 1945). Arrow (1974) articulates that agents enter exchanges based on considerations of both present and future consumption and production plans. "Any variables which improve his ability to predict the future have a very large meaningful economic value to [an agent … thus,] … he will seek to acquire additional information" (Arrow, 1974: 7).

The same is true for firms. Firms selectively reveal elements of their own utility functions to stakeholders in an effort to receive better value propositions of which the firm is not aware or to design (or co-create) a new, innovative offer that improves its welfare. Like its stakeholders, a firm's utility function is not transparent, nor is it derived exogenously. The interdependence of stakeholders' and firms' utility functions grows as both become more informed by alternatives outside the relationship as well as new, innovative alternatives that arise from within the relationship.

If revealing information about utility functions is potentially beneficial to stakeholders, then why don't they freely reveal this information so that firms in the market can structure offers through which their welfare can be improved? The reason is that such behavior can also result in *lower* stakeholder welfare. By revealing both the vector of factors that determine their utility and the relative weightings of those factors to a firm, a stakeholder enables that firm to compare its

offerings to the stakeholder's next best alternative (i.e., its opportunity cost). Some firms (referred to in our paper as those taking an "arms length" approach) would use this information to exploit the stakeholder by structuring an offer that distributes zero stakeholder surplus and appropriates maximal firm surplus. Stakeholders who expect such treatment have incentive to reveal only their bargaining positions (Fisher, Ury and Patton, 1991).

Consequently, trust—defined as "the mutual confidence that no party to an exchange will exploit another's vulnerabilities" (Barney and Hansen, 1994: 176; Sabel, 1993) —is one of the ingredients essential to sharing of utility functions. However, trust is not sufficient alone to motivate a stakeholder to reveal its utility functions. A rational stakeholder will reveal such information only if they believe that doing so will improve their own position. For example, an employee may share information that will improve the processes of the organization if they believe the organization will listen to them and that ultimately the value created will be fairly distributed by the firm, which means that the employee will also reap benefits. As another example, a party to a venture might reveal technical knowledge it possesses to one of its venture partners, fully recognizing that the partner can use the information to improve its own operations, if it also believes that ultimately the new value that is created will be fairly distributed by the partner. These two examples imply that trusting relationships exist, but they also demonstrate other important facilitators such as salience, distributional justice and reciprocity. These facilitators are discussed in the next section.

Facilitators to Obtaining Information about Stakeholder Utility Functions

One conclusion upon which stakeholder theorists are practically univocal is that justice and fairness are core considerations in managing for stakeholders (i.e., Bosse, Phillips and Harrison, 2009; Donaldson and Preston, 1995; Jones and Wicks, 1999; Mitchell *et al.*, 1997;

Phillips, Freeman and Wicks, 2003). At least two essential facilitators lead to the types of relationships that unlock nuanced information about stakeholder utility functions. They are (1) a history and expectation of fair distribution of value to stakeholders and (2) a history of giving voice to stakeholders as managers make strategic decisions.

Distributional justice and reciprocation. The phenomena of creating and distributing value are inseparable aspects of an integral structure. Managers exercise at least some discretion with regard to how firm value is distributed (Hambrick and Finklestein, 1987**;** Shen and Cho, 2005). In firms that create a large amount of value, discretion is increased. As we mentioned previously, firms that manage for stakeholders use their discretion to allocate value more widely across their stakeholder networks than a direct, short-term shareholder wealth maximization objective function would prescribe (cf., Friedman, 1962; Jensen, 2001). This concept is related to what some micro-economists might call overinvestment. The managing-for-stakeholders approach is manifested by outcomes such as more employee stock grants or options, better customer satisfaction guarantees, better service, sharing cost savings with collaborative suppliers, or higher returns for shareholders, relative to other firms in the same industries and locations (Sisodia *et al.*, 2007). We should clarify at this point that distributional justice demands a fair distribution of value, not an equal distribution (Adams, 1965; Phillips, 2003). Consequently, stakeholders that provide more to the value creation process should enjoy greater benefits.

The concept of reciprocity is at the heart of understanding perceptions of fairness between firms and stakeholders and the behaviors that are manifested as a result of these perceptions (Bosse, *et al.,* 2009). Reciprocity is what Donaldson and Dunfee (1994) call a hypernorm – a universally accepted moral norm (Dunfee, 2006; Phillips and Johnson-Cramer,

2006). It involves mutual reinforcement by stakeholders of each other's actions (Simon, 1966).

