When Competitive Advantage Doesn't Lead to Performance: The Resource-Based View and Stakeholder Bargaining Power

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Competitive advantage does not always lead to higher levels of firm performance. It all depends on how much of the rents created by competitive advantage are appropriated by stakeholders. This paper addresses the rent appropriation problem and develops a resource-based theory explaining which stakeholder will be able to appropriate rent and when.

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Abstract

What if rent from a competitive advantage is appropriated so it cannot be observed in performance measures? The resource-based view was not formulated to examine who will get the rent. Yet, this essay argues that the factors leading to a resource-based advantage also predict who will appropriate rent. Knowledge-based assets are promising because firm-specificity, social complexity, and causal ambiguity make them hard to imitate. However, the roles of internal stakeholders may grant them a great deal of bargaining power especially relative to investors.

This essay integrates the resource-based view with the bargaining power literature by defining the firm as a nexus of contracts. This new lens can help to explain when rent will be generated and, simultaneously, who will appropriate it. In doing so, it provides a more robust theory of firm performance than the resource-based view alone. It is also suggested that this lens might be useful for examining other theories of firm performance.

(*Rent Appropriation*; *Resource-Based View*; *Bargaining Power*; *Knowledge-Based Assets*)

[Microsoft] has warned its investors and employees that, as partners, they are also rivals who compete for the same spoils. (Lowenstein, *Wall Street Journal,* 12/4/97)

Microsoft has signaled that employees and shareholders compete directly for any rent that the firm generates. This rivalry raises a broader question, when a firm has a competitive advantage, how much rent will be appropriated by employees? This is important because appropriated rent may be unobservable in performance measures (e.g., wages and benefits are deducted).

Many assume that the resource-based view is a useful tool for predicting performance (Barney 1997). However, it was formulated to explain when firms will generate rent—not who will appropriate it (Wernerfelt 1984). As such, in its current form, it may not be a powerful tool for predicting when rent can be detected in performance measures.

I argue that the resource-based view can be augmented to predict when rent will be generated and, simultaneously, who will appropriate it. Knowledge-based assets, for example, are especially promising because they are hard to imitate (Barney 1991). At the same time, people with critical knowledge may also have enormous bargaining power. Such employees may be in a stronger position to appropriate rent generated from a resource-based advantage than shareholders.

In order to predict when rent will be apparent in performance measures, we must examine two questions in concert (see Figure 1): 1) what resources generate rent? and 2) who has bargaining power to appropriate rent? The nature of rent generating resources has been studied extensively (Barney 1991, Lippman and Rumelt 1982, Peteraf 1993, Reed and DeFillippi 1990). However, rent appropriation has received little attention in the specific context of the resource-based view.

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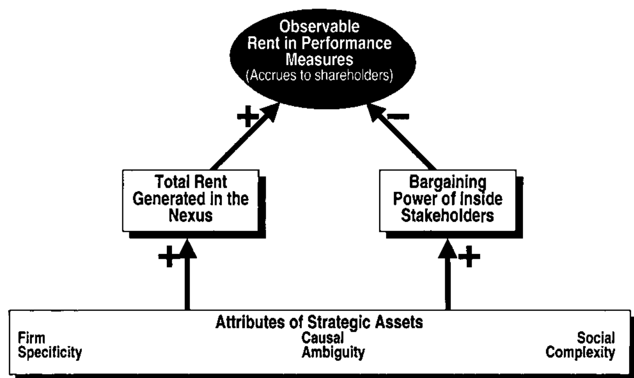
Figure 1 **How Much Rent Will Be Observable in Performance Measures?**



This article examines how bargaining power is linked to roles in rent generation. I first introduce the problem in greater detail and explain the bargaining power model. I apply this model both in a simple team and in a corporation to explore how bargaining power will be distributed in a firm with a resource-based advantage. I conclude by discussing the sustainability of an *appropriated advantage* (i.e., rent appropriated by employees) and suggested research directions.

1. Organizations Don't Appropriate Rent, People Do: The Firm as a Nexus of Contracts

The core question for strategy researchers is, "*Why do some firms perform better than others?*" (Rumelt et al. 1991). The resource-based view offers one important explanation: if firms are viewed as heterogeneous bundles of resources, a given firm may gain an advantage based on its unique access to rare resources (Barney 1991, Wernerfelt 1984).

Accordingly, a central question in the resource-based literature has been, *what resources and capabilities will generate rent for the firm?* (Amit and Schoemaker 1993). Specifically, resources must be valuable, rare, and hard to imitate, and the firm must be organized to take advantage of them (Barney 1991). Knowledge-based assets hold special promise because firm-specificity, causal ambiguity, and social complexity make them hard to imitate. Thus, recent work focuses on the means by which complementary knowledge-based assets can be woven together to form strategic capabilities (Teece et al. 1997).

In this way, proponents of the resource-based view generally assume that there is a strong link between having strategic resources and firm performance (Amit and Schoemaker 1993, Hall 1993, Peteraf 1993).[1] Prescriptions to increase firm performance tend to focus on the acquisition and management of strategic resources and capabilities.

However, the assumption of a tight link between rent generation and firm performance is inaccurate and misleading. The resource-based view ascribes most rent to knowledge that is embodied in individuals or in networks of individuals. Therefore, it follows that many employees or groups of employees, in addition to shareholders, will have a claim over the rents generated.

Thus, it is not sufficient to say that strategic resources generate rent for the "firm" without decomposing the firm into stakeholders who appropriate rent. Put another way, performance is an outcome of a two-stage game. Rent generation is the first stage, and rent appropriation is the second stage. We cannot predict firm performance if our theory only speaks to the first stage.

There are numerous examples in which rent is generated but flows in unanticipated directions (Teece 1988). The U.S. auto manufacturers clearly were generating rents before intense foreign competition changed the nature of the game. Yet unions and management, as opposed to shareholders, appropriated a significant portion of the rent (Freeman and Medoff 1984). Similarly, IBM assembled the strategic capabilities that built most of the modern personal computer industry. Yet Intel and Microsoft were ultimately able to appropriate much of the associated rent. Another example might be Japanese firms that appear to have very strong strategic capabilities and yet have exhibited lackluster financial performance (well before economic woes struck the region). Finally, some sports teams win national championships repeatedly and yet fail to turn a profit.

