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Stakeholder cohesion, innovation, and competitive advantage

Mario Minoja, Maurizio Zollo and Vittorio Coda

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Abstract

Purpose – *The purpose of this paper is to explore the limits of stakeholder governance and to contribute a better comprehension of the relationships between corporate social performance (CSP) and corporate financial performance (CFP) through the development of a dynamic model that links together innovation and change, stakeholder cohesion, and competitive advantage.*

Design/methodology/approach – *The approach takes the form of theory building through the development of eight testable propositions.*

Findings – *Stakeholder cohesion may have a ''dark side'' to the extent that it results in inertia and resistance to change, thus reducing propensity to innovation and change. The latter, in turn, are vital for both competitive advantage and stakeholder cohesion itself. Therefore, propensity to innovation and change is the pivotal variable that helps to explain the complex, non-linear, often inextricable relationships between CSP and CFP. Furthermore, external (environmental dynamism) and internal (firm culture) variables moderate, respectively, the impact of innovation and change on firm performance and the impact of firm performance on its propensity to innovation and change.*

Originality/value – *The paper represents a first attempt to use system dynamics to improve the comprehension of the relationships between CSP and CFP and, from a practical point of view, to interpret the economic crisis as a consequence of a too high level of stakeholder cohesion.*

Keywords *Competitive advantage, Innovation, Dynamics*

Paper type *Conceptual paper*

1. Introduction

A high level of alignment between managers and stakeholders about firm strategies and managerial choices is often perceived as a condition allowing a firm to have access to consensus, support and resources it needs from its stakeholders and hence, ultimately, to achieve competitive advantage. We contend that such a perspective alone is partial and even dangerous. The recent financial and economic crisis at a global level could be interpreted also as an unpredicted outcome of a too high level of alignment between managers and stakeholders as far as firm strategies and managerial choices. Stakeholders often failed to play their crucial role of challenging, stimulating, even criticizing firm managers. Managers, in turn, lacked adequate stimuli to challenge their cognitive frames, to refresh their strategies, and to find innovative solutions to meet different stakeholders' demands. A strong alignment between managers and stakeholders resulted in homogeneity of views, which, in turn, led to inertia and to static, unchallenged ways to conduct business, as well as to an unbalanced managerial power. In several cases – like in some well-known investment banks – both managers and stakeholders have implicitly assumed an endless growth of the world economy, which led the former to take huge amounts of risk and the latter to fail in their monitoring and challenging function on managerial action. The final and unpredicted outcome has been a serious threat to firm survival, huge losses and damages for many stakeholders, as well as a widespread loss of trust in firm managers or even in the market economy.

Moving from these assumptions, we propose a conceptual framework that links together stakeholder cohesion – or alignment with a firm's key decision makers –, innovation and competitive advantage. We first briefly summarize the literature on corporate social performance (CSP) – corporate financial performance (CFP) link. Second, we introduce and define the concept of stakeholder cohesion, which relates to the construct of CSP. Third, we develop some theoretical, testable propositions that link stakeholder cohesion to innovation and to competitive advantage. We then present a dynamic model that links together all these theoretical propositions and postulates that propensity to innovation and change is the key variable around which the relationships between CFP and CFP are shaped and evolve over time. Finally, we discuss some conditions that are likely to prevent the negative effects of a too high level of stakeholder cohesion and alignment for firm vitality and survival in the long run.

2. The CSP-CFP literature

A huge number of empirical studies (e.g. Orlitzky *et al.*, 2003; Waddock and Graves, 1997) explored the relationships between CSP and CFP. While methodologically contested and not straightforward (e.g. McWilliams and Siegel, 2000; Margolis and Walsh, 2003), these studies show a clear majority of cases where CSP positively affects CFP. One of the most widespread explanations of this empirical evidence is that CSR would positively contribute to competitive advantage by enhancing differentiation or, in line with the resource-based view of the firm, by fostering intangible assets like reputation and trust, which, in turn, facilitate firm access to resources. Some studies provided more fine-grained contributions by distinguishing the impact of different types of corporate responsibility on financial performance (e.g. Hillman and Keim, 2001; Halme and Laurila, 2009), or by asking what contingencies may affect the sign and the intensity of the CSP-CFP relationship (e.g. Goll and Rasheed, 2004; Harting *et al.*, 2006; Mackey *et al.*, 2007).