Three basic forms of exchange define the level of anticipated reciprocity between or among stakeholders: negotiated, reciprocal and generalized. A negotiated exchange is similar to what we have been calling an arms-length transaction. The terms of the exchange are negotiated and the benefits of the exchange to both parties are direct (Molm and Cook, 1995). The parties to the exchange give little attention to the potential benefits associated with developing a stream of exchanges with the same partner. Reciprocal exchange involves bilateral exchanges in which the benefits are derived, at least in part, in different episodes (Emerson, 1976). In other words, contributions to the exchange do not require immediate reciprocation.

Direct reciprocity helps to explain why stakeholders and firms might be willing to reveal their utility functions to each other in the quest for joint value creation. A firm that is perceived of as fair and respectful of reciprocal obligations is one that is less likely to act opportunistically when sensitive utility functions are revealed. The longer reciprocity is observed, the greater the confidence that it will continue to be observed as the parties' mutual vulnerability increases. However, sometimes no direct benefits accrue to a particular stakeholder, a situation that may be explained by a form of reciprocity called generalized exchange.

Generalized exchange involves three or more actors who are part of an integrated transaction in which there is no one-to-one correspondence between what they directly give to and take from another (Ekeh, 1974). Reciprocations are indirect. Generalized exchange also explains situations in which significant time elapses between events that are significant to stakeholders (Wade-Benzoni, 2002). Stakeholders have memories and expectations. A firm may make a decision or pursue a course of action that is inconsistent with the desires or needs of a stakeholder at one point in time; however, that stakeholder can put the decision or action in the

context of other decisions or actions the firm has pursued in the past or is expected to pursue in the future. Because considerations of fairness and justice go both ways – the firm towards its stakeholders and stakeholders towards the firm (Dill, 1975; Goodstein and Wicks, 2007) – stakeholders can be expected to understand and accept alternatives that make some actor in the firm's stakeholder network (with a given amount of bargaining power) better off without making any other actor (with more or less bargaining power) in the stakeholder network worse off. However, over time most stakeholders arguably expect that at least some of the decisions or actions of the firm will enhance their own welfare.

Generalized exchange helps explain the willingness of suppliers to re-write a contract or employees to take a pay cut, as long as their views are considered and there is an expectation that their interests will be addressed in the future. They may believe that the decision will advance the good of other stakeholders that are a part of a firm's network (the greater good) or they may put the decision in the context of other decisions the firm has made or is expected to make. This is especially important because firms cannot completely satisfy all of their stakeholders, nor is any one decision likely to be perceived as maximizing any one stakeholder's utility function. Instead, firm decisions involve a balancing act over time.

Before proceeding, we should acknowledge that firm allocations of value to stakeholders are influenced, sometimes dramatically, by the power of particular stakeholders (Coff, 1999; Freeman, 1984; Frooman, 1999; Porter, 1980) and by the firm's dependence on them to obtain needed resources (Pfeffer and Slancik, 1978). Powerful stakeholders can extract value from a firm in a variety of forms. For instance, a powerful customer can insist on a high level of service or a powerful supplier can demand higher prices. Arguments regarding distributive justice are strongest in situations in which dramatic power imbalances do not exist. In fact, firm discretion

may be dramatically reduced in situations in which a stakeholder has substantial power (and insists on using it), even to the point that distributive justice is no longer effective.

It is also important to distinguish between the value that a firm creates and its accounting-based bottom-line profitability. A firm with low accounting-based profitability may create a lot of value but allocate most of it to stakeholders such as customers, suppliers or employees during the normal course of business (Coff, 1999). Alternatively, a firm with high profitability may either have a lot of value to distribute or may be under-allocating value to particular stakeholders. We would argue that a firm in the latter situation is unlikely to enjoy the benefits discussed in this section.

Stakeholder salience, procedural and interactional justice. Firms that manage for stakeholders give salience to multiple and often competing stakeholder interests when they make decisions (Mitchell *et al*., 1997). These firms are more likely to employ systems that promote stakeholder communication and discourse of sensitive information than other firms. This promotes a perception of both procedural and interactional justice.

