Corporate Purpose as a Competitive Advantage

Vicente Salas Fumás

University of Zaragoza

March 2022

Outline

- Background, motivation and plan of the exposition
- Comparing the outcomes from competition for value creation and the outcomes from competition for profits
- Discussion of the results
- Unveiled underlying assumptions in value based and profit based competition
- Implications and conclusions

Background

- A growing opinion that Capitalism does not perform well and must be reformed: climate change, deterioration of the natural capital, socially unacceptable levels of income and wealth inequality, concentration of economic and political power…
- Capitalism: a market economy (prices and private property) where production takes place under the direction of investors that finance the capital needed for that production, or under the other people that they designate.
- Capital is owned by legal entities, corporations, that investors finance and receive in exchange shares with economic and political rights. Corporations contract with the parties that contribute to production with their resources, under the privilege of limited liability.
- The corporation controlled by the shareholders is the most distinctive institution of Capitalism
- The proposals for reforming Capitalism necessarily touch on the reform of the corporation

Background

- The debate around reforming the corporation as a way of reforming capitalism is summarized in the different positions that people have taken historically when answering the following question: In the benefit of whom corporations ***are*** managed, and in the benefit of whom ***should*** be managed?
- More recently the question has been restated in the terms: what is the ***purpose*** of the corporation and, and what should it be? Purpose, the reason why the corporation exists
- Answers to this question:

Background

- i) “**IS”**: THE PURPOSE OF THE CORPORATION IS TO MAKE PROFITS FOR THE SHAREHOLDERS. WHY? BECAUSE THE SHAREHOLDERS CREATE, OWN AND MANAGE THE CORPORATION, LEGAL ENTITY, AND PROFITs REPRESENT WELL THE PREFERENCES OF THE SHAREHOLDERS
- ii) “**SHOULD**”: TO MAKE PROFITS FOR THE SHAREHOLDERS EVEN WHEN SHAREHOLDERS DO NOT MANAGE THE CORPORATION AND THEREFORE DO NOT MAKE THE BUSINESS DECISIONS (Friedman, 1970)
- iii) “**SHOULD**”: TO CREATE SOCIAL VALUE/STAKEHOLDERS VALUE. WHY? BECAUSE IT IS A WAY TO EARN HIGHER PROFITS IN THE LONG RUN.
- WHY? BECAUSE MAXIMIZING SOCIAL VALUE IS THE SAME THAN MAXIMIZING THE SIZE OF THE PIE AND PROFIT IS ONE SLICE OF THE PIE (IF THE PIE GROWS, THE PROFIT WILL GROW, TOO (Edmans, 2019).
- WHY? BECAUSE, IN ITS ORIGIN, THE CORPORATION WAS A PRIVILEGE RESERVED TO ENTREPRENEURIAL INITIATIVES WITH A SOCIAL PURPOSE (Mayer, 2018, 2020).
- WHY? BECAUSE IT IS A MORAL OBLIGATION. CORPORATIONS ARE POWERFUL ENTITIES AND SHOULD BE MANAGED AS STATE-MINDED ORGANIZATIONS (Corporate reforms 1920s).

Background: Relation with business strategy and competitive advantage

- **This paper**: Value created (the difference between utility from consumption and the opportunity costs of the resources used in production) has been proposed as a source of competitive advantage (Porter) for business (positively correlated with profits)
- Firms will have incentives to maximize value created because it is a way to gain or sustain a competitive advantage, and ultimately increase their profits. There may be no conflict between maximizing value and maximizing profits (Edmans)
- WE FORMALY COMPARE THE PRIVATE AND SOCIAL OUTCOMES IN TWO MARKET ENVIRONMENTS, ONE WHERE FIRMS COMPETE MAXIMIZING VALUE CREATED AND ANOTHER WHERE FIRMS COMPETE MAXIMIZING PROFITS. We show that the two competition environments correspond to two different theories of strategy: resource based-view, value based view (value maximization; B &S, 1996) and imperfect competition (profit maximization; Porter 1980s)
- What conclusions/recommendations we can draw from the comparison, in the context of proposals for corporate reforms and the position that management scholars should take in front of them?