While acknowledging that such a massive amount of both empirical and theoretical studies have significantly improved the comprehension of the relationships between CSP and CFP, we argue that a deeper understanding of the complex interplay between social and economic sides of firm performance would require a broader spectrum of perspectives and approaches. First, there is a need of an in-depth exploration also of the negative implications of CSP, going far beyond the traditional argument that corporate social responsibility is costly and entails, *per se*, lesser amounts of profit for shareholders. Second, a deeper investigation of the CSP-CFP relationships would benefit from taking a dynamic approach, well suited to explain the complex, non-linear, often inextricable mechanisms linking together the economic, social and environmental firm outcomes. Third, the identification of moderating variables would be helpful to the advancement of a contingent approach to the CSP-CFP relationship.

3. Stakeholder cohesion

We define stakeholder cohesion as the degree to which stakeholders of the firm are aligned with the firm's key decision-makers, and among themselves, about the vision, the strategy and the values that should guide the firm's behaviour. It is thus conceived as a cognitive construct, having to do with the alignment of perceptions and of representations about what the firm exists for, what objectives it should prioritize and how it should aim to reach them.

We view stakeholder cohesion as the outcome of perceived managers' commitment and effort to act fairly and responsibly, even in case of difficult trade-offs to make between stakeholders' interests to prioritize. Stakeholder cohesion is thus a stock variable which depends on managers' past behaviours, and which influences present and future stakeholders' reactions. The concept of stakeholder cohesion also does not imply that the needs of various stakeholders are equally weighted. They do not necessarily have the same influence on the firm, neither can one assume that the firm has equal impacts on them.

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Stakeholder cohesion can be considered as a proxy of corporate social performance. Nevertheless, a high level of stakeholder cohesion can be, but not necessarily is, a consequence of high levels of stakeholder satisfaction. Stakeholders may be aligned with a firm's key decision makers also when they are required to accept sacrifices or trade-offs, as in case of firm restructuring or turnaround. In such cases, managers' past responsible behaviours fostered stakeholders' trust, which, in turn, makes them confident that sacrifices will be equally shared and current strategies will generate future benefits that more than offset today sacrifices. Stakeholder cohesion can also be the cause of higher levels of satisfaction, given the possible increasing levels of commitment and engagement of stakeholders in the firm's pursuit of its strategic objectives.

Finally, cohesion does not necessarily develop through a process of direct interaction and contact among different stakeholders. Different stakeholders may influence each other's perceptions and behaviours through a system of inter-stakeholder signals (Triantis and Daniels, 1995), which makes each stakeholder perception of a firm and of its management to be affected by perceptions manifested by other stakeholders.

4. Propositions

''The existing business ethics literature lacks an integrated treatment of the complex interplay between ethics and entrepreneurial innovation in different contexts'' (Harting *et al.*, 2006, p. 44). Innovation and change are often required to successfully solve dilemmas and tension that managers have to deal with in presence of conflicting demands from different stakeholders. Innovation may involve the discovery of new, environmentally viable, production processes, the development of new products and services affordable by people at the ''bottom of the pyramid'' (Prahalad and Hammond, 2002), as well as new ways to integrate CSR and the interests of a plurality of stakeholders into business processes and organizational routines (Crilly *et al.*, 2009). Innovation may positively affect stakeholder cohesion through strategic and operational changes. Continuous innovation is expected to produce stronger social or environmental impacts (Sharma and Vredenburg, 1998). When disruptive, innovation may lead to social change (Christensen *et al.*, 2006). Therefore:

> *P1.* All else being equal, firm propensity to innovation and change positively affects stakeholder cohesion.

On the one hand, stakeholder cohesion is likely to enhance stakeholders' commitment and support to managers, since it leads stakeholders to rely on firm's key decision makers, as well as to accept short term sacrifices, if required. Therefore, stakeholder cohesion allows the firm to avoid the costs and inefficiencies implied by the need of managing conflicts and negotiations, to benefit from higher degrees of freedom in defining its own strategy, as well as better access to resources. From this point of view, stakeholder cohesion can be seen as a strategically valuable asset (Dierickx and Cool, 1989). Following Barnett's (2007) perspective, stakeholder cohesion is a ''stock'' that the firm exhibits at a particular point in time and that has been fostered by the past ''flows'' of responsible behaviours of a firm's key decision makers. Hence, it can be argued that higher levels of stakeholder cohesion lead to higher levels of stakeholder commitment and support to managers.

