# On Creating Public Value

## What Business Might Learn from Government about Strategic Management


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## For Further Information

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## Abstract

Over the past twenty years, scholars from both the Kennedy School of Government and Harvard Business School have worked with public sector executives to develop a concept of “strategy in the public sector”. The symbol of this idea became a “strategic triangle”, the purpose of which was to focus the attention of government managers on three complex issues they had to consider before committing themselves and their organizations to a particular course of action:

- First, what was the important “public value” the organization sought to produce?
- Second, what “sources of legitimacy and support” would be relied upon to authorize the organization to take action and provide the resources necessary to sustain the effort to create that value?
- Third, what “operational capabilities” (including new investments, innovations and alliances) would the organization rely on (or have to develop) to deliver the desired results?

In the following paper, the authors apply this “strategic triangle” to corporate strategy, focusing on the question, “what would it mean for our conceptions of corporate strategy if we started thinking that corporations, too, had to be more systematically concerned about their wider ‘legitimacy and support’? In recent years there has been a sharp escalation in the social roles corporations are expected to play. Companies are facing new demands to be accountable not only to shareholders, but also to other stakeholders such as customers, employees, suppliers, local communities and policy makers. As a result of this changing business environment, the authors argue that the concept of organizational strategy developed for government agencies may work as well or even better than traditional business models when applied to business organizations. At a minimum, this is probably true for private sector organizations that operate in intensely politicized environments, or that depend on maintaining a certain kind of social credibility and legitimacy in order to be successful in consumer and investor markets.

# On Creating Public Value

## What Business Might Learn from Government about Strategic Management

About twenty-five years ago, in the early days of the Kennedy School of Government's efforts to develop the field of "public management," the elder of the two authors of this article was dispatched to the Harvard Business School to learn what they knew about "private management." His assignment was simply to import (or, if necessary, adapt) as much of that knowledge as seemed both useful and appropriate for the task of managing government agencies. At that time, the KSG took it for granted that "business" had a great deal to teach "government" about management, and that we could advance our work on managing government agencies by learning what the Business School knew about managing private sector firms.

Over the next decade or so, a community of scholars from both the Kennedy School and the Business School worked on that task. We did so in the company of many distinguished public sector executives who had shown that they knew how to manage public sector enterprises not by writing theories, but by succeeding at the task. Eventually, that informal but powerful learning community seemed to settle on a relatively simple idea that could be used by government managers to help set strategy for government agencies.[1]

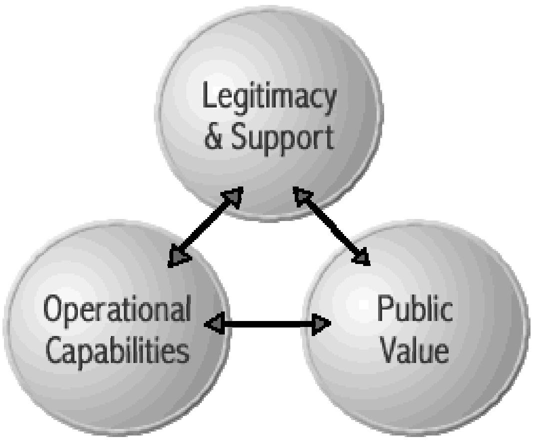
We argued that just as the goal of private managers was to create private (economic) value, the goal of government agencies was to "create public (social) value." To determine what constituted public value, and to act to produce it, we developed a concept of "strategy in the public sector." The symbol of this idea became a simple diagram we called the "strategic triangle." (See Figure 1.) The purpose of this diagram was to focus the attention of government managers on three complex issues they had to have considered before (or, while!) committing themselves and their organizations to a particular course of action:

- First, what was the important **"public value"** the organization sought to produce?
- Second, what **"sources of legitimacy and support"** would be relied upon to authorize the organization to take action and provide the resources necessary to sustain the effort to create that value?
- Third, what **"operational capabilities"** (including new investments and innovations) would the organization rely on (or have to develop) to deliver the desired results?

[1] These ideas are developed at length in Mark H. Moore, *Creating Public Value: Strategic Management in Government*. (Cambridge, Mass: Harvard University Press, 1995)

**Figure 1.**

Strategic Triangle




We wrote about this concept, and taught it in both our degree programs and executive classes.[2] And, as we taught it, we learned more about it. The tool began to be shaped by the various uses to which it was put, and, as a result, it became richer and more powerful.[3]

For most of that time, we thought of this concept as a simple adaptation of basic ideas of business strategy to the government sector. We assumed that business scholars and practitioners had worked out and tested the idea of corporate strategy for the private sector, and that they did not need much help or guidance from us in this work. Our idea was one that had been adapted to the special problems of managing government agencies in environments where all the money needed to keep an organization going came from collectively supplied tax dollars rather than private consumer choices; where authority over the use of those dollars was widely dispersed rather than concentrated; and where the issue of what constituted a result that was worth paying for was both hotly contested at the conceptual level, and exceedingly difficult to measure at the concrete and operational level.