Procedural justice refers to a stakeholder's perception of how fair a decision making process is (Lind and Tyler, 1988). Phillips, et al. (2003) argue, "Stakeholder theory is concerned with who has input in decision-making as well as with who benefits from the outcomes of such decisions. Procedure is as important to stakeholder theory as the final distribution (2003: 487)." If one of the key factors of a stakeholder's welfare is to have their concerns heard and their voice included in decision analyses, then a firm that explains to a stakeholder the alternatives it faces and the process through which it makes decisions will be improving that stakeholder's welfare. Often stakeholders' utility functions incorporate the effect on welfare from tradeoffs of

intangible (e.g., self-image, fairness, process, relationships) as well as tangible (e.g., cost, time, quality) outcomes.

Closely related to the concept of procedural justice is what scholars have come to call interactional justice, which refers to fairness in the way that stakeholders are treated in transactions with the firm (Cropanzano, Bowen and Gulliland, 2007). Appropriately sharing information and treating shareholders with respect is consistent with a managing-for-stakeholders approach. It is also important as a precondition to developing the level of trust necessary for obtaining information about stakeholder utility functions. Together, procedural and interactional justice compensate for the fact that a genuinely fair distribution of tangible value among stakeholders is elusive (Brockner, 2006). In other words, although a stakeholder may not believe that their portion of the value distributed to them is precisely fair, they may still believe that processes are fair and that they have been treated with respect.

The firm behavior described in this section is not "free." Managers in firms that exhibit procedural and interactional justice expend large amounts of time giving voice to stakeholders through meetings and other forms of communication. They also communicate with stakeholders regarding their decisions and actions. In addition, as they give salience to multiple stakeholder perspectives in their decisions, some of their decisions will lead to allocation of additional resources to stakeholders that might not have been allocated otherwise. These costs represent a form of overinvestment in stakeholders to the extent stakeholders receive more utility than they would get from their next best alternative.

Thus far we have discussed why firm behavior associated with managing for stakeholders may allow a firm to obtain enhanced knowledge about stakeholders' utility functions. We now

turn to the issue of how this knowledge can be translated into the creation of additional value leading to competitive advantage.

STAKEHOLDER UTILITY FUNCTIONS AND COMPETITIVE ADVANTAGE

Competitive advantage is often thought to be related to possession of resources that are valuable, rare, and non-substitutable (Barney, 1991). Furthermore, if these types of resources are also difficult or costly to imitate, then the advantages they provide may be sustainable over time. We begin this section with a discussion of how nuanced information about stakeholder utility functions can create additional value. We then discuss factors that help to determine if the competitive advantages associated with the ability to obtain this information are likely to be sustainable.

Creation of Value

Assuming that a firm is able to obtain nuanced information about the factors that drive a stakeholder's utility function and that the firm also has some notion of the importance of these factors to the stakeholder's total utility, how can this information be translated into the creation of additional value? Although it may be possible to extrapolate a number of possibilities for value creation, three stand out due to their potential magnitude: increased demand and efficiency, increased innovation, and greater ability to deal with unexpected changes in the environment.

Increase in demand and efficiency. A firm can use nuanced information about stakeholder utility functions to shift the demand curve for its products, services, and business transactions. In the case of customers, we are referring to the basic economic concept that, with a shift in the demand curve to the right, demand for a firm's products will be greater at a given price. In this case, the shift comes from the ability of the firm to fine tune its product offering to better satisfy customers' utility functions.

A similar concept can be applied to other primary stakeholders. Firms that really understand their stakeholders' utility functions are in a better position to successfully complete a transaction with them, whether it is a sale (customer) or a contract for needed services (employee or supplier). They are in a better position because they understand what is important to each stakeholder in terms of both utility factors and their weightings. Basically, the demand to do business with the firm increases, thus increasing the ability of the firm to grow. Stakeholders are drawn to the firm because they have higher utility in doing business with the firm compared to other firms.