It is not enough to predict when rent will be generated. In order to predict performance differentials among firms, it is just as important to understand who will appropriate the rent.

The Firm as a Nexus of Contracts

A principal flaw in most discussions of the resource-based view is the overly simplistic definition of a firm. It is normally assumed that the firm owns the strategic resources and will, in turn, appropriate most of the rent. The problem is that the firm is not, as this scenario presumes, a unitary actor. Indeed if, as the resource-based view maintains, the firm is a unique bundle of resources, it stands to reason that we must define the firm to highlight what holds the bundle together. The fact that strategic resources are typically knowledge-based and/or socially complex clearly suggests that there are myriad

stakeholders who must somehow be tied to the firm—some of whom may be quite powerful. In most cases, though, it is inappropriate and unrealistic to assume that firms can actually own knowledge-based assets. The resource-based view, then, requires a definition of the firm that reflects the complexity of the underlying resources.

Accordingly, I will address this flaw by defining the firm as a *nexus of contracts* (Jensen and Meckling 1976). While this terminology is common in the financial economics literature, it has not been linked to the resource-based view. This terminology is especially valuable because it focuses specifically on what ties the strategic factors to the firm: typically, implicit contracts.

Jensen and Meckling (1976) view the firm as a legal fiction with which factors form contracts. The definition is a fundamental starting point central to the arguments in this essay. At the most basic level, a legal fiction cannot appropriate rent for itself or be personified in any way. Jensen and Meckling (1976, 311) wrote that viewing the firm as a nexus makes it clear that

> the personalization of the firm implied by asking questions such as "what should be the objective function of the firm," or "does the firm have a social responsibility" is seriously misleading. *The firm is not an individual.*

Defining the firm as a nexus of contracts deepens the resource-based view in two important ways. First, it highlights the process by which resources are tied to the firm with a precision that the "bundle" metaphor lacks. Second, and most critical for this essay, it is clear that a firm cannot appropriate rent because the firm is not a person and, in the end, it is people who appropriate rent. Furthermore, since strategic resources are *nodes* in the nexus that the firm cannot own, the property rights to the rent are quite ambiguous. As such, this metaphor is particularly appropriate for exploring which nodes in the nexus will appropriate rent.

Nexus Rent and Competitive Advantage

When we define the firm as a nexus, it profoundly affects what is meant by a "firm" generating rent. The existence of rent in the nexus must be defined separately from who appropriates the rent. That is, *nexus rent* is the sum of all the rent in the nexus regardless of which stakeholders appropriate it.

Employees receive rent when their wage is greater than what is needed to prevent them from quitting (Milgrom and Roberts 1992). Quasi-rent may be available for other stakeholders when a factor has a higher marginal product than is required to hold it in place (Klein et al. 1978). For example, employees may only appropriate a portion of the rent arising from specialized skills. Since competing firms cannot apply the skills, the wage only needs to match other alternatives to keep employees from quitting. Put another way, such employees would lack bargaining power to appropriate rent if other firms do not value their skills.

Nevertheless, whether employees appropriate rent or whether rent is left for other stakeholders, it is still *nexus rent.* Thus, at the firm or "nexus" level, a firm generates rent when *all stakeholders receive sufficient compensation to hold them in place (pay $\geq$ opportunity cost)* ***and*** *some stakeholders get more than would be required to hold them in place (rent).*

This definition of nexus rent differs from Amit and Schoemaker's (1993) concept of *organizational rent,* which refers to the residual that accrues to shareholders. Organizational rent excludes rent that is generated but appropriated by other stakeholders—confounding rent generation with rent appropriation. That is, if rent accrues to shareholders, it implies a specific distribution and incorporates a normative assumption about who *should* get the rent. The investors or owners are merely "nodes" in the nexus along with the other factors—all of whom compete to appropriate rent. Accordingly, I define rent generation apart from rent appropriation to explore the dynamics of rent appropriation in a descriptive (rather than a normative) sense.

Competitive advantage, a concept closely related to rent generation, is central to the field of strategic management. What does it mean for a *nexus* to have a competitive advantage? Again, the literature tends to confound rent generation with rent appropriation. Does a competitive advantage require that shareholders get the rent or merely that the nexus has a valuable strategic capability?

The resource-based view helps to address this question. It focuses on unique assets that grant the firm valuable and inimitable capabilities (Barney 1991). In its current form, rent appropriation is viewed as an exogenous factor. Consistent with this perspective, I assume that competitive advantage merely requires rent generation from a firm's strategic capabilities. Thus, all factors must receive sufficient compensation to keep them in place, while some factors get more than is required.

In other words, a firm may have an advantage over competitors even if rent does not accrue to investors—rent may be distributed anywhere in the nexus. The nexus can still have strategic capabilities that other firms lack even if rent is appropriated by nodes other than the shareholders. Of course, "super-normal profit" refers specifically to rent that accrues to shareholders.

Implications for Observable Performance

The reader should not construe this to mean that a firm with a competitive advantage could perform poorly.

Rather, it would generate at least average returns for all stakeholders and above average returns for some stakeholders. Furthermore, the nexus would include valuable, inimitable capabilities that competing firms lack.

However, the firm might not generate super-normal returns based on traditional measures of organizational performance. For example, profit is the residual calculated after employees have been paid. Since pay includes rent that employees have appropriated, profit may reflect primarily the rent that shareholders are able to appropriate. Because profit confounds rent generation with rent appropriation, however, it is a poor indicator of total rent in the nexus. Indeed, most performance measures focus on the residual that accrues to shareholders and ignores other rent. How, then, can we identify the total rent and who will appropriate it?

While it is clear that the rent will be appropriated, few have studied how the gains from a resource-based advantage are distributed (Amit and Schoemaker 1993, and Collis and Montgomery 1995 are notable exceptions). Even where appropriability is explored, it is presented as uncorrelated to the factors that make resources hard to imitate. Here, I treat appropriability as tightly linked to the knowledge-based assets that drive a sustainable competitive advantage.

The resource-based view can become a significant tool for predicting firm performance if it simultaneously explores how rent is generated and how it is appropriated. In the following sections, I apply a bargaining power model to predict rent appropriation in the context of a resource-based advantage.