On the other hand, a high degree of stakeholder cohesion is expected to negatively affect stimuli to innovation and change that stakeholders address to firm managers (Figure 1). This phenomenon occurs through several mechanisms. First, while a variety of perspectives stimulates innovation and the discovery of new alternatives (Amabile *et al.*, 1996; Beckman, 2006), cohesion tends to produce and reinforce homogeneity. Some level of diversity in opinion might actually generate the type of frictions that are likely to spark creative insights and actually produce more innovative output (Leonard and Swap, 1999). Second, stakeholder cohesion can impair managers capacity to acknowledge environmental changes and hence to promote adaptation, thus leading to strategic myopia (e.g. Hannan and Freeman, 1984; Huff *et al.*, 1992; Grabher, 1993). Third, stakeholders' cohesion is often

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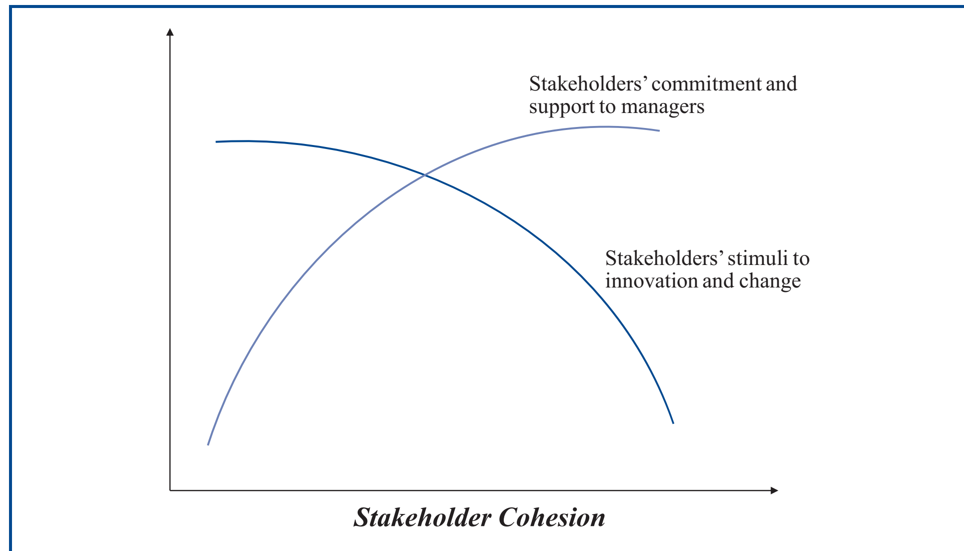
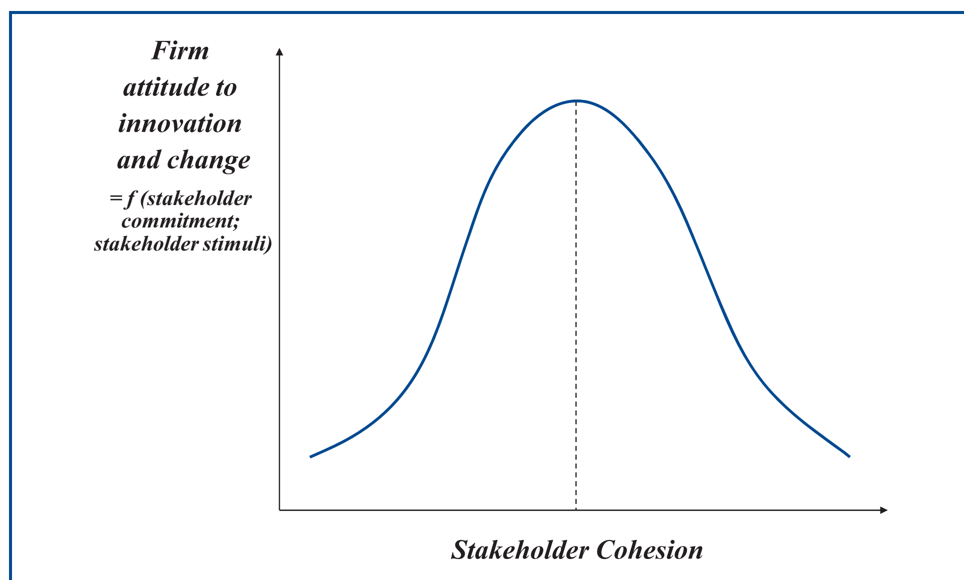
Figure 1 The consequences of stakeholder cohesion: a trade-off between commitment and stimuli to innovation and change



associated to stakeholders' satisfaction about how the value created by the firm is shared, which leads them to avoid or reduce any forms of pressures, challenges or even demands addressed to managers. Hence, the latter are neither compelled nor encouraged to find innovative ways to manage tensions and deal with conflicting demands. Fourth, stakeholders' cohesion may lead to resistance to change.