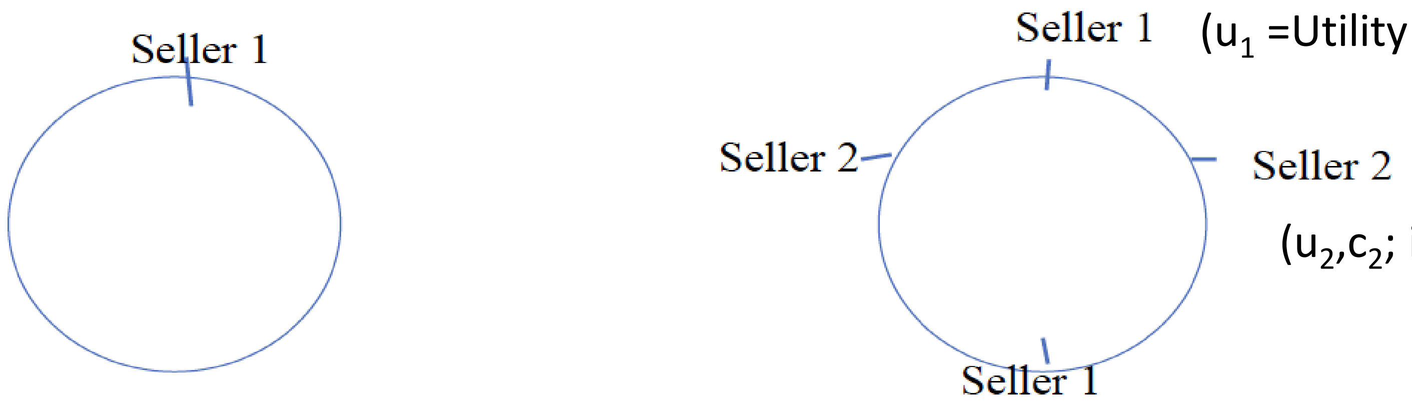
Comparing outcomes from value based and from profit based competition: Assumptions

- Model of spatial competition with vertical and horizontal differentiation; buyers uniformly located in the circumference of the circle (IO set up; Salop, 1979).
- Only two type of stakeholders, buyers (customers) and sellers (shareholders). Extension at the end
- Value created for buyers: Consumers' surplus: Utility-purchasing costs
- Value created for sellers: Profits= Revenue collected- production costs
- Value-based competition: Separation between, value creation and value appropriation; Value created by one coalition depends on decisions made by other coalitions
- Profit-based competition: Value creation and value appropriation take place at the same time.

Comparison of outcomes with competition for value and competition for profit: Formal modelling

- Definition of the spatial market (only case B discussed here)

Figure 1. Circular markets (Salop, 1979) with one seller and with multiple sellers



(u_1 =Utility buyers,c_1= unit production costs)