2. Determinants of Stakeholder Bargaining Power

This section briefly reviews the determinants of bargaining power to predict when stakeholders will be in a position to appropriate rent. Later, I use the determinants to explore rent appropriation in a simple team (§ 3) and a corporation (§ 4). While the bargaining power literature is well established, it has not been applied specifically in the context of a resource-based advantage.

The four determinants of bargaining power are adapted from the negotiation and bargaining power literature (Hickson et al. 1971, Marburger 1994, Pfeffer 1981, Porter 1980). Specifically, bargaining power is highest when stakeholders 1) are capable of acting in a unified manner, 2) have access to key information, 3) have a very high replacement cost to the firm, and 4) face low costs if they move to another firm.

Capable of Unified Action. The first determinant is the extent to which stakeholders can act in a unified manner. Union bargaining power stems from its ability to get workers to act in concert (Forrest 1986, Leap and Grigsby 1986, Mishel 1986). Often though, stakeholders cannot act in concert and no single person has enough power to extract rent. This scenario reduces bargaining power since there are strong incentives to undermine "cartel-like" agreements. In contrast, if stakeholders can act as a cohesive unit, their threat of exit will be more serious and more credible.

Access to Information. A second determinant of bargaining power is access to information. Given that asymmetric information is central to the resource-based view (e.g., in the form of causal ambiguity), information may be an especially important source of bargaining power. Stakeholders who control information can release only enough to make the outcome they desire the obvious choice (Pfeffer 1981). At the extreme, some stakeholders may not even know that rent exists.

Replacement Cost to the Firm if a Stakeholder Exits. The third determinant is the cost the firm would bear (e.g., to acquire and deploy a comparable resource) if the stakeholder were to leave. For example, if an expert were to leave, what would be required to find a new expert who could serve in that position—what loss would be incurred while the firm searched? In addition, what investments must be made to bring a new employee up the learning curve? Accordingly, there may be very high setup or redesign costs required to replace employees with specific knowledge.

The availability of substitutes is also a key factor in the replacement cost. If a factor is easily substituted with a strategic equivalent, it will have relatively little bargaining power. For example, if a firm can substitute an expert system for a person, it would reduce the individual's bargaining power (note that firm-specific expertise may make the cost of an expert system prohibitive). In other words, suppliers have more bargaining power for differentiated or specialized inputs. Of course, if the input is irreplaceable, the supplier would have significant power (Pfeffer 1981).

Cost of Exiting to the Stakeholder. Finally, the stakeholder also faces switching costs that may affect bargaining power. For example, if an individual faces very high personal costs of exiting, a threat of exit might not be credible. This threat may be necessary in order to hold up other stakeholders and appropriate rent. Firm-specific skills may reduce bargaining power if they raise the cost of exiting substantially (Klein et al. 1978).

Which stakeholders have the greatest bargaining power in the context of a resource-based advantage? The following sections link rent generation to bargaining power in

two contexts. First, I describe bargaining power using a simple team as a model of the firm. Section 4 then describes a more complex model linking rent generation to bargaining power in a corporation.

3. Rent Appropriation in a Simple Team

Team production, or social complexity, is central to understanding a resource-based advantage (Barney 1991). It occurs when the product is greater than the sum of separable resources and one person does not own the resources (Alchian and Demsetz 1972, Milgrom and Roberts 1992). Competitors will find it hard to duplicate an advantage if it results from a collection of valuable, firm-specific complementary resources such as a team (Teece et al. 1997). What is the relationship between team member roles in rent generation and their bargaining power?

To assess bargaining power, we must first ask who is on the team I begin by exploring the firm as a *simple team* of individuals. Specifically, I consider a small software firm comprised of an owner/manager, a programmer, and a sales person. First, I assume that this team has unique rent-generating capabilities. Second, each person has access to unique knowledge and skills that others lack. As such, each team member is essential for creating the capability, and any one person can halt production—hence each member has a very high replacement cost. Third, some portion of each person's knowledge is firm-specific: it refers only to the firm's product, customers, or routines and is not applicable in other firms. Finally, I assume that suppliers, customers, and other outside stakeholders lack bargaining power to appropriate rent.[2]

Bargaining Power Within the Production Team

While each person in the software firm contributes to rent production, bargaining power may only be loosely associated with roles in rent production. The following analysis of bargaining power explores each person's 1) access to information, 2) replacement cost, and 3) cost of exiting. Since each person is a separate bargaining unit, we need not focus on the ability to act in unison. However, this issue is critical for complex teams and will be explored in the next section.

Employee Bargaining Power. In the software firm, the sales person and the programmer will almost certainly be able to appropriate rent. That is, since they form the basis of the firm's unique capability, they may earn above-normal wages. Each of these professionals, afterall, has access to information that may be a source of bargaining power. The sales person knows the idiosyncrasies of the customer, while the programmer understands the unique technical aspects of the product.

A second source of bargaining power is replacement cost. The firm might face a very high cost to replace people given that their skills are, by definition, idiosyncratic and rare (to be the source of a resource-based advantage). Such individuals may have bargaining power based on this cost. For example, Raymond Ozzie, the software designer behind Lotus Notes, was able to dictate the terms under which IBM acquired Lotus (Hayes, *Wall Street Journal,* June 13, 1995, A3). IBM recognized that the cost of replacing Mr. Ozzie might render the acquisition unprofitable. Given the nature of the sales and programming professionals' knowledge, these people would be costly to replace. This potential cost, then, may allow them to appropriate a significant share of the rent.

The third determinant of bargaining power, however, may work against employees. That is, the bargaining power of the sales person and the programmer may be limited by exit costs. First, some portion of their skills and knowledge are firm-specific and not applicable in other firms. For example, the marketing person's personal network and the programmer's idiosyncratic knowledge may not be useful to other firms. A related factor is that causal ambiguity might make it hard for an individual to take credit for his or her firm's success. A rival firm might be reluctant to pay a wage premium if it is unclear how critical the individual was to the firm's success (Chiang and Chiang 1990). If employees cannot offer a credible threat of exit, they may be less able to appropriate rent.