Knowledge about stakeholder utility functions can also result in efficiency because a firm can fine tune its strategies and tactics to offer what is really important to a stakeholder rather than offering things that might be expensive to the firm but are of less concern to stakeholders. How responsive is a customer or prospect to changes in price? Which variable pay plan would employees prefer over a raise in salary? How much price latitude does a firm have with a supplier before quality begins to suffer? Information of this type is very helpful to firm managers as they make decisions regarding short-term tactics, but it can also help them know how best to allocate resources. In addition, this sort of information is valuable to managers as they anticipate outcomes related to longer-term strategies.

Stakeholder utility functions and innovation. Understanding stakeholder utility functions may also lead to higher levels of innovation. Firms that manage for stakeholders can use information about stakeholder utility functions to devise new ways of satisfying stakeholders. The process of inventing alternatives that increase utility is a creative envisioning process that requires entrepreneurial intuition and imagination. The process itself entails analyzing the similarities and differences between the firm's utility function and the focal

stakeholder's utility function. For example, value can be created in exchanges when firms identify differences in factor values that suggest greater potential gains from trade or complementary technical capabilities that can be profitably combined (Sebenius, 1992). This type of knowledge about stakeholders also makes it possible to envision other outcomes such as new products or services, new product or factor markets, new ways of producing or delivering, or new ways of obtaining resources (Schumpeter, 1934).

Beyond the potential to innovate through bilateral relationships with individual stakeholders, firms may also engage in innovative activities through their participation in social networks. For instance, they may help to fill structural holes in their networks (Burt, 1992). Structural holes exist when two parties in a social network do not typically engage in activities with each other. It is not that they are unaware of each other, but that they are so focused on their own activities that they do not attend to the activities of the other group (Burt, 1992). A firm can act as a third party in coordinating cooperative activities and facilitating knowledge transfer between two stakeholders that might not otherwise engage directly with each other, thus filling a structural hole. A firm may also serve as a "hub firm" in an innovation network (Rowley, 1997). Innovation networks may be viewed as "loosely coupled systems of autonomous firms" (Dhanaraj and Parkhe, 2006: 659). Hub firms coordinate the activities of network stakeholders (Jarillo, 1988). Since knowledge is the "chief currency" of an innovation network (Dhanaraj and Parkhe, 2006), hub firms play the role of identifying where valuable information exists in the stakeholder network and allocating it where it can do the most good.

Firms that manage for stakeholders are in a strong position to fill structural holes and perform duties as hub firms because stakeholders are more likely to trust that such firms will act responsibly with regard to their own interests (Capaldo, 2007; Coleman, 1988). Moreover,

reciprocity and generalized exchange suggest that stakeholders are more likely to reveal valuable knowledge because they expect to share in the value that is created. These factors should also have a positive effect on knowledge mobility, which is "the ease with which knowledge is shared, acquired and deployed within the network (Dhanaraj and Parkhe, 2006: 660)".

Dealing with unexpected events. When a firm seeks to understand a broader set of stakeholders' utility functions, it increases the likelihood that it will be able to use unexpected events, such as changes in technology, changes in relative prices, changes in consumer tastes, or changes in regulations, to create value (Freeman and Evan, 1990; Rumelt, 1984). For example, a firm that has a nuanced understanding of the utility functions of its customers will be better positioned to alter its products or services as consumer tastes change. Similarly, a firm that really understands the utility functions of suppliers will be in a better position to work with those suppliers in adapting to technological changes. Building on this type of knowledge, managers can envision potential resource combinations that will exploit the potential to create value. A firm that provides just enough value to stakeholders to keep them willingly engaged with the firm (i.e., an arms length approach) is more likely to see stakeholders exit when hit with an unexpected event than a firm that manages for stakeholders. The latter firm has greater strategic flexibility. Strategic flexibility refers to a firm's capability to respond to demands and opportunities that exist in a dynamic and uncertain competitive environment (Harrigan, 2001).

Of course, managing for stakeholders might actually render one source of unexpected events—those derived from an inadequate understanding of stakeholder utility functions—less likely in the first place. The firm may still be blind-sided by technological or macro-economic shocks, but understanding the utility functions of stakeholders can provide an early warning

system for stakeholder-created shocks (such as a change in regulations or a strike) that is not available to the arms length firm.

We have now provided arguments that support the idea that firms that manage for stakeholders may enjoy benefits associated with increased demand and efficiency, higher levels of innovation, and an increased capacity to deal with unexpected events. We will now discuss whether these benefits are likely to be rare and non-substitutable, two factors that help to determine whether a competitive advantage is likely to be obtained.