> "…the concept of organizational strategy we developed for government agencies might actually be a more general model than we first thought – one that would work as well or even better than traditional business models when applied even to business organizations. At a minimum we think this is true for private sector organizations that operate in intensely politicized environments, or that depend on maintaining a certain kind of social credibility and legitimacy in order to be successful in consumer and investors markets."

[2] For other books, see Philip B. Heymann, *The Politics of Public Management* (New Haven, Conn. Yale University Press, 1987), and Robert B. Reich, *Public Management in a Democratic Society* (Englewood Cliffs, N. J.: Prentice Hall, 1990). For compatible approaches about public management and governmental strategy for policy reform in developing countries, see Merilee S. Grindle and John W. Thomas (1991), *Public Choices and Policy Change: The Political Economy of Reform in Developing Countries*, Baltimore, MD: The Johns Hopkins University Press, as well as Derick W. Brinkerhoff and Benjamin L. Crosby (2002), *Managing Policy Reform: Concepts and Tools for Decision-Makers in Developing and Transitioning Countries*, Bloomfield, CT: Kumarian Press.

[3] Claude Levi-Strauss talks about the ways in which conceptual tools become richer with use. See Claude Levi Strauss, *The Savage Mind.* (Chicago, Ill.: University of Chicago Press, 1966)

Recently, however, the younger of the co-authors has led the Kennedy School into a new world: one of globalization, multinational corporations, transnational nongovernmental organizations and novel forms of (global) governance. That has brought us into contact with businesses that have become concerned about the pressures they are experiencing that drive them towards the acceptance of increased "corporate responsibility." That contact, in turn, has encouraged us to consider an exciting idea: namely, that the concept of organizational strategy we developed for government agencies might actually be a more general model than we first thought – one that would work as well or even better than traditional business models when applied even to business organizations. At a minimum, we think this is true for private sector organizations that operate in intensely politicized environments, or that depend on maintaining a certain kind of social credibility and legitimacy in order to be successful in consumer and investors markets. More ambitiously, we want to argue that our strategy model both helps to resolve some troubling and neglected issues in business strategy, governance and accountability generally. Further, we want to argue that the resolution of these issues is particularly important in a world in which business has been increasingly called upon to address broader social and environmental issues, and some businesses have increasingly claimed that they have significant capacity to do so.

We will first set out the concept of strategy we developed for government agencies in a bit more detail, and then discuss the ways in which it challenges and improves on more traditional as well as emergent business models.

# I. Organizational Strategy in Government Agencies

From one perspective, those managers who are responsible for leading government agencies face a problem that is entirely analogous to the problem that those leading for-profit entities face. Like for-profit managers, they have been entrusted with a bundle of assets. Their job is to find high value uses for these assets in relatively dynamic environments in which ideas about what is valuable, and the methods that can be used to transform liquid or general purpose assets into valued results, can both change rapidly. At the strategic level, their success turns on seeing the connection between the things that they now know how to do (or could learn to do) on one hand, and the things that the world values (and is willing to pay for) on the other. At the operational level, their success turns on finding a less costly way of producing the goods and services they now produce. In short, both private and public sector managers ought to be interested in getting the most out of the bundle of assets entrusted to them by figuring out the best use of the assets, and finding ways to produce their products and services or achieve their desired social results at the lowest possible cost. At this level of abstraction, the challenge of those who lead both private and public organizations is about the same.[4] Once one drops down a level of abstraction, and looks more closely at the economic and political conditions under which these individuals manage, however, things begin to look quite different.[5]

## Sources of Revenue

Perhaps the most important difference lies in the ways in which private and public organizations earn the revenues needed to continue their operations. In the private sector, while many firms have had to go into capital markets to get initial financing for their operations, the bulk of their financing has to come ultimately from revenues earned by the sale of products and services to individual customers who have money to spend, and decide to spend it on what the organization is producing. If they cannot succeed in generating revenues of this kind, their success in generating investment dollars will not last very long, for investors are pumping money into the firm precisely because they expect such returns in the future.

In the government, the principal source of money – both financial capital and operating revenues – is not investors or consumers making individual choices to invest and buy; it is citizens, taxpayers, clients of government, and their elected representatives making a collective choice that there is a result that can plausibly be produced by the government organization that is worth taxing ourselves to produce. Government managers secure the resources they need to operate not by selling products and services to individual customers, but by selling a story of public value creation to elected representatives of the people in legislatures and executive branch positions.[6] Typically, they receive little revenue directly from those who are provided with publicly financed goods and services. Most of their revenues come from executive branch recommendations that are then passed as legislative appropriations. The people that have to be sold on the value of what is being produced, then, are not those "across the counter" at the "tail end of the production process;" they are those "upstream" customers who authorize the use of public money for public purposes. Those public purposes can include providing services and benefits to particular classes of individuals at more or less subsidized prices. But they could also involve the production of more aggregate results such as protecting the environment or going to the moon.