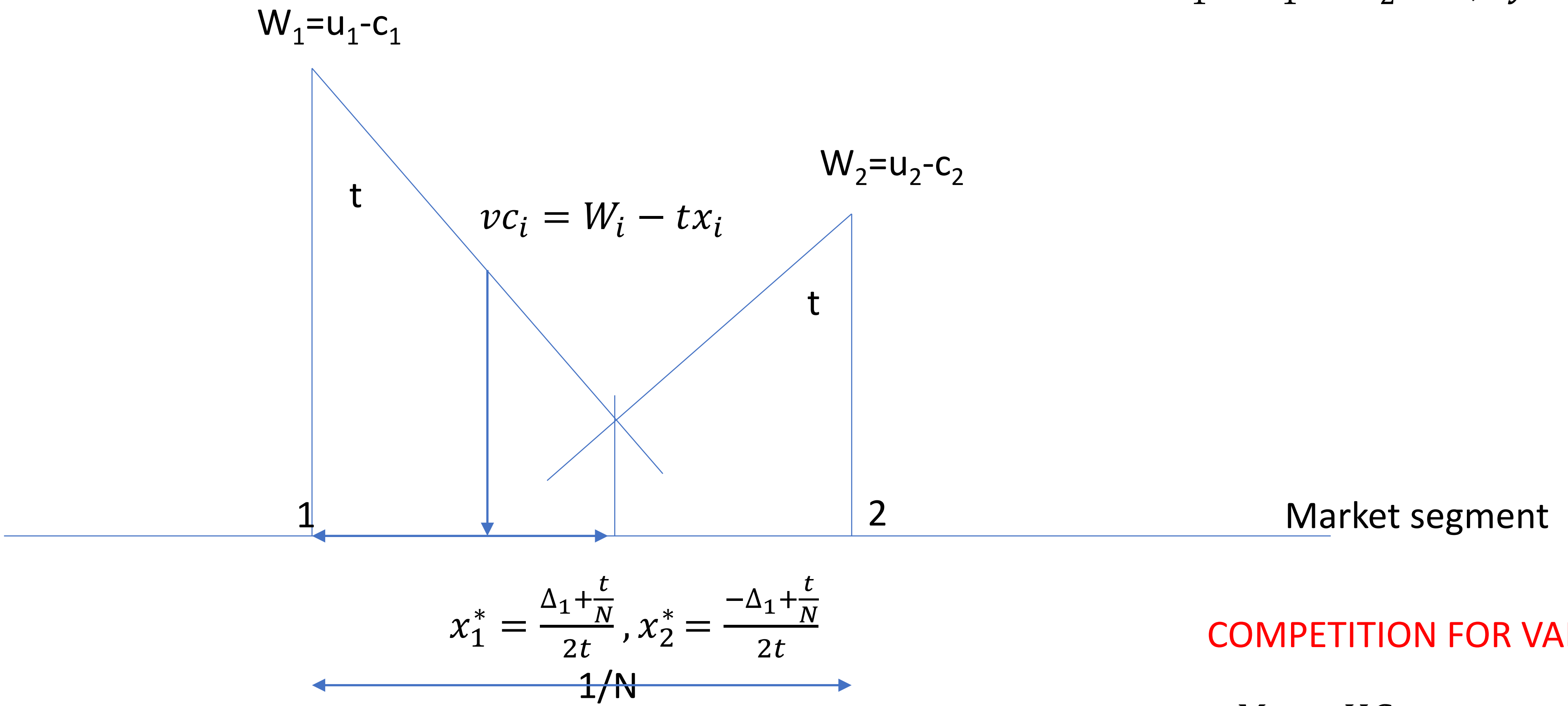
(u_2,c_2; idem)

Case A: Only one seller serving the whole circumference market

Case B: several sellers 1 and 2 symmetrically located in an alternate way

VALUE BASED COMPETITION (All market covered)

Define: $\Delta_1 = W_1 - W_2 > 0, \textit{by assumption}$



$$x_1^* = \frac{\Delta_1 + \frac{t}{N}}{2t}, x_2^* = \frac{-\Delta_1 + \frac{t}{N}}{2t}$$

$$VC_1 = \int_0^{x_1} (W_1 - tx)dx = W_1 x_1 - \frac{1}{2}x_1^2$$

$$VC_2 = W_2 x_2 - \frac{1}{2}x_2^2$$

$$x_1 + x_2 = \frac{1}{N}$$

COMPETITION FOR VALUE

$$Max_{x_1} VC_1$$

$$Max_{x_2} VC_2$$

$$x_1 + x_2 = \frac{1}{N}$$

(PRICE) COMPETITION FOR PROFITS

Firms use prices to attract potential buyers to cluster around them. The indifference condition for a buyer in location x between buying from seller 1 or 2 is similar to the condition when coalitions compete for buyers maximizing the total welfare created but with prices instead of unit production costs,

$$u_1 - p_1 - tx = u_2 - p_2 - t(\frac{1}{N} - x)$$

The quantities demanded from each seller at the given prices are (from the left and from the right):

$$2x = \frac{u_1 - u_2 - p_1 + p_2 + \frac{t}{N}}{t}, \qquad 2\left(\frac{1}{N} - x\right) = \frac{u_2 - u_1 - p_2 + p_1 + \frac{t}{N}}{t}.$$

The firms choose the prices that maximize profits,

$$Max_{p_1}\left(\frac{u_1 - u_2 - p_1 + p_2 + \frac{t}{N}}{t}\right)(p_1 - c_1)$$

$$Max_{p_2}\left(\frac{u_2 - u_1 - p_2 + p_1 + \frac{t}{N}}{t}\right)(p_2 - c_2)$$

The equilibrium prices and quantities from Nash competitive behavior are:

$$p_1^* = \frac{\Delta_1}{3} + \frac{t}{N} + c_1; \;\; 2x_1^* = \frac{\Delta_1 + \frac{3t}{N}}{3t}$$

$$p_2^* = \frac{-\Delta_1}{3} + \frac{t}{N} + c_2; \;\; 2x_2^* = \frac{-\Delta_1 + \frac{3t}{N}}{3t}$$

Table 1. Value based and price competition with multiple sellers and differentiation