Owner/Manager Bargaining Power. Like the other two team members, the owner/manager has bargaining power based on his/her role in creating the resource-based advantage. He/she must organize and coordinate employees to generate rent in the context of causal ambiguity, social complexity, and tacit knowledge—a formidable task. The manager must develop systems that mitigate the information dilemmas associated with strategic resources (Coff 1997). This includes identifying key complementary skills, making decisions under extreme ambiguity, and retaining people who are central to rent-generating capabilities.

These activities grant the owner/manager access to information that may not be available to the others. While the professionals' tacit knowledge requires direct experience to understand, the owner/manager may be close enough to the process to have a working knowledge of the customers and the underlying technology. Although other team members may have a better understanding of some aspects, the manager must know enough to oversee

the process. In addition, the manager has access to information about operating performance such as managerial accounting reports. Such information is explicit, but it may not be easily available to others. For example, the cast of NBC's sitcom "Friends" had no idea how much revenue the show generated and did not attempt to increase their pay until some information leaked (*The New York Times,* July 17, 1996, C14). If other stakeholders are not aware of the rent, they cannot easily bargain to appropriate it.

On balance, then, the owner/manager should have significant bargaining power based on his/her role in generating rent and his/her legitimate position of residual claimancy. As such, in the simple team, a substantial portion of the rent generated should accrue to the owner/manager. However, measures of organizational performance might significantly understate the total rent generated in the nexus because the other two members of the production team will also appropriate rent. The rent would be even more understated in performance measures if external stakeholders (i.e., buyers or suppliers) were able to appropriate some of the rent.

4. Rent Appropriation in the Corporate Form

The resource-based view is rarely used to describe a simple team such as that above. Rather, it is typically applied in a multi-business or corporate context (Prahalad and Hamel 1990, Burgh 1995). As such, a more realistic model of the firm would resemble a collection of teams and coalitions rather than a single team as discussed above. Here, we can imagine that each of the single stakeholders described previously is, in fact, a team. Thus, the firm now has a marketing team and a software development team rather than one individual in each position. In fact, there may be multiple teams in each function if the firm has multiple divisions. For example, Microsoft has separate divisions that develop and market applications for businesses, schools, and home users—each of which is a collection of teams.

Within these teams, individual productivity is hard to observe, and it seems unlikely that any one person could hold up rent production. Let us also assume that management is now a team rather than a single individual and that a separate "team" of shareholders owns the firm. In this more complex model of the firm, which stakeholders are in the best position to appropriate rent?

While this scenario introduces a number of new possibilities, the most significant change from the simple team is the stakeholders' ability to bargain as a unit. The following discussion explores bargaining power for employees, management, and shareholders. Table 1 presents a summary of each stakeholder's bargaining power profile. Note that coalitions may form within and across the categories of stakeholders discussed here. However, since a similar analysis of coalition bargaining power would apply, I will focus on a simpler scenario in which each stakeholder class is a separate bargaining unit.

Bargaining Power in Employee Coalitions

Since human assets are at the core of rent generation, it stands to reason that employees may have bargaining power: the cost of replacing them may be prohibitive. This is especially true for employees who are close to the firm's technological core since they are likely to have valuable tacit knowledge. They are critical to the firm's rent-generating capabilities because their knowledge may be irreplaceable and inimitable. Other stakeholders cannot typically match employees' mastery of the firm's tacit knowledge.

The Inability of Employees to Bargain as a Unit. While their position may be strong, it should not be assumed that employees have an unlimited ability to appropriate rent. The main challenges to employee bargaining power come from an inability to act in concert and from the specificity of their skills. While the problems associated with specificity were discussed previously, the ability to act in concert is linked to the nature of complex teams.

Since professional employees are rarely unionized, their ability to act in concert is far from certain. Under conditions of social complexity, professionals may have to act as a unit to exercise bargaining power. That is, while an individual may threaten to quit, this threat might not hold up rent generation if the rest of the team remains intact. However, a "union" may be difficult to assemble because individuals make highly idiosyncratic contributions to generate a resource-based advantage. This means that a union may not be able to pool individuals' interests as they can for labor in more standardized jobs. Put another way, there is a prisoner's dilemma that may prevent professionals from organizing as a union even though, on average, individuals might benefit. Thus, the attributes of the employees prevent them from forming a cohesive bargaining unit.

A second factor limiting the ability of professionals to act in concert is the lack of an obvious authority structure. Management and unions provide a formal authority structure that effectively allows these stakeholders to act in concert. Non-union professionals lack any natural authority structure. Without legitimate leadership, a team may not be able to act in concert to appropriate rent. Put

Table 1 Determinants of Bargaining Power by Stakeholder†

Determinant of Bargaining Power	Stakeholder Bargaining Power		
	Management	Employees	Shareholders
Capable of unified action	+ Strong when leadership is unified with little in-fighting.	—/? Strong only with unified leadership or when there are a few key people.	— Strong only when outside owners are cohesive & concentrated.
Access to/Control over information	+ May guard information about rent and operations.	+ Have tacit knowledge but may not know residuals.	— Stockholders have the least access to information.
Replacement cost if stakeholder exits	+ Scarce skills & implicit contracts with employees may be broken.	+ Scarce skills by definition/hard to identify and acquire.	— The cost may be limited to its impact on the cost of capital.
Stakeholder exit costs (reversed)	— Due to firm-specificity, the cost may be quite high.	— Due to firm-specificity, the cost may be quite high.	+ The cost is normally low (unless it is a big stake).
Summary: Probable ability to appropriate rent	+ Can often hold up other stakeholders/threaten to quit.	+ Can often hold up other stakeholders/threaten to quit.	— Hinges on board governance and ownership concentration.

†A "+" denotes a positive impact on bargaining power while a "—" suggests a negative impact.

another way, the firm's formal hierarchy may not reflect negotiation skills or even mastery of the technical knowledge-base (if knowledge becomes obsolete over time, those with the most tenure may also be obsolete). As such, the professionals' positions in the firm may not help them organize to appropriate rent.

To return to our previous example, the ensemble cast of NBC's sitcom "Friends" banded together and demanded a significant raise. As a team, they increased their bargaining power well beyond what the individuals would have had. Management's response is also telling. They tried to undermine the "team" by suggesting that some stars were worth more and therefore might be able to get more money by bargaining separately (*The New York Times,* July 17, 1996). Ultimately, though, the network met the team's demand when the cast proved to be true "friends" and stuck together.