[4] On important similarities and differences between management in the public and private sector, see Graham T. Allison, "Public and Private Management: Are They Fundamentally Alike in All Unimporant Respects?" in Jay M. Shafritz and Albert C. Hyde, eds. *Classics of Public Administration* 2nd ed (Chicago: Dorsey Press, 1987). On similarities, see also Donald F. Kettl (2000), *The Global Public Management Revolution: A Report on Transformation in Governance*, Washington D.C.: The Brookings Institution.
[5] See also Malcolm Sparrow (2000), *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*, Washington D.C.: The Brookings Institution.
[6] Mark H. Moore, Creating Public Value, pp. 92-94.

## Management Discretion

A second key difference is that government managers typically have much less discretion to define the purposes of their organizations, and the ways they intend to pursue those purposes.[7] Government managers are both surrounded and thickly engaged by what we came to call their "authorizing environment."[8] That "authorizing environment" includes the large number and wide variety of people in particular positions who authorize them to take action, or appropriate money for them to use. The authorizing environment also includes those who can influence the particular individuals who make these decisions and have reasons to do so. Together, these individuals can call managers to account for their performance, and choose to continue or withdraw the authorizations and money the managers need to operate.

One might imagine there is rough analogy here between the relationship of a CEO of a private sector firm and her Board of Directors, and Stockholders. And the analogy holds up in the sense one can reasonably argue that a CEO is ultimately accountable to the Board and the shareholders, and that it is their interests and purposes the CEO is bound to pursue. But the analogy breaks down when one looks closely at the nature of this key interaction.

For one thing, the authorizers in the public sector – the elected representatives of the people, and those who influence them – are much more active in their oversight than are shareholders. They demand and get significantly more information. Moreover, because they cannot sell their shares if they are disappointed, they use the "voice" option much more than the "exit" option. So things get rather noisy.[9]

For another, the authorizers have substantially more varied interests that they seek to pursue through the organization's activities than is true for private sector firms. In looking at a welfare program, for example, some of the authorizers want to minimize the overall cost of the program; others want to keep the administrative costs very low; still others want to make sure that no one gets any money who is not entitled to it under the program; others want to protect the privacy and dignity of the welfare clients; others want to make sure that the benefits are adequate to provide a secure and healthy home for children; others want to be sure that the program both equips and motivates welfare clients to become independent; etc.[10] In principle, these partially conflicting, partially consistent interests were resolved when the organization was given its mandate. In reality, however, both because we cannot be sure how the enterprise will actually perform along each of these dimensions, and because it is hard to think about the trade-offs among these good things, the conflict over the program that was always present among the elected representatives is simply pushed onto the organization to handle as best it can.[11]

Finally, while in the private sector the capital market provides only one source of funds and customers provide a second, in the public sector the authorizing environment is often the *only* source of funds. The only way that government agencies can secure revenues to cover their costs is to satisfy these authorizers that they are doing something valuable for them. Unlike business, they cannot have the value of what they are producing be demonstrated in the market place in which customers provide companies with the wherewithal to continue their operations.

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[7] For the amount and kind of discretion that public managers have, see the following: Herbert Kaufman, *The Administrative Behavior of Federal Bureau Chiefs* (Washington, DC: The Brookings Institution, 1981; Jameson Doig and Erwin C. Hargrove, *Leadership and Innovation: A Biographical Perspective on Entrepreneurs in Government* (Baltimore: Johns Hopkins University Press, 1987), and James Q. Wilson, *Bureaucracy: What Government Agencies Do and Why They Do It* (New York: Basic Books, 1983)

[8] Moore, Creating Public Value, p.114

[9] For a discussion of "voice" and "exit" as means of influencing collective enterprises, see Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, Mass.: Harvard University Press, 1970

[10] For an empirical examination of the different "dimensions of value" monitored by groups in the authorizing environment of police departments in two cities, see Mark H. Moore, et. al. *Recognizing the Value of Public Police Departments: The Challenge of Measuring Police Performance* (Washington, D.C.: Police Executive Research Forum, 2002)

[11] James Q. Wilson, *Bureaucracy*, p. 238

## Performance Measurement

This leads to the third major difference between the contexts of private sector managers on one hand, and government managers on the other. While private sector managers can measure the financial performance of their organizations relatively easily and quickly through the use of financial measures, government managers face a far more difficult problem in measuring the performance of their organizations in objective terms that prevent or discourage arguments. Of course, following the work of Robert Kaplan and the emergence of research on triple-bottom line (economic, social and environmental) accounting and reporting, we have come to understand that even businesses need more than financial information about their past performance to manage themselves well.[12] And it is important to keep in mind that government managers can have as much financial information about their costs as is available to private sector managers. So, there may be less difference here than one first imagines.