	Value based competition	Imperfect competition
Value created per coalition/seller 1	$\left(\frac{\Delta_1+\frac{t}{N}}{t}\right)\left(\frac{3W_1+W_2-\frac{t}{N}}{4}\right)$	$\left(\frac{1}{N}+\frac{\Delta_1}{3t}\right)\left(\frac{11W_1+W_2}{12}-\frac{t}{4N}\right)$
Value created per coalition/seller 2	$\left(\frac{-\Delta_1+\frac{t}{N}}{t}\right)\left(\frac{3W_1+W_2-\frac{t}{N}}{4}\right)$	$\left(\frac{1}{N}-\frac{\Delta_1}{3t}\right)\left(\frac{11W_2+W_1}{12}-\frac{t}{4N}\right)$
Profit seller 1	$(1-\alpha_1)\left(\frac{\Delta_1+\frac{t}{N}}{t}\right)\left(\frac{3W_1+W_2-\frac{t}{N}}{4}\right)$	$t\left(\frac{3t+N\Delta_1}{3Nt}\right)^2$
Profit seller 2	$(1-\alpha_2)\left(\frac{-\Delta_1+\frac{t}{N}}{t}\right)\left(\frac{W_1+3W_2-\frac{t}{N}}{4}\right)$	$t\left(\frac{3t-N\Delta_1}{3Nt}\right)^2$
Value created by the N coalitions/firms	$W_1-\frac{\Delta_1}{2}+\frac{N\Delta_1^2}{4t}-\frac{t}{4N}$	$W_1-\frac{\Delta_1}{2}+\frac{5N\Delta_1^2}{36t}-\frac{t}{4N}$
Value created with N equilibrium and $W_1=W_2=W$	$W-\sqrt{tf}$	$W-\frac{5}{4}\sqrt{tf}$

Results from the comparison of value-based and profit-based competition

- Under similar market structures (t, N), value based competition creates higher total value (value per firm times number of firms) than profit based competition.
- With unlimited bargaining and side payments, the total value created under value based competition can be allocated to shareholders (profits) and buyers (surplus) so that every one is better off than it would be under profit based competition
- The transition from profit based to value based competition can take place in a decentralized way: if a firm shifts from profit to value based competition, the own and total market value created increase, in the equilibrium, irrespective of what other firms do.

Results from the comparison of value-based and profit-based competition (continuation)

- In the short term market equilibrium, the upper limit in competitive disadvantage between high and low value creating firms depends on market structure variables, and is tighter under value based competition than under profit based competition; MARKET STRUCTURE MATTERS
- Value based competition avoids strategizing behavior in the short and mid turn, when value and cost are given, but not in the long term when firms make decisions to increase value and/or lower cost.

Unveiled underlying assumptions in value based and profit based competition

Value Based/Resource based competition (Branderburger and Stuart, 1996, 2007); Peteraf and Barney (2002); Stuart (2016), Gans and Ryall (2017)	**Profit Based/Imperfect competition** Porter (1975, 1985), Makadok (2010); Makadok and Ross (2018)
Cooperative Game Theory/Organizational behavior	Competitive Game Theory/Industrial Organization
Unrestricted bargaining (Nash bargaining). Side payments allowed	Highly restricitive bargaining (Nash competitive behavior and equilibrium). Side payments not allowed
Separation between value creation and value appropriation	Value creation and value appropriation jointly determined
Implicit zero transaction costs in bargaining, contracting and enforcing contracts (Coase (1960) Theorem)	Infinite direct transaction costs beyond announcing a price and accept or reject trade at that price; transaction costs in residual losses.
Implicit perfectly contestable markets (no costs of creation and closing of coalitions)	Markets can be contestable or not (general or specific assets)

Conclusion

- The transition by firms from profit maximizing to value maximizing behavior would not be a major issue in a world of zero transaction costs and perfectly contestable markets. But, with transaction costs, institutions matter, which means that the focus should not be in the objective function of firms, but in the constraints, technological, informational and institutional, under which they operate.
- Salas-Fumás (2021) discusses how to account for transaction costs in the implementation of stakeholders approaches to Strategy
- Price equal to marginal cost as a business policy to implement value maximization competition
- The analysis has been limited to two stakeholders, buyers and sellers; the analysis could be extended to separate sellers into shareholders and employees, but it would be more complicated to include indirect global stakeholders (environment, economic inequality issues).