In sum, while employees may have significant bargaining power, this power hinges on their ability to act in a unified manner and on the credibility of their threat to exit. Unlike the simple team, employees in a corporation are less able to hold up rent generation single handedly. However, as the union bargaining power literature illustrates, even employees with relatively generic skills can appropriate rent if they are unified and can bring production to a halt (Freeman and Medoff 1984).

Management Bargaining Power

In order to understand management's bargaining power, we must examine its role in generating a resource-based advantage in a complex organization. First, management must identify and acquire strategic resources—even though causal ambiguity may make it hard to identify the desired skills. If causal relationships are unclear, management must use semirandom experimentation to obtain the best mix of skills and capabilities. Mosakowski (1997), for example, describes a diversification strategy wherein managers respond to causal ambiguity by acquiring and experimenting with new lines of business in hopes of creating synergy. Thus, an adept management team is required to bring in a stream of human capital to maintain an advantage.

Second, management must be able to oversee the development of tacit knowledge. Employees close to the firm's technological core have the best grasp of the firm's knowledge-base—especially in larger, more complex organizations. This means that managers must be adept at monitoring, creating incentives, and investing under conditions of asymmetric information. The information imbalance means that management faces serious challenges in providing adequate monitoring or performance-based incentives (Ouchi 1980). For example, 3M manages this process by granting employees the freedom and resources

to test their ideas without management approval. However, inevitably, management must decide if the ideas have sufficient merit to be pursued further.

These factors make management a very costly stakeholder to replace in a complex rent-generating organization.[3] Like other key employees, management is costly to replace due to the rare and idiosyncratic skills required to organize the knowledge creation process. However, management's replacement cost is amplified because all other stakeholders in the nexus form implicit contracts with management. Therefore, if management were to exit, many of the other contracts might be viewed as void (Shleifer and Summers 1988).

Management's Ability to Bargain as a Single Unit. Like the owner/manager in the simple team scenario, management may derive power from superior information and a high replacement cost. The critical new question in the context of a complex team, then, is whether management can bargain as a single cohesive unit.

Unlike other employees, management draws on an existing hierarchy of leadership that allows them to act in concert. They do not need a union to take action since the lines of authority are clear. This may also allow top management to appropriate rent from lower levels of management as well as other stakeholders. Management skills in a multibusiness context are a source of premiums in executive compensation (Henderson and Fredrickson 1996), so there is evidence that these skills are valuable and allow senior managers to appropriate rent (Castanias and Helfat 1991). Furthermore, management bargaining power may accumulate at the top of the hierarchy where managers can use their legitimate authority to enhance bargaining power.

Investor Bargaining Power

The biggest change when shifting from a simple team scenario to a corporate scenario is the separation of ownership and control. As we shall see, while investors have a claim to the residual, their property rights are weak because employees own much of the rent-generating human capital. Here, I focus on the implications of the separation of ownership and control for bargaining power.

Of course, the difficulty of enforcing residual claims when ownership and control are separated has long been recognized (Jensen and Meckling 1976, Smith 1776). An analysis of bargaining power further reveals the tenuous position of investors. First, shareholders may be widely disbursed, hindering unified action more than other stakeholders. In order to monitor management or design incentives, shareholders must generally act through the board of directors. In the absence of ownership concentration, though, investors may lack sufficient influence to implement governance mechanisms that serve their interests (Dyl 1988).

Investor bargaining power may be further diminished because the financial resources that they provide are generic, fluid, unspecialized, and easy to substitute (Barney 1991, Castanias and Helfat 1991). If a shareholder or coalition of shareholders does not own enough stock to affect the price, their resources can be substituted easily by those of other investors (*assuming that the firm is reporting at least average returns*). Furthermore, if the firm has a sustainable advantage, financial resources may be rather plentiful. Thus, the firm may have low switching costs if a given shareholder exits. This low switching cost means that, without ownership concentration, investors may only capture the normal return that is required to attract capital (Castanias and Helfat 1991).

Perhaps the most significant factor in shareholder bargaining power is their lack of information and expertise. On most issues, they must rely on management for information. Investors may have difficulty monitoring management, particularly if the firm reports normal returns. For example, significant attention has focused recently on the unreported cost of employee stock options. Such options form a key component of compensation, especially in knowledge-intensive industries. However, since these are not treated as costs, income statements overstate firm performance (Morgenson 1998). Although employees have been appropriating rent in this way for years, it was not detectable in performance measures and investors are only now beginning to object.

Mechanisms for Applying Shareholder Power: Board Structure and Incentives. Shareholders' bargaining power is only as strong as their ability to monitor or provide incentives—in other words governance structures. A resource-based advantage complicates monitoring because outside investors, like competitors, cannot understand the firm's tacit knowledge-base.

Investors' ability to monitor begins with board representation. For example, outside shareholders do lobby for and elect outside directors to monitor management (Li 1994). Furthermore, boards that are dominated by outside directors are more likely to replace management for performance reasons (Boeker and Goodstein 1993, Weisbach 1988, Zajac and Westphal 1996a). Similarly, ownership concentration among outside investors forces management to focus on the core business and divest unrelated business units (Burgh 1995).

Ownership concentration and board representation are also precursors to performance-based managerial incentives (Mehran 1995, Tosi and Gomez-Mejia 1989). As predicted in the agency literature, these tools can produce higher shareholder returns (Chung and Pruitt 1996) and

induce management to adopt accounting methods that report higher profit (Watts and Zimmerman 1986). Furthermore, concentrated outside owners seem able to constrain the overall amount of CEO compensation while placing a greater portion of it at risk (Gomez-Mejia et al. 1987; Riahi-Belkaoui and Pavlik 1993). Concentrations owned by institutional investors may also serve in this monitoring function (Smith 1996; Wright et al. 1996).

However, outside directors and performance-based incentives do not necessarily grant stockholders power. The asymmetric information associated with a resource-based advantage exacerbates the already serious information dilemmas that investors face in traditional agency theoretic models. Since outside directors are in a weak position to understand the firm's tacit knowledge, management may argue convincingly for self-serving projects or policies. For example, CEOs seem to have a great deal of influence in structuring compensation contracts to suit their needs (Sanders et al. 1995). As such, management may be adept at influencing outside directors or selecting passive directors who are their peers in other firms (Williamson 1985, Zajac and Westphal 1996b).