Hence, we argue that, until a given level of stakeholder cohesion is reached, the positive effects of increasing commitment and support to managers prevail on the negative ones consisting of decreasing stimuli to innovation and change. Beyond that level, inertial mechanisms are likely to prevail, impairing firm propensity to innovation and change (Figure 2).

Figure 2 The U-reverse shaped relationship between stakeholder cohesion and firm attitude to innovation and change



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Therefore:

P2. All else being equal, the relationship between stakeholder cohesion and firm propensity to innovation and change is U-reverse shaped.

Innovation is a strong driver of competitive advantage (e.g. Burns and Stalker, 1961; Christensen and Bower, 1996). Many organizational scholars (e.g. March, 1991, Gibson and Birkinshaw, 2004) have emphasized the importance of even the most radical forms of innovation – namely exploration – for firm survival in the long run. A lack of exploration leads firm resources and capabilities to obsolescence (Levinthal and March, 1993). Innovation is needed to sustain profitability and competitive advantage particularly in those contexts where resources are not immobile (Barney, 1991). Similar arguments apply to change. While patterns of change may differ from one company to another and within the same company along time, change is a fundamental condition for firm survival, mainly in highly dynamic environments. Therefore:

P3. All else being equal, firm propensity to innovation and change positively affects competitive advantage.

On the one hand, competitive advantage, which is widely conceptualized as a situation in which a firm earns a higher rate of economic rents than the average competitor (Besanko *et al.*, 1999), leads to higher amounts of resources available to invest, to foster learning and innovation, and to develop new capabilities.

On the other hand, competitive advantage exposes a firm to the risk of inertia and lock-in. While ‘‘strategic fit among activities is fundamental not only to competitive advantage but also to sustainability of competitive advantage’’ (Porter, 1996, p. 73), such a fit can – ‘‘ironically’’, as O'Reilly and Tushman (2007, p. 18) have acknowledged – become a source of inertia. Similarly, Audia *et al.* (2000) argue that success tends to increase decision makers' feelings of self-efficacy, leading to the ‘‘paradox of success’’; Miller and Chen (1994) contend that success causes complacency, defined as drifting without further attempts at improvement. Highly successful strategies may lead to co-evolutionary lock-in and hence to inertia (Burgelman, 2002). Success may reinforce managerial beliefs about the ‘‘recipe’’ required to achieve competitive advantage, thus making it difficult to introduce innovation and changes into the existing business model (Tripsas and Gavetti, 2000).

Hence, the relationship between competitive advantage and propensity to innovation and change is similar to that linking stakeholder cohesion to propensity innovation and change (see *P2*). Therefore:

P4. All else being equal, the relationship between competitive advantage and firm propensity to innovation and change is U-reverse shaped.

A great number of authors (e.g. Eisenhardt, 1989; D'Aveni, 1994; Brown and Eisenhardt, 1997) have emphasized that the higher the environmental dynamism, the greater the commitment to innovation and change that a firm needs in order to preserve adaptation to its environment, thus competitive advantage. The same logic can be extended to the stakeholder domain: to the extent that stakeholders' demands addressed to the firm change over time or new stakeholders emerge, the need of innovation and change is likely to increase. On the contrary, in case of stability of either social or competitive environment, a low propensity to innovation and change is expected to be less penalizing for firm performance. Therefore:

P5. Environmental dynamism moderates the relationship between firm propensity to innovation and change and stakeholder cohesion.

P6. Environmental dynamism moderates the relationship between firm propensity to innovation and change and competitive advantage.