Rarity and Substitutability

If all firms are able to pursue a strategy, is it still a potential source of competitive advantage? The first point we would like to make is that there is substantial variance in the way firms treat their stakeholders (Berman *et al*., 1999; Hillman and Keim, 2001; Preston and Sapienza, 1990; Sisodia *et al*., 2007; Waddock and Graves, 1997). Furthermore, there are short-term incentives not to pursue a managing-for-stakeholders approach in a consistent fashion. Jones *et al*. (2007) describe an instrumentalist approach to managing stakeholders as one in which firms treat stakeholders morally except when it is economically advantageous not to do so. Most firms consist of multiple decisions makers and this sort of inconsistency means that decision makers will be forced to make individual judgments regarding treatment of particular stakeholders. If a decision maker treats a stakeholder poorly the firm could lose significant future benefits associated with understanding that stakeholder's utility functions. In addition, the firm's reputation for distributional, procedural and/or interactional justice is also likely to be tarnished in the eyes of other stakeholders, thus eroding their trust in the firm.

On the other hand, a firm that is consistent in its application of a managing-for-stakeholders approach may be able to develop expertise associated with managing stakeholders

and obtaining information from them. These skills become a core competency that may be transferred widely across a firm's business operations. They can be reinforced across the firm's managers and employees through means such as training programs, internal communications, meetings and employee transfers. Over time the firm's approach to managing stakeholders becomes embedded into the firm's culture (Jones, *et al*., 2007).

For these reasons, we believe that a consistent stakeholder management strategy is likely to be more competitive than a strategy that "picks and chooses" the stakeholders it wants to treat well. A consistent managing-for-stakeholders approach means that a firm will forgo some opportunities for short-run profit maximization. Although such actions may seem counterintuitive from a purely economic perspective, our arguments are similar to those advanced by Schumpeter (1934), who explained that it is possible for an economy to deviate from short term maximizing in every period and yet still create more value over the long term. We are arguing that the same sort of relationship can apply to the creation of firm value.

Returning to the issue of rarity, there may also be a first-mover advantage to competing firms that are first to develop the types of stakeholder relationships we have described in this paper. Firms that that capture customers or other stakeholders by targeting their utility functions may actually "lock-out" their rivals from exploiting these advantages with the same stakeholders (Ghemawat and del Sol, 1998). Loyalty and reputation work to reinforce these advantages, although we recognize that there are limits to loyalty and that rational decision makers are not bound by it as they make decisions with economic consequences. Nevertheless, the loyalty of stakeholders and the reputation of the firm both represent barriers to other firms who may want equal access to information about stakeholder utility functions. More will be said about imitability in the next section.

A question remains regarding whether information about stakeholder utility functions can be obtained through other sources. Is there a viable *substitute* for a managing-for-stakeholders approach that will yield similar results? The outcomes we have described in this paper *require* nuanced information about stakeholder utility functions that is only likely to be revealed in the presence of distributional, procedural and interactional justice. As stated previously, stakeholders have no incentive to reveal information unless there is some expectation of eventually enjoying positive outcomes from the value that is created. Similarly, although firms frequently employ research firms and consultants in an effort to better understand stakeholder utility functions, these third parties have very little opportunity to develop a relationship based on distributional fairness, reciprocation or procedural or interactional justice. Therefore, a nuanced understanding of stakeholder utility functions is unlikely to be revealed.

Sustainability

As the forgoing discussion illustrated, it is hard to discuss rarity without also discussing imitability, which is a key to understanding whether the advantages of a managing-for-stakeholders approach are likely to be sustainable over time. Sustainability can be addressed by an examination of whether the resources created in a firm that manages for stakeholders are difficult or costly to imitate, at least on a limited basis. At issue is whether other firms can easily imitate the firm characteristics and behavior that lead to obtaining knowledge about stakeholder utility functions. Resources that are difficult or costly to imitate are characterized by isolating mechanisms that adhere them to the firm (Rumelt, 1984). Two isolating mechanisms that seem most appropriate to this discussion are path dependence and causal ambiguity (Barney, 1991).