Yet, government managers are missing one crucial piece of information that private sector managers have: the magnitude of the revenues earned by the sale of goods and services to willing customers. To see how significant this might be for government management, just consider what a private sector manager – say an automobile manufacturer – would do in a world where he could have all the cost information he wanted, but could not have any information about the price of the cars, and the revenue earned by selling them. What that manager would be missing is an objective measure of the gross value of what he was producing that he could use to set against his costs to discover whether he was a net value creator or not. Since the crucial thing for a manager to know is whether his activities are increasing net value, he would face no choice but to try to find some other way of measuring net value. He might ask those who bought his cars how much they "liked" them. He might ask some engineers whether they thought his cars were "good" in technical terms. (In these respects, the private manager would be forced to rely on much that public managers now rely on to measure the value of their activities.) But it is clear, we think, that a manager's ability to run his operation to create value – to find value creating products and services, to allocate resources to the highest value uses, to find ways to reduce costs and widen the gap between costs and the value of what is being produced in particular product lines – is radically diminished when he lacks precise, objective, quantitative information about the value of the products and services being produced.

To deal with this problem, government managers have been forced to construct measures of value other than the revenues earned by the sale of goods and services. On one hand, they have tried to focus their attention on the "social outcomes" that their mandate obligated them to produce.[13] This is, again, fine in principal, but it turns out to be both expensive and difficult to measure the outcomes of government action; partly because the desired results often occur some years after the government has acted, in a place that has become far removed from the government agency's current operations. Further, precisely because so much happens between the actions of the government agency on one hand, and the social results on the other, even if we can see a change, we cannot be sure it ought to be attributed to the government's action rather than some other cause.

On the other hand, they have tried to measure "customer" or "client" satisfaction with government services.[14] Again, there is nothing wrong with finding out whether a person visiting the registry of motor vehicles was satisfied with the way

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[12] Robert S. Kaplan and David P. Norton, *The Balanced Scorecard:Translating Strategy into Action* (Boston, Mass.: HBS Press, 1996). On triple bottom line, or social and environmental, or sustainability reporting , see J. Emil Morhardt (2002), *Clean, Green and Read All Over: Ten Rules for Effective Corporate Environmental and Sustainability Reporting*, Milwaukee, WI: ASQ Quality Press, and Chiristopher D. Ittner and David F. Larcker, "Coming Up Short on Nonfinancial Performance Management," *Harvard Business Review*, November 2003. See also the work of the Global Reporting Initiative at www.gri.org.

[13] J. S. Wholey, Mark A Abrahamson, and Christopher Bellavita, *Performance and Credibility: Developing Excellence in Public and Nonprofit Organizations* (Lexington, Mass. DC Heath, 1986); and Joseph Wholey, "Performance-Based Management: Responding to the Challenges" *Public Productivity and Management Review, 22 (3), 288-308.*

[14] For a positive view on the use of customer service measures, see Kettl, *The Global Public Management Revolution*. For a more critical view, see Sparrow, *The Regulatory Craft*.

he was treated, or asking a drug addict whether he was satisfied with the quality of the drug treatment program in which he enrolled, or even asking a prison inmate whether the products and services he is receiving suit him. But one has to ask the question whether "customer satisfaction" is the ultimate goal of all or even most government activities. Often, that seems doubtful – even for those government activities that deliver benefits and confer privileges on individual clients, let alone those such as law enforcement, regulation, and tax collection that inflict costs and impose obligations rather than deliver benefits. The reason is at least in part that most often in government we are interested in achieving social outcomes, and that goal may or may not include or require customer satisfaction. Indeed, in an important way, once we say that our interest is in achieving social results rather than customer satisfaction, the customer or client of the government becomes a means to an end (the achievement of the desired social outcome) rather than an end in itself (unless the desired social outcome is to make the client happy).

Because it is hard to measure the value of government operations in terms of either social outcome or client satisfaction, government agencies have often been forced back on to an unsatisfactory third alternative: namely, the measurement of their concrete outputs and activities. Such measurement has the enormous advantages of being relatively simple and inexpensive. It also has the great managerial advantage of coming in early enough to allow top level managers to hold lower level managers accountable for their level of accomplishment, and to learn what seems to be working well and where the operational glitches are. But the difficulty is that these assessments cannot ever be taken as reliable measures of the public value of what is produced.

So, public managers have a difficult time measuring and demonstrating the value of what they are producing. This makes the problem described above – the continuing contention about whether the organization is producing something of value to diverse authorizers – even more difficult. There is no easily available objective, empirical evidence to decide whether an organization is successful in what it is now doing, or that a given program works to achieve the desired social result. Without an objective standard that can answer arguments about whether things are going well or badly, managers in the public sector have to be engaged in a daily struggle to establish their authority and focus the efforts of their organizations against contending political forces. It is as though a private sector manager faced a proxy fight or a hostile takeover on a day-to-day basis.

These differences in context matter. They force us to make some changes in traditional business models to usefully guide government managers. But they do not change everything about management, and there is much from the business world we tried to hold onto as we developed our concepts of strategy in government.

We took from the private sector the image of a manager as a restless value creator – a person who was responsible for creating value, and took the initiative in meeting this responsibility.