Arguments supporting *P2* must not automatically lead to conclude that stakeholder cohesion should be kept below a given level. Neither could one maintain that a strong competitive

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advantage is an undesirable outcome of firm strategy because it is expected to lead to a ''success syndrome''. Rather, in case of high levels of cohesion between managers and stakeholders or of competitive advantage, the key question is how to exploit stakeholders' commitment to managerial decisions and resources arising from firm profitability while simultaneously avoiding that reduced environmental scanning and inertial forces weaken the fit between the firm and its environment. We argue that the reconciliation between a firm's success, either competitive or social, and its capability to continuously adapt to environmental changes occurs when innovation and change are values deeply rooted in its culture. These values can prevent a firm from the risks of perceiving its own success as definitely achieved, or of believing to have found the right, universally valid, strategic ''recipe''. They also lead decision makers to proactively undertake in innovation and change regardless of stimuli and demands from stakeholders. Therefore:

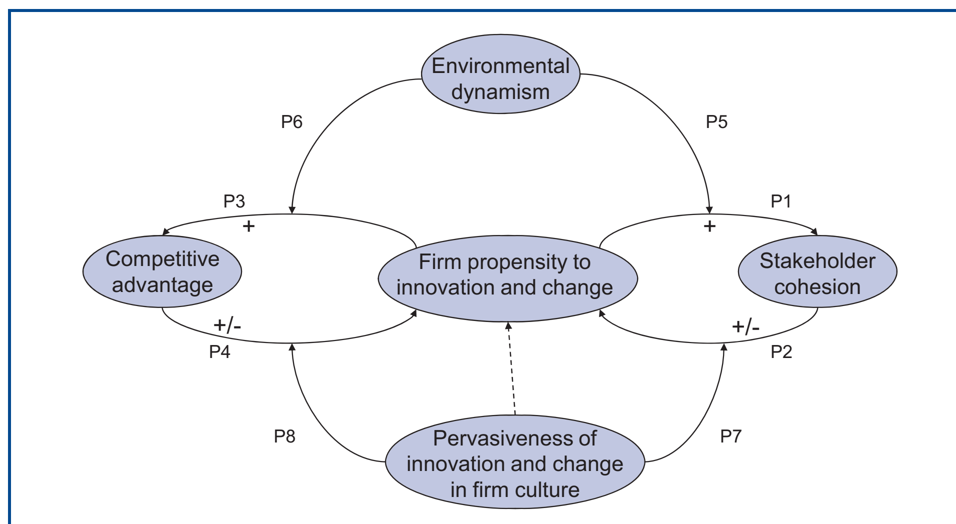
P7. Pervasiveness[1] of innovation and change in firm culture moderates the relationship between stakeholder cohesion and firm propensity to innovation and change.

P8. Pervasiveness of innovation and change in firm culture moderates the relationship between competitive advantage and firm propensity to innovation and change.

5. A system dynamic model

The eight propositions presented above form a dynamic model (Figure 3) where firm propensity to innovation and change is the pivotal variable, as it positively affects both competitive advantage (namely CFP) and stakeholder cohesion (namely CSP). This is in line with recent studies that focus on innovation as a mean to solve social or environmental problems and, at the same time, improve financial performance, creating a win-win situation (Halme and Laurila, 2009). In turn, firm performance, either financial or social, has feedback effects on innovation. While in presence of extreme levels of stakeholder cohesion propensity to innovation and change is inhibited by conflict (in case of very low levels) or by inertial forces (in case of very high levels), intermediate levels of cohesion ensure adequate stakeholders' commitment and managers' vitality. A similar logic applies to the relationship between competitive advantage and propensity to innovation and change. Thus, if we use the language of system dynamics[2] (Forrester, 1961, 1968), we can say that a negative feedback loop between firm performance and propensity to innovation and change is in place. Stated differently, the system fluctuates around anequilibrium, since if a ''too'' high

Figure 3 A dynamic model linking together stakeholder cohesion, competitive advantage and innovation



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level of stakeholder cohesion results in a lack of innovation and change, the latter will impair firm adaptation to its social or competitive environment. That ''misfit'' will encourage or constrain firm managers to undertake strategic or operational innovations and changes. The same line of reasoning applies if competitive advantage is the ''starting point'' of the loop. Moderating variables – i.e. environmental dynamism and firm culture – are likely to affect the intensity of these relationships.