Furthermore, at least to some extent, governance structures should be viewed as arising from bargaining power rather than as precursors to bargaining power. First, governance structures depend on stakeholder bargaining power when the corporate charter is set up. For example, the charter may specify the compensation structure or the portion of outside directors. Second, changes in the charter may reflect shifts in the bargaining power. Thus, if outside ownership concentration increases, it may lead to more powerful incentives or changes in the board's structure. In this way, a governance structure that favors stockholders is a manifestation of their bargaining power rather than a tool used to grant bargaining power in the first place.

Inside Stakeholders' Ability to Appropriate Rent

In sum, stakeholders on the "production team" (internal stakeholders) have better information, critical skills for rent generation, and, accordingly, a very high replacement cost. While some internal stakeholders have limited abilities to act in concert, shareholders may also lack that ability—perhaps to a much greater degree (see Table 1). The internal stakeholders, then, are most likely to be in a position to appropriate rent generated from a resource-based advantage.

Note that most of the bargaining power that the owner/manager had in the simple team flows to management in a complex team. In the simple team, the owner is central to the rent generation process, has command of the firm's knowledge base, and often has superior information. With the separation of ownership and control, shareholders are at a disadvantage in each of these areas. In fact, depending on whether other internal stakeholders form a bargaining coalition, management may be in a better position to appropriate rent than all other stakeholders.

Rent may be appropriated through year-end bonuses, special benefits, or above market wages. The continuing uproar about high CEO salaries may be evidence of appropriation. However, other employee salaries that go unreported may also be a major source of rent appropriation. In addition, management may use rent to enhance their own power positions (Jensen 1988). Some of these expenditures may promote the firm's growth, while others may actually hurt the firm. For example, investments in research and development (Baysinger et al. 1991; Zahra 1996) and high premia in corporate acquisitions (Hayward and Hambrick 1997) are both associated with insider ownership (e.g., external shareholders have little bargaining power).

Such rent appropriation activities have implications for what will be observed from outside the firm. The most significant implication is that rent may be hard to detect in traditional performance measures. This may mean that, unless stockholders have bargaining power, rent may go undetected. Management need only post average returns to keep investors from becoming alarmed.

Of course, if a firm generates rent over time, it seems unlikely that rent production will be completely uncorrelated with measures of firm performance. That is, if management invests in productive activities such as research and development at least some of the time, the firm may generate even more rent. As such, we might still observe a positive relationship between rent and performance measures. Nevertheless, the link between rent generation and performance should be stronger when outside investors have bargaining power since they have a strong interest in making the amount of the residual known, *ceteris paribus.*

5. Sustainability of an "Appropriated" Advantage: Property Rights, Internal Threats, and the Market for Corporate Control

The previous sections outline how a common form of resource-based advantage might be what I term an *appropriated advantage.* That is, the firm will have valuable inimitable capabilities and will generate rent. However, inside stakeholders may appropriate the rent so it is not apparent in performance measures. This is especially likely if the firm is a complex team or corporation.

Since competitive advantages typically erode over time (Jacobsen 1988), it is reasonable to ask whether this form of advantage is more or less likely to erode. The answer is linked to the resolution of property rights to the rent, the stability of bargaining power profiles over time, and the response of external markets to the rent.

Property Rights and the Appropriated Advantage

The stability of an appropriated advantage may be threatened by ambiguous property rights (Barzel 1989). Shareholders cannot own the primary rent-generating resources outright because employees own the human capital. Therefore, the "appropriate" return on physical capital may approach normal profit and investors may have weaker property rights than is often assumed.

The agency literature acknowledges this issue in the context of professional partnerships (Milgrom and Roberts 1992). Professionals with very high human capital must be managed by similar professionals to avoid agency problems that arise from asymmetric information. Information dilemmas, coupled with limited physical capital requirements, make it appropriate for the professionals to own rights to the residuals. Milgrom and Roberts (1992, 523) note:

> The most important specialized input in partnerships is typically the knowledge and abilities of the workers, that is, their human capital. Human capital is not easily tradable, and if the residual returns on that capital belong to the humans who embody it, then the usual arguments about ownership rights suggest that the residual control should be assigned to them, too.

Increasingly, human assets have the greatest potential to generate rent even in the corporate form. Accordingly, while we may refer to a corporate form of governance, we should not assume that stockholders automatically have strong rights over the rent. In a knowledge-based economy, property rights may be increasingly ambiguous, and the production team may correctly claim rights to residuals. For example, Microsoft and other corporations have recognized skilled employees as important residual claimants in addition to shareholders:

> In fact, many companies have embraced a second constituency: skilled employees. By awarding them huge bundles of stock options, such companies have been transferring ever-appreciating portions of their profits to workers. (Lowenstein 1997, C1)

The Stability of Bargaining Power Profiles over Time

While employees may have a stronger claim to the rent than is normally assumed, ambiguous property rights raise questions about the stability of an appropriated advantage. The first question is whether such an advantage is internally stable. If internal stakeholders became dissatisfied with the distribution of rent, they might quit and dissipate the rent-generating capabilities. This possibility, however, seems unlikely if all stakeholders earn at least normal returns. Quitting would reduce their income, and they would incur substantial exit costs.

A stakeholder, then, who is not getting the portion of rent commensurate with his or her bargaining power, might instead renegotiate. The case of the "Friends" cast illustrates this process. Such a renegotiation would change the distribution of the rent but should not generally threaten the status of the advantage unless it leads to an impasse.

Another threat is the possibility that individuals may engage in inefficient activities to enhance their bargaining power. For instance, managers may make investments that ultimately erode the advantage in order to enhance their power. While the economics literature has increasingly explored such influence costs (Milgrom and Roberts 1988), it has not focused specifically on resource-based advantages or on the possibility that all rents will be dissipated. The costs associated with these activities may be greater for an appropriated advantage.

However, if shareholders have bargaining power, it is not certain that the advantage would be more sustainable. For example, large institutional investors such as mutual funds often discount future performance at a high rate. They may pressure the firm to create short-term gains in their portfolios. This is analogous to the self-interested behavior on the part of management. It is unclear, then, which stakeholder is the best steward for maintaining an advantage.