Path dependence. The prevalent social norm of reciprocity discussed above suggests that firms that are able to generate sustainable competitive advantage from stakeholder relationships

enjoy an advantage that is difficult to imitate due to path dependence. The stakeholder relationships examined by Larson (1992) demonstrate how the reciprocal behavior – either positive or negative – initiated by one party tends to dictate the subsequent behavior of the other party. The experimental economics literature also widely supports this phenomenon where the earliest moves of one actor heavily influence all future moves of both actors (see Fehr and Gachter, 2000).

The path dependence of this advantage is also evident beyond the firm's dyadic relationships in its reputation. A firm's reputation is an example of a resource that is intimately path dependent (Fombrun, 2001; Rindova *et al*., 2005). Although some firms have been known to spend enormous sums on marketing trying to buy a reputation (or buy their way out of an undesirable one), the best way to gain a reputation as a firm with strong stakeholder relationships is to *be* such a firm. Becoming (and becoming known as) such a firm can be challenging. Not the least of these challenges is that of authenticity – a notoriously difficult commodity to purchase. Authenticity results from consistent behavior and it is difficult to ensure this sort of behavior because there are so many incentives not to do so. Desirable stakeholder management behavior must become a part of a firm's culture (Jones *et al*., 2007). Replication is the key. Thus, stakeholder relationships must be continuously monitored and reinforced in order maintain the type of trust that is necessary to unlock value creation opportunities. But it is precisely this path dependence that contributes to sustainability.

Causal ambiguity. The collective benefits from a broad stakeholder management approach are often not traceable to a particular stakeholder relationship. Rather, they accrue from the amalgamation of the dyadic, third-party, and temporal factors discussed in this paper that reveal new value creation opportunities. A firm attempting to imitate the precise benefits realized

by a competitor that manages for stakeholders will be unable to determine the exact stakeholder relationship(s) that resulted in those benefits. The ambiguity surrounding the cause of this advantage is further intensified given the interdependence of stakeholder and firm utility functions that develops over time as new, innovative value propositions are developed and exploited in these relationships. Thus, the competitive advantages from stakeholder relations we have described in this paper are also difficult to copy due to their causal ambiguity.

These arguments regarding path dependence and causal ambiguity suggest that the competitive advantages associated with knowledge of stakeholder utility functions are likely to be sustainable. Nonetheless, not all firms that pursue a managing-for-stakeholders approach will enjoy competitive advantage. We discuss limitations next.

DISCUSSION: LIMITATIONS AND FUTURE RESEARCH

The kind of stakeholder relations we have described in this paper are not a resource that every firm has or even one that every firm is able to translate into an advantage over other firms. Rather, our more modest claim is that we believe we have accurately described how and why a managing-for-stakeholders approach has led to sustainable competitive advantage in some firms that have pursued such an approach. Nevertheless, several factors would seem to limit successful execution and therefore stand as limitations to achieving competitive advantage. These factors include over-allocating value to stakeholders, an inability to measure value created using accounting measures, a lack of ability to translate knowledge into value-creating opportunities, measuring value creation over too short of a time frame, and the potential for opportunism.

Over-allocation of value. One clear caveat associated with this analysis is that the benefits of managing for stakeholders must exceed the costs for competitive advantage to be achieved. The costs of managing for stakeholders include allocations of managerial time spent in

communicating and managing relationships with stakeholders as well as the direct allocation of financial and other firm resources to them. It is possible for a firm to allocate too many resources to obtaining information about stakeholder utility functions. Also, firms that manage for stakeholders, because of their desire to allocate value fairly, may end up allocating too many resources to stakeholders directly. This amounts to "giving away the store" to stakeholders.

Another type of problem occurs when too much value is distributed to a stakeholder because it has a large amount of power (Coff, 1999; Pfeffer, 1981; Porter, 1980). For instance, powerful unions sometimes cripple firms by forcing them to pay higher wages than the market would otherwise command. Similarly, Porter (1980) demonstrated that powerful customers or suppliers can absorb much of the profitability in an industry. As Barney and Arikan (2001) explain, "It might be the case, for example, that implementing a particular strategy generates real economic rents for a firm, but that those rents are fully appropriated by a firm's employees, its customers, or even its suppliers (175)."