We also happily incorporated the idea that fitting an organization's capabilities to the environment was a key managerial task. Of course, the environment that mattered to public sector managers differed from the one that faced private sector managers. Private managers faced *market environments* populated by customers and competitors. The task was to find those things that appealed to customers more powerfully than the things one's competitors had for sale. Public managers, in contrast, faced two somewhat different environments. On one hand, like private managers, they had to be concerned about what could be characterized as the "*task environment*" in which value was created – the world of objective conditions that they might be responsible for altering, or of individual needs which could became the focus of public concern. On the other, they had to be concerned about which of these conditions and needs were their responsibility, and what resources they could tap in trying to deal with these conditions and needs. They couldn't rely on the "customers" to supply the resources. They had to rely principally on the commitment of citizens and those who represented them to offer guidance about which conditions and needs should focus their energies, and to provide the authorization and funds they needed to do their work.

And finally, we embraced the private sector's enthusiasm for a certain kind of customization and dynamism. Not every level of government had the same priorities. Not every client had the same needs or responded to the same actions by the government. Further, the world changed over time. New problems and new needs arose. New political aspirations created new mandates for action. Technologies changed in ways that allowed managers to make significant productivity gains. The task of management was, consequently, to respond to these changes through innovations of various kinds. This forced managers to look for flexibility in the way that they operated even as they understood that they would also be held accountable for using their powers and resources consistently and fairly as well as efficiently and effectively. All this created problems for a traditional view of public administration that focused primarily on protecting the institutional continuity and integrity of government organizations.[15]

## The Strategic Triangle

In this context, we thought it best to focus managerial attention first on the issue of "public value." We understood that what constituted public value would be hotly contested. But that was the point. The manager had to enter this debate to help him clarify what he or she should be trying to produce, and what results he or she should feel accountable for achieving. It was important to establish a sense of purposefulness in management even in a world in which values were contested. Thus, the first point on our triangle was the idea of "public value."[16]

We added to the idea of public value that it was not sufficient for a public manager to have his or her *own* view of public value; others had to *share* it. In particular, the group of people in positions that could confer legitimacy and provide financial support to the manager would have to agree with the conception of public value that was to be pursued. Thus the second point on our triangle focused on the idea of gaining "legitimacy and support" from the manager's authorizing environment.[17]

> "The strategic problem for public managers thus came to be: imagine and articulate a vision of public value that can command legitimacy and support, and is operationally doable in the domain for which you have responsibility."

Finally, we understood that there was an important managerial challenge associated with building or adapting or exploiting the real "operational capabilities" of a given organization. We added to this idea a recognition that, in the public sector, much of the capacity that a manager needed to produce public value lay outside the scope of the organization he could control directly, and that this created both an opportunity and a challenge in thinking about what constituted the relevant operational capacity. A school superintendent could think that the most important operational capacity he had to educate students lay in the assets and capabilities he could directly control: e.g. the buildings, the teachers, the curriculum in general, the lesson plans more particularly, etc. Or, the superintendent might imagine that his ability to achieve his goal lay with the contributions that parents and teachers could make on a voluntary basis as well as his teachers. If he thought the latter was important, he might allocate resources and design operations to find ways to mobilize parents as well as teachers.[18]

The strategic problem for public managers thus came to be: imagine and articulate a vision of public value that can command legitimacy and support, and is operationally doable in the domain for which you have responsibility.

[15] Moore, Creating Public Value, pp. 16-22
[16] Ibid, Chs. 2, 3.
[17] Ibid. Chs. 4,5
[18] Ibid, Chs. 6,7

Understand that you will have to engage in tough substantive and analytic work to figure out what constitutes the valuable ends and means. Understand that there will be a constant political fight for resources and authorization, and do not shun this as unimportant. Understand that the capabilities you need will come from outside the organization as well as within.

As noted above, this idea has worked well for many government managers. The important question is what, if anything, does this idea have to say to private managers in the for-profit and non-profit world?

# II. Corporate Strategy and the Strategic Triangle: Does Business Need to Focus on Legitimacy and Support?

In contrast to the strategic triangle shown in Figure 1, current conceptions of corporate strategy give pride of place to the important issue of how a private sector organization plans to compete in product, service, and input markets to achieve the goal of maximizing long-term shareholder wealth.[19] At the center of a corporate strategist's concern is a set of markets. These markets consist of customers, suppliers and competitors of various kinds. The firm enters these markets with products and services to sell. Those products and services have particular attributes that make them more or less desirable to individuals with money to spend on them. Among the important attributes of a product is its price. The price is important not only as an attribute that will influence a customer's decision to buy, but also as something that guarantees a flow of financial returns to the company. Those financial returns, in turn, pay for the continued operation of the firm, and offer returns to investors who have placed their trust in the firm. There is a simple, powerful coherence in this idea of "competitive strategy" that has helped market organizations perform well in meeting customer and investor demand over long periods of time, and across many different market conditions. What, if anything, could the strategic triangle, developed for government managers, add to this well-honed conception?