The one century history of the Rosignano chemical plant of Solvay in Italy helps exemplify the complex interplay between competitive and stakeholder domains suggested by our dynamic model. For a long time since the establishment of the Solvay plant in the Rosignano area at the beginning of twentieth century, the local community asked for employment protection, as very few alternative opportunities of jobs were locally available. Solvay, in order to preserve its legitimization while exploiting new technological opportunities and less labour intensive processes, adopted all possible initiatives (from reduced employees' turnover to voluntary integration of pension funds) to reduce the impact of its replacement of labour with capital. In the last two decades the emergence of new sources of jobs and of tourism in the Rosignano area resulted in a diminished relevance of the employment issue and led the local community to attack Solvay for the supposedly negative environmental impacts of its productions. The ''acceptation problem'' that Solvay, as a chemical plant, has to deal with at local level has resulted in flows of innovative solutions to cope with emissions, use of water, use of other natural resources. These solutions, in turn, have both made possible cost reductions and have been licensed to firms facing similar problems in other industries. Moreover, Solvay has proactively committed to innovative forms of partnerships with both private and public institutions, which allowed it to share costs and investments necessary for environmental protection and to simultaneously benefit from improved reputation. Just to summarize, the Solvay history shows, first, how stakeholders' demands may change over time, second, how a moderate gap between stakeholders' expectations and current outcomes can contribute to keep a firm vital and open to change, and, third, how innovation on social or environmental domains may have spillover effects on financial performance (Porter and Kramer, 2006).

6. Discussion and conclusions

''What was lost was that 'healthy spirit of discontent' that helped define Motorola's innovative capability for years'' (Finkelstein, 2006, p. 158). This insightful explanation of Motorola's unexpected decline in the mobile phone industry in the late Nineties helps us clarify the first major contribution of our paper, consisting of shedding light on what we could call the ''dark side'' of stakeholder cohesion or, in broader terms, the ''dark side'' of corporate social performance. A very high level of alignment between managers and stakeholders may result in inertia and resistance to change, whereas a moderate gap between expected and current outcomes for stakeholders is likely to inoculate in an organization a ''sound'' tension that stimulates propensity to innovation and change.

Furthermore, this approach confirms and integrates previous research that found innovation to positively affect cognitive alignment between managers and stakeholders, thus leading to corporate social performance (Zollo *et al.*, 2009). Our theoretical model, while acknowledging that innovation and change foster stakeholder cohesion, postulates that the reverse relationship is not so straightforward.

The proposal of a system dynamics approach – that, to our knowledge, has never been used before in the CSR and stakeholder theory domains – is the second major contribution of our paper. We are aware that our model is only a very first attempt in this direction, but believe that system dynamics has the potential to capture the complex, nonlinear, time dependent relationships that connect CSP to CFP and that have still remained relatively unexplored.

Finally, we tried to contribute to the advancement of a contingency approach to the studies on the relationship between CFP and CSP. While this is not an innovative one (e.g. Simpson and Kohers, 2002; Goll and Rasheed, 2004), there is still a need of a better comprehension

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of which factors – either external or internal to a firm – may affect the direction and the intensity of that relationship. We thus argued that both environmental dynamism and corporate culture can have significant impacts on how and to what extent CSP and CFP are related to each other.

As stated in the introduction, the dramatic financial and economic crisis that still involves the entire world may be interpreted also as a consequence of a long period of high levels of stakeholder cohesion, resulting in unchallenged managerial beliefs and ways to conduct business, as well as unbalanced managerial power. Thus, the key question is how managers and stakeholders can behave to ensure that a firm plays a ''sound'' role in society continuously over time. Starting from this assumption and drawing on our theoretical model, we propose some very first ideas to answer this question.

First, values of innovation and change should be inoculated in all possible ways into a firm culture, in order to prevent, or at least reduce, the negative implications of success on competitive and/or social environments. If innovation and change are part of the leaders' value system, they can be infused into a firm's culture mainly by shaping organizational mechanisms and reward systems. Otherwise, they might be absorbed by organizational culture after a long time of environmental pressures that force a firm to develop innovative solutions to cope with them. Second, firm stakeholders should be aware that they have the key responsibility to challenge, stimulate or even criticize managers in order to help them ensure firm adaptation and alignment through innovation and change. It's ultimately a matter of stakeholders' culture. Third, we contend that heterogeneity of views within a firm has positive effects on its capability to preserve adaptation to environment. To that purpose, corporate governance structures and mechanisms should be designed in order not only to ensure the representation of a wide range of stakeholders' interests, but also to facilitate variety, heterogeneity of perspectives and discussion, thus promoting the development of continuous learning mechanisms.

Notes

1. While firm propensity to innovation and change is an operating variable (behaviours and activities), pervasiveness of innovation and change in firm culture is a cognitive one (values and culture).

2. System dynamics would require that in a model flow variables follow stock variables and vice versa. In our model it would entail, for instance, that propensity to innovation and change (a stock variable) leads to ''flows'' of innovative actions and initiatives (a flow variable), that, in turn, impact on stakeholder cohesion (a stock variable). For sake of simplicity, we prefer not to make explicit all these cause-effect relationships.

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