Measuring value creation. Some of the measurable outcomes that should be evident from a managing-for-stakeholder approach include growth, efficiency, and higher levels of innovation. While we expect that firms that manage for stakeholders will consistently provide good returns for their shareholders, we also realize that, by definition, these firms distribute value widely across their stakeholder networks. Value may be distributed through means such as higher wages or better benefits for employees or managers, better terms provided to suppliers, community service programs, or lower prices, safer or better products, or enhanced services for customers.

We cannot expect, therefore, that bottom-line profits or shareholder value will necessarily be maximized at any given point in time. The reality is that maximizing shareholder value at a

point in time at the expense of other stakeholders is an inherently shortsighted strategy, for reasons previously expressed in this paper. Consequently, while greater value may be created in the entire system through a managing-for-stakeholders approach, such value may be hard to detect using bottom-line accounting or shareholder returns measures, because the value distributed to any one stakeholder (such as shareholders) does not provide a complete picture of the value that is created. Inability to accurately measure total value created can act as a deterrent to implementing the managing-for-stakeholder's approach because some stakeholders (i.e., managers, stockholders, creditors) may consider bottom-line profits as the most important or only valid criterion of success. These stakeholders can put pressure on the firm to abandon its managing-for-stakeholder approach. Fortunately, the research evidence we reviewed previously in this manuscript provides support for the notion that firms that manage for stakeholders also have higher financial performance, thus mitigating to some degree the concerns of stakeholders that are obsessed with the bottom line.

Ability to translate knowledge into value. At the right side of Figure 1, between the potential advantages of understanding stakeholders' utility functions and the creation of value, is an arrow representing a firm's ability to translate those advantages into actual value. Barney (1995) explained that organizational capabilities are necessary to unlock the potential of sources of sustainable competitive advantage from resources. A firm's capability to translate knowledge into value is influenced by its absorptive capacity, defined by Cohen and Levinthal (1990) as "the ability of a firm to recognize the value of new, external information, assimilate it, and apply it to commercial ends (128)." A firm will not be able to create value from knowledge about stakeholders' utility functions without the appropriate capabilities, systems and processes associated with absorptive capacity.

Time frame issues. A likely (perhaps necessary) concomitant to an emphasis on generalized reciprocity is a focus on longer-term time horizons. The beneficial effects of generalized reciprocity among stakeholders tend to accrue over time as compared to the effects of immediate reciprocation. Further related to generalized reciprocity and longer-term time horizons is an emphasis on procedural fairness as compared to distributive fairness among stakeholders. Actors reliant on generalized rather than immediate reciprocity, nevertheless, desire assurance that all are getting (or will get) their due. Similarly, confidence that one will be rewarded in the long-term is facilitated by assurance that the procedure by which decisions are made is itself fair and just. Considerations of procedural justice and fairness contribute to stakeholder expectations of future benefit. These considerations suggest that it may take a while to develop the type of relationship with stakeholders that will lead to a detailed understanding of their utility functions, which can then lead to value creating opportunities. From an empirical perspective, researchers should be careful to examine performance outcomes after a sufficient amount of time has elapsed since a firm started exhibiting the behaviors described herein.

The longer time frame incorporated into much of this paper would seem to imply that a managing-for-stakeholders approach is only helpful for firms with stable relationships found in rather static environments. While it is true that information about stakeholder utility functions takes time to acquire and utilize, several aspects of the theory we have developed in this paper are particularly useful in dynamic or hypercompetitive markets. Perhaps the most obvious advantage comes from a firm's reputation. Firms that are able to generate competitive advantage from a managing-for-stakeholders approach gain this advantage not only by creating and sharing value with stakeholders (through distributional, procedural and/or interactional justice), but by *becoming known* as a firm that does so. Such firms are more attractive to potential stakeholders

as they consider whether to engage with a firm. Developing productive relationships with new stakeholders is vital to success in rapidly changing environments. Also, while it is true that firms in dynamic environments are likely to engage with new stakeholders as a result of changes that occur, they will also retain many of their existing stakeholders, resulting in longer-term relationships. As we explained in the section on value creation, nauanced knowledge of the utility functions of current stakeholders can increase a firm's ability to take advantage of unexpected events such as changes in technology, relative prices, consumer tastes or regulations (Freeman and Evan, 1990; Rumelt, 1984). Finally, firms that manage for stakeholders are well suited to serve as hub firms in innovation networks and/or to help fill structural holes in their social networks, thus providing them with sources of innovation that may not be available to other firms.