From the point of view of someone steeped in the lore of the strategic triangle, one of the most obvious differences between the concept of strategy in the public sector on one hand and the dominant model of strategy in the private sector on the other is that the "legitimacy and support" circle that is so important in public sector conceptions is missing from conceptions of strategy in the private sector. An important question is: why? Why is it that this issue is a consideration of the first rank for public managers, and of lesser importance to private sector managers? And what would it mean for our conceptions of corporate strategy if we suddenly started thinking that corporations, too, had to be more systematically and strategically concerned about their "legitimacy and support?"

## Customers as a Source of Legitimacy and Support

One important answer to this question is that private corporations do not have to worry too much about "legitimacy and support" because they get all they need from customers. After all, if an important part of "legitimacy and support" is really just "material" or "financial" support (i.e., securing the financial means to continue operations), then the most important source of "support" to a private firm is the willingness of customers to pay money for the products and services the firm produces. It is the revenue stream generated by sales of products and services that, as a practical matter, keeps the enterprise afloat.

But the idea of "legitimacy and support" goes beyond the idea of material and financial support; it is also concerned with a kind of social and political "legitimacy;" about how a particular organization maintains its right to operate in a particular social and political environment as well as economic viability or financial sustainability. The basic idea here is that any large social enterprise (including private corporations) needs some kind of implicit or explicit authorization from society to stay alive and to continue operating. For private sector firms, one could conceptualize this as kind of "license to operate." One might also imagine that this "license to operate" is granted by something that could be seen as a kind of "authorizing environment" for business enterprises. One could go still further and observe that in capitalist societies this "license to operate" is granted very freely, almost as a matter of right.

It is at this stage that one might recall that the reason we as a society might be so free in giving out the license for private firms to operate is not only that we think those who create the firms might have a right to do so, but also because we think it is in the public interest that they be allowed to pursue their economic interests by producing

[19] Kenneth Andrews, *The Concept of Corporate Strategy,* rev. ed. (Homewood, Ill. R.D. Irwin, 1980), Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York, Free Press, 1980)

products and services for customers. In effect, the customers who buy the products and services of companies provide not only the material support the firm needs, but also no small part of its social legitimacy. Within the political theory of liberal society, a private firm gains the right to exist at least in part because it provides products and services that individuals want; and that suffices to give the enterprise a certain kind of social legitimacy.

Now, as hard core public sector folks, we can sometimes get a bit sanctimonious and moralistic about public goals, and a bit impatient with the apparent frivolity of private sector products and services. When we are in such a mood, we ask in our most aggrieved tones, "Why, when there are so many pressing public problems in the world, are we as a society spending any time and attention focusing on producing stuff like lemon-scented furniture polish and hula hoops?" We feel good when we say this. But we recognize that the private sector has an important answer to this question. Their answer is simply that society should consider the production of these goods and services worth doing *because individuals value them*. We know that individuals value them because they are willing to plunk their money down to buy them. And, if they value them, and are willing to pay for them, who are we to say that these things are not valuable? And, if the price they pay more than covers the cost of production, who are we to say that something of public value has not been produced – particularly if we think that an important goal of society is to produce the greatest good for the greatest number?

> "…the idea of "legitimacy and support" goes beyond the idea of material and financial support; it is also concerned with a kind of social and political "legitimacy;" about how a particular organization maintains its right to operate in a particular social and political environment as well as economic viability or financial sustainability."

These observations remind us of the simple point that customers willing to pay money for goods and services give firms more than financial and material support; they also confer no small amount of social legitimacy to the successful firm. As long as the firm is producing what individuals want and are willing to pay for, arguably some public value is being created (as long as we understand the concept of public value to include in part the aggregated satisfaction of individual consumer desires.) Indeed, one of the principal political arguments for why a society should prefer private markets over many other ways to organize economic activity is that markets are socially efficient in the sense that they deliver most of the value that an economy is able to produce for individual customers.[20]

Viewed from this perspective, then, private business doesn't need a separate "legitimacy and support" circle. All the "legitimacy and support" it needs comes directly from customers when they choose to buy the firm's products and services.

### Investors as a Source of Legitimacy and Support

There is much to be said for the idea that customers provide most of the legitimacy and support that private sector firms need to operate. Yet, a little reflection suggests that customers might not be the end of the story; or, for that matter, even much of a beginning.

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[20] Worth noting that this argument differs in some important ways from the fiduciary idea that the goal of a firm is to maximize shareholder wealth. That is a *legal* theory of the firm, and it is built in part around the idea of private property rights, and partly around the idea that the public as a whole would benefit if the law recognized the existence of a corporate actor. A social theory of the market, however, does not say that the good thing about firms is that they make owners rich. The normative argument for the private market is that in the pursuit of wealth, capitalists and entrepreneurs will end up producing and delivering what individual consumers want. Their excess "rents" will be taxed away through competition. All that they hoped to gain will be delivered to customers instead. This then translates into the idea that what is good about markets is that they maximize the "consumer surplus" enjoyed by customers, not the "wealth" earned by shareholders.