Market Threats to the Stability of an Appropriated Advantage

There are two primary market threats that may erode an advantage. The first is the threat of normal competition. Competitor persistence is arguably the main reason that advantages erode over time (Jacobsen 1988). Interestingly, an appropriated advantage may be less prone to erosion since competitors may not detect the rent. For example, unusually high returns would attract competitors who would actively try to erode the advantage. While competitors may suspect an advantage exists, the "appearance" of average performance might exacerbate the effects of causal ambiguity.

The second external threat to an appropriated advantage is the market for corporate control. Of course, equity markets discipline firms when they report poor returns. However, if the firm is posting normal rates of return, equity markets might not be alarmed. In fact, we might see managers selecting accounting methods specifically

to underreport performance so that the reported returns are no more than average (Watts and Zimmerman 1986).

This underreporting poses a problem since the market for corporate control focuses on poorly performing firms (Morck et al. 1988). Average returns would not mark a firm as a candidate for discipline. Moreover, if a raider attempted a hostile acquisition to appropriate rent, the strategic assets might exit—destroying the rent-generating potential. As such, this situation differs from that described in the literature about the market for corporate control (Jensen 1988).

However, astute outside investors may be able to gain bargaining power without a hostile takeover. They may buy shares or form coalitions to enhance their bargaining power, which might force managers to distribute more rent to shareholders. This is essentially what Kirk Kirkorian and Lee Iacocca did when they tried to force Chrysler to distribute the firm's "war chest" to investors. However, Chrysler's management team was able to convince most shareholders that the cash reserves were part of a prudent business strategy to help the firm weather economic downturns.

The Chrysler example illustrates an important barrier to this method of asserting control—shareholders often rely on management's judgment. This is especially true if the firm is performing reasonably well. However, even if shareholders gain power, it may not directly threaten the advantage over competitors. Rather, it may make the rent more apparent in performance measures.

In sum, while there are threats to the stability of an appropriated advantage, it may still be relatively robust. If employees appropriate rent, it will not be reported as super normal returns. As a result, the firm may avoid tax liabilities, and competitors, investors, and raiders may not be aware that the rent exists. There is little reason to believe that an appropriated advantage would be any less stable than a more visible advantage in which investors have a great deal of bargaining power.

6. Discussion and Implications

The strategy literature has ignored the implications of bargaining power for determining which stakeholders will appropriate rent from a resource-based advantage. Accordingly, researchers have generally assumed that strategic capabilities lead to above normal financial performance that is easily observable. This essay suggests that the link between such capabilities and performance measures might be much weaker than is traditionally thought.

Specifically, when we view the firm as a *simple team,* employees are likely to appropriate a significant portion of the rent although they may lack formal residual claimancy rights. While some rent would accrue to the owner/manager and therefore be visible in performance measures, it may only be a portion of the rent generated. When the firm is viewed as a *complex team* (i.e., the corporate form), the effect may be even more dramatic. Shareholders seem less likely to have bargaining power, and internal stakeholders (especially management) may appropriate all or most of the rent. In sum, if rent from a resource-based advantage were observable in traditional performance measures, it would reflect the "tip of the iceberg." Employees would typically capture much of the rent (e.g., it would be "below the water line").

This assertion arises from a core premise of the resource-based view—sustainable advantages stem from causally ambiguous, firm-specific, or socially complex assets. The roles of internal stakeholders in creating and managing tacit knowledge may grant these stakeholders substantial bargaining power. At the same time, though, the asymmetric information associated with such resources exacerbates the already serious dilemmas that investors face in standard agency theoretic models. Thus, the factors that generate rent in the nexus also enhance employee bargaining power.

The concept of bargaining power, then, should clarify the link between strategic assets and measures of firm performance. For example, it suggests that unless outside investors have significant bargaining power, the firm may not report super normal returns. These observations raise new research questions as well as methodological problems.

Stakeholder Roles in Rent Generation and Appropriated Advantages

This essay has theoretical and empirical implications for research in the resource-based view and competitive advantage. It seems clear that powerful stakeholders and appropriated advantages pose new challenges for developing a complete theory of competitive advantage.

Theoretical Implications for the Resource-Based View. As the resource-based view develops, it is tempting to suggest that empirical contributions are more important than additional theorizing (Eisenhardt 1997). Nevertheless, there is a need to further integrate a more robust definition of a firm (e.g., nexus) and the bargaining power literature with resource-based theory. In this way, the resource-based view can be developed into a more complete model that predicts firm performance.

Accomplishing this goal requires a closer examination of the nexus configurations implied by a resource-based advantage. How are stakeholders involved in assembling complementary assets to form a strategic capability? What knowledge must they have to organize the assets to create a strategic capability? What are the different types

or configurations of capabilities that that can lead to an advantage? Answering these questions requires an integration of the complementarities literature (Milgrom and Roberts 1992) with resource-based theory.

Ultimately, the stakeholder roles required to develop a given type of capability may dictate where in the nexus the rent will accumulate. We must therefore study stakeholder roles in each configuration to understand how bargaining power, and accordingly, rent, will be distributed.

Although the resource-based view is often assumed to predict above normal performance, this article suggests that bargaining power arising from stakeholder roles may be an important moderator of that relationship. Since firm performance is a central focus in strategic management research, the critical nature of stakeholder roles cannot be overstated. A complete model of a resource-based advantage must include bargaining power in order to predict above normal returns.

Stakeholder Bargaining Power and Other Theories of Performance. Bargaining power may also be an important extension of other theories. While I have focused on the resource-based view, other theories (dynamic capabilities, transaction cost economics, etc.) may have implications for stakeholder bargaining power. Many of these theories also envision major roles for inside stakeholders. If they have strong bargaining profiles, the rent may not appear in performance measures. By using the lens of bargaining power to reexamine theories of performance, we may begin to understand how and when strategic competencies will be observable.

For example, the flexible competencies required under conditions of hypercompetition may grant bargaining power to specific stakeholders (D'Aveni 1994; Grant 1996; Teece et al. 1997). Similarly, new organizational forms may empower distinct stakeholders through the flatter design. In this way, they may simultaneously produce and distribute rent.