Opportunism. The potential for opportunism exists in all stakeholder relationships (Das, 2006; Williamson, 1975). A firm that has great knowledge about the utility functions of its stakeholders is also likely to reveal aspects of its own utility function. Stakeholders are expected to act opportunistically in that they will do things that promote their own interests. However, opportunism often implies pursuing actions that will help one party while hurting the other. Williamson (1975) suggests that opportunism entails "guile." A firm should avoid future interactions with a stakeholder that exhibits this type of opportunism. If they cannot avoid interactions because of resource dependence, then they may be forced to rely on contractual or other types of safeguards.

The model proposed herein assumes that both firms and their stakeholders will act honestly and responsibly with regard to the interests of others. There are incentives for doing so. For instance, a firm that violates trust is likely to be precluded from future joint value-creating

opportunities with individuals and firms whose trust was violated (Sullivan, et al., 2007). Also, the firm's reputation for justice may be tarnished, thus hurting prospects for transactions with other firms as well. Nevertheless, when opportunism occurs, the value creating processes described herein are disrupted.

Suggestions for Future Research

The central ideas of this paper require validation through empirical testing. While there is some empirical support of a positive relationship between managing for stakeholders and performance, the underlying reasons need testing. Testing the reasons for the relationship could lead to recommendations for improving it. Specifically, live case and survey research could examine whether new sources of value creation are more likely to emerge from a managing-for-stakeholders approach.

Furthermore, research is needed to examine those factors that influence a stakeholder to reveal its utility function to a firm. We have identified facilitators that we believe lead to a relationship of trust as a precondition to sharing knowledge about utility functions. However, there may be other factors as well. In a recent study employing structural equation modeling, de Luque *et al*. (2008) discovered that CEOs with stakeholder values tend to be perceived as visionaries and that this perception is associated with extra effort on the part of employees and ultimately higher performance. This type of study is helpful in explaining the intricacies of the relationships between a managing-for-stakeholders approach and firm performance. In addition, longitudinal studies could help to validate the idea that firms that manage for stakeholders create more value over the long run.

Because value creation and appropriation are inseparable, improved methods are needed for measuring value creation. The profits of some companies may be lower simply because

accounting- or shareholder-based measures are not sufficient to represent the total value created. This may partially explain why the profits of many firms in Japan, where a broader stakeholder orientation exists, are lower than the profits of companies in countries with more of a bottom-line or shareholder focus. In support of this perspective, Wan *et al.* (2008) found that strong business group relationships in Japanese banks were positively related to financial performance during an economic expansion, while those same ties had a negative effect on performance during a recession. They reasoned that Japanese banks with strong affiliations used their own resources to help business group members during difficult times, thus negatively impacting their own performance. Although value was transferred from banks to stakeholders, it was not lost. Their study empirically illustrates the need to develop more complete measures of value. It also demonstrates a potential advantage of affiliating with firms that manage for stakeholders. Specifically, such affiliations may provide a sort of insurance against bad economic times. More research is needed to confirm this idea.

This paper also suggests other research questions that may be worthy of exploration. How does managing for stakeholders affect the transaction cost efficiency of a firm? That is, does such a firm have a superior capability of determining, *ex ante*, which transaction partners are more and less likely to act opportunistically in the future? As firms reveal knowledge about their own utility functions to stakeholders, are those stakeholders more likely to attempt to acquire them? How much discretion do managers actually have to adopt a stakeholder approach and how does their use of the available latitude affect future relationships with stakeholders? How can firms enhance their ability to collect and utilize information about a stakeholder's utility function to create new sources of value?

CONCLUSION

In this paper, we applied a stakeholder management approach to the central question in strategic management: why some firms have higher performance than other firms. The relationship between managing for stakeholders and value creation was examined in depth, thus filling a void in the literature. This paper matters because it provides a detailed explanation of how and why the firm behaviors associated with managing for stakeholders work to unlock the potential for value creation and the conditions that either facilitate or disrupt this creation process. These explanations provide a strong rationale for including stakeholder theory in the discussion of firm competitiveness and performance.

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FIGURE 1
Managing for Stakeholders and Value Creation