Indeed, if a private sector manager were asked to bring the public sector strategic triangle into his context and adapt it for his purposes, the private sector manager's first move would probably be to observe that a public manager's need to secure legitimacy and support from an external authorizing environment closely resembled the problem the private sector manager faces in mobilizing capital from and maintaining relationships with private investors. In short, the private sector manager has to build legitimacy and support not only with customers, but also with *investors*. And, in many respects, investors in the private sector seem a lot like the authorizers in the public sector, and quite a bit different from customers.

> "In these respects, investors in the private sector looked a lot like citizens, taxpayers, and their representatives in public organizations. The private managers sold a story of value creation to individuals who put up their own money to benefit from the productive activities of the organization."

For one thing, the investors seemed to occupy a similar position vis-à-vis the production processes of the organizations. Whereas private firms meet customers "downstream" at the production end of the organization, they met investors "upstream" at what might be considered the financing or reporting end of the organization. Whereas customers have individual transactions with the organization in which they carry away bits and pieces of the organization's productive activities in exchange for a purchase price, investors "bought" the "story" that the organization told about its value creating strategy, and got for its purchase a claim on the future productive value of the organization.

In these respects, investors in the private sector looked a lot like citizens, taxpayers, and their representatives in public organizations. The private managers sold a story of value creation to individuals who put up their own money to benefit from the productive activities of the organization. On this view, the proxy fights or hostile takeovers that break out in the private sector as contests over who has the best judgment about how the assets of a firm could best be utilized, are roughly equivalent to the policy and political struggles about what should be done with publicly owned assets deployed in government organizations.

To say that the politics that surrounds the work of government agencies is similar to proxy fights and hostile takeovers in the private sector serves both to show the similarities but also the important differences between the two sectors. Most private managers exposed to the challenge of managing in the "fish bowl" of the public sector would not think these were similar at all. In fact, they think the political struggles in the public sector are much more present, much more intense, and much more difficult to resolve than the political struggles in the private sector. Gearing up for an annual stockholder's meeting is a lot different than having to respond to several critical news stories a week, several legislative investigations a month, and the certain prospect of a public referendum on one's work that could sweep a new management team into place regardless of one's performance! Or is it?

No doubt, part of the reason for the intensity of the politics surrounding government agencies comes from the fact that it is much more difficult for citizens to "exit" than it is for private investors.[21] If private investors develop concerns about the direction a company is taking, they can simply dump their investment. This drains away some of the intensity of the investors' concerns. In the public sector, however, it is not easy to simply walk away from one's relationship with government. As a result, one has to rely more on "voice" and less on "exit." The "voice" is what emerges as sharp political controversy about the best use of a commonly owned asset; namely, the authority and money of a government – particularly one that is elected rather than appointed or imposed.

[21] Hirschman, Exit Voice and Loyalty

The difference may also come, however, from the fact that citizens have much more heterogeneous aims with respect to the performance of government organizations than do private investors with respect to firms. To be sure, investors in the private sector may have different ideas about what they want from the firms in which they invest. They may also have different views about the best path for the firm to follow in delivering what they want. On the purely financial level, for example, investors may have different discount rates, or different levels of risk aversion. They may also have quite different predictions about the financial consequences of different strategies that could be pursued by a private company. They may even have different views about the extent to which they would be willing to sacrifice some financial returns in exchange for fulfilling social responsibilities of one kind or other. And these differences may generate conflict among investors, particularly when the choices are about the best strategy for the organization to follow.

However great these differences might be in the private sector, they will always seem small when compared to the differences that can arise among citizens about the best use of government resources. The reason is that in government we debate not only about the best means for achieving the end; we also debate (collectively) about what the ends of the government should be, and how much of our money and commitment we are prepared to give over to the government to help it meet our collectively defined goals.

> "To describe these actors as "stakeholders" is to point principally to the fact that they have interests in the conduct of the firm. More important, however, is that these groups not only have interests in what the firm does, but some practical capacity to shape the firm's goals and activities to their aims. In doing so, the stakeholders tax the assets of the firm (both literally and figuratively!). They may also constrain the firm's choice of strategy."

So, yes, private managers may have some experience with something that looks like the kind of political "legitimacy and support" issues that government managers face. But the differences in degree are substantial. And for these reasons, business may not have had to pay so much attention to the kinds of legitimacy and support that it gets from investors, as government managers have had to pay to citizens and their elected (and un-elected!) representatives. Business might be advantaged if it paid more attention to investor relations. And there will be times when it will need something like a political, public relations campaign to serve its investor strategy well. This is not to suggest that business does not consider investor preferences and behavior as crucial drivers of strategy, but rather that it is understandable why business might not have considered investors as a key source of political legitimacy and support.