Empirical Research of Appropriated Advantages. This inquiry also suggests directions for empirical research of the resource-based view. Constructs like bargaining power, causal ambiguity, social complexity, and asymmetric information must be measured to predict super-normal returns. These are difficult to measure for the very reasons that make strategic resources hard to imitate. Still, even imperfect measures may yield useful insights if they predict firm performance and existing measures in the bargaining power literature, such as resources available to sustain a strike, may serve as a starting point (Navarro 1983).

A critical measurement question is, how can researchers identify firms with appropriated advantages if the firm reports average returns? Although some problems with accounting measures are known (Watts and Zimmerman 1986), I address a new issue: accounting measures do not distinguish between normal wages and rent, confounding rent generation and rent appropriation.

Nevertheless, performance measurement problems might not be as hard as they seem. A competitive advantage should be evident over time using a variety of measures simultaneously (i.e., market share, market valuations, consistency in performance over time, growth, etc.). While no measure is perfect, combinations of measures may tease out advantages that are not obvious otherwise. The question then becomes, "What combination of measures is sensitive enough to detect the portion of the rent that is observable?" A related question is how different measures may give clues about the distribution of bargaining power among stakeholders. Ultimately, it is difficult to imagine a performance measure that would be completely independent of bargaining power.

In the long run, survival may be the best measure, since all stakeholders have an interest in the organization's continuing existence. Furthermore, an advantage that is hard for competitors and other stakeholders to detect may help the firm survive even more than if the rent were easily observable. This hidden advantage may be a fruitful way to link population ecology with the resource-based view.

A different approach for identifying appropriated advantages is to examine the return by stakeholder. To what extent do stakeholder returns vary with bargaining power? Is the sum of the various stakeholders' returns over time above normal? This approach suggests the integration of variables in strategic management research that have not yet been explored. That is, rent would be identified at the factor level rather than the firm level. However, such studies may help us to understand the dynamics of competitive advantage.

This inquiry is linked to the final empirical question: how do stakeholders apply bargaining power? There is a need for research exploring the structure of the "bargaining process." In many instances, it may not be the result of a formal negotiation as much as an informal threat of holdup. In addition, different stakeholders may rely on different mechanisms. For example, as discussed earlier, the board of directors is a primary structure through which shareholders exercise power.

Nexus Bargaining Power Configuration as a Lens to Explain Organizational Phenomena

In addition to advancing specific theories, bargaining power might provide a parsimonious explanation for a variety of organizational events. For example, by eliminating outside investors, management buyouts may return the firm to the owner/manager setting or simple team.

Given that the asymmetric information favors management, they may not have to pay out all of the rent in order to acquire the firm in this way. While bondholders may gain influence, they will not have claims to the residual as long as the firm makes its debt payments. In other words, a buyout would shift bargaining power by removing external stockholders.

Other examples may be drawn from the international literature since institutional governance structures in a country affect the distribution of bargaining power in the firm. For example, the co-determination system in Germany allocates power directly to employees by granting them board representation. It is not surprising that we see relatively high wages in such systems.

In contrast, the Japanese capital structure provides a different bargaining profile. Because large institutional investors (e.g., banks) own 20% of all outstanding stock, they should have significant bargaining power (Dietl 1998). Yet, Japanese firms are not known for their large returns to shareholders. One explanation to the puzzle might be that institutional investors are tightly aligned with the firm in a web of transactions. Banks make 17–20% of their loans within their kieretsu (Dietl 1998). As such, they are able to extract rent through a number of transactions other than stock appreciation or dividends—the only two avenues available to U.S. institutional investors. In other words, the primary stockholders in Japan have other mechanisms through which to exercise bargaining power. These do not require that the rent be detectable in financial statements.

Although only suggestive, these examples help to illustrate how bargaining power in the nexus might be a useful lens through which to explore a variety of problems. Additional research should examine situations in which bargaining power provides a more parsimonious explanation of phenomena than existing theories.

What Is a Resource-Based Competitive Advantage?

Perhaps, on the most fundamental level, this essay challenges and stretches what is normally meant by the term "sustainable competitive advantage." If a firm generates rent that is not observable in traditional measures of performance, does the firm have an advantage?

Strategy textbooks differ on whether a competitive advantage can exist if rent does not accrue to the owners. Some authors argue that competitive advantage requires above normal profit that accrues to owners (Besanko et al. 1996, Grant 1995, Hill and Jones 1995, Hitt et al. 1997). Others merely suggest that economic rent must be generated (Barney 1997) or that the firm has a superior ability to attract and retain customers (Thompson and Strickland 1995). Interestingly, a number of texts offer no definition at all.

While I have argued that the key issue is whether the "nexus" has valuable capabilities that competitors lack, the definition of *competitive advantage* is at the core of strategic management and deserves a spirited debate. Many strategy texts adopt a pseudo-agency theoretic perspective in which stakeholder bargaining power might be considered a form of agency cost. However, employees may be entitled to much of the rent based on their roles in rent generation (Henderson and Fredrickson 1996, Milgrom and Roberts 1992).

Nevertheless, especially for those who believe that a competitive advantage means that the rent should accrue to investors, it is critical to study the conditions under which this will happen. Referring to bargaining power as a form of inefficiency does not illuminate these conditions. At a minimum, this inquiry suggests that there should be a dialog to identify more carefully what is meant by sustainable competitive advantage.

Conclusion

In sum, a resource-based advantage may result in relatively little rent observable in measures of firm performance. This lack of observability does not mean that rent is not generated. Rather, most performance measures capture only the rent that is not appropriated by the most powerful stakeholders. The observable portion of the rent may reflect only the tip of the iceberg—a complete theory of competitive advantage and firm performance must explain and predict both rent generation and rent appropriation.

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Endnotes

[1]The only major exception discussed is that the firm must have management capabilities to organize the resources and generate a strategic capability (Barney 1991, Castanias and Helfat 1991, Coff 1997).

[2]Technically, the terms *inside* and *outside* do not apply when defining the firm as a "nexus" (Jensen and Meckling 1976). However, the terms highlight asymmetric information experienced by external stakeholders. External stakeholders should be unable to capture much of the rent due to their information deficit. We could extend this analysis to buyers and suppliers through a simple application of Porter's (1980) five forces.

[3]While management is a type of complementary asset (Amit and Schoemaker 1993) or organizational capability, it is essentially human capital and defines the managerial role in rent generation (Castanias and Helfat 1991).

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