## "Stakeholders" as Sources of Legitimacy and Support

A more important reason to be concerned about the idea of "legitimacy and support" arises from the fact that private corporations develop and pursue their strategies in a social context encumbered by "stakeholders" who have claims they wish to make on the organization, and some capacity to press them (presumably at some cost to the quite powerful shareholders as well as other less powerful or at least less organized stakeholders of the firm).[22] Important stakeholders of the firm include those actors whom we have already discussed: namely, investors and owners who hope the firm will earn them significant financial returns, and customers who hope the firm will provide them with high quality products at a low price. But it extends quite naturally to those economic actors who (in exchange for economic rewards) help the organization produce and distribute its products and services: for example, employees who contribute their

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[22] The classic statement of the stakeholder perspective to strategic management is R. E. Freeman (1984), *Strategic Management: A Stakeholder Approach*, Boston, Pitman.

labor in exchange for wages, suppliers who sell inputs that the firm needs to produce its final output, and distributors and franchisees who help the firm reach markets it wants to reach.

With a bit more strain, the concept of stakeholders extends to actors who are not directly linked economically to the productive activities of the firm. This includes the local communities in which the firms are located and whose individual and collective lives are importantly shaped by the actions of the firm. Business associations that are either sectorally or geographically organized might encourage their members to behave in certain ways. It also includes different levels and agencies of government that tax, regulate, or contract with private firms. And it can include the media and the general public that together form views about the appropriateness and decency of the firm's conduct. Perhaps the most difficult stakeholder to see is the natural environment itself, as it is not an actor. But those individuals and groups that articulate environmental concerns can certainly become some of the most vocal and influential stakeholders of the firm.

To describe these actors as "stakeholders" is to point principally to the fact that they have *interests* in the conduct of the firm. More important, however, is that these groups not only have *interests* in what the firm does, but some *practical capacity to shape the firm's goals and activities to their aims*. In doing so, the stakeholders tax the assets of the firm (both literally and figuratively!). They may also constrain the firm's choice of strategy. Yet they may also contribute to expanding the markets or increasing the efficiencies of the firm and thus broaden the choice of organizational strategy.

How much capacity the various stakeholders have to press their claims (either as unique entities vying with one another, or as an entire set with the separate effects of each stakeholder to push the firm in different directions netted out) depends at least in part on decisions made by the wider society about the degree to which companies should be accountable to these stakeholders, the powers that society puts in their hands, and the ways in which society, acting through the state, makes claims on the firms that are aligned with particular stakeholder interests. Such judgments are contained most obviously in laws that create certain kinds of accountabilities of firms to the society as a whole.

> "These social judgments – the normative views held by the general or parts of the public that shapes their actions as economic actors, the procedural rules that make the firm accountable to various stakeholders for certain aspects of their conduct, and the substantive rules through which society as a whole directs the firm towards the protection of individual rights or the achievement of socially desired results – form an important part of the context in which businesses operate. In important ways, they condition the degree to which the firm's conduct will be viewed as "legitimate." "

Now, it is important to keep in mind that such laws are not always hostile to the economic performance of the firm, or the interests of the particular stakeholders who typically embody the concern with economic performance such as owners and shareholders. Indeed, the laws establishing and conditioning rights to private property, enforced by public courts, give private firms many rights against those who would make claims on them. It is also true that government action is often designed to encourage business as well as constrain it.

Still, there are many laws that constrain business' efforts to pursue profitability for their shareholders and owners. Generally speaking, these laws can be of two different types.

The first type could be considered **procedural rules** that give particular stakeholders including shareholders and managers rights and privileges vis-à-vis the firm. Such rules enable these stakeholders to make their claims and interests felt in the strategic decisions, the operations, and presumably the financial bottom line of the firm. Security and Exchange laws, for example, require firms to file financial reports to protect the rights and interests of investors vis-à-vis other stakeholders including managers, laborers, and customers. Labor law gives workers the right to form unions and bargain collectively rather than individually with firms about wages and working conditions. Consumer protection laws, that prohibit fraud and deceptive practices, set and enforce weights and standards, and require that certain kinds of product information be given to customers, protect the rights of customers. The law of contracts protects the interests of suppliers and distributors and franchisees. And so on. What makes these laws important is not that they tell a firm what to do to satisfy the interests of various stakeholders, but rather that they give different stakeholders certain kinds of legal resources in bargaining with the firm for their own interests. The substantive result – how much the stakeholders can get from the firm, given their rights and privileges in negotiating with the firm – is left indeterminate, and it is up to the parties to jointly determine within the negotiating framework that is constructed.

The second type of law could be viewed as **substantive rules**. These rules are created when government, acting as an agent for the general public, makes rules that impose specific substantive duties on the firm. These rules are important not only as a method of advancing the rights of those protected by the substantive rules, but also as a way of advancing collectively defined public interests. We require firms, for example, to not discriminate, to promote equal opportunity, to maintain safe and healthy working conditions, to refrain from polluting the environment, to sell products that have been tested for safety and efficacy, and so on. In these cases, government is not just structuring relationships between a firm and stakeholders to give the stakeholders a chance to press their claim on the firm. Government is intervening as a stakeholder itself with powers to require the firm to deliver some particular result that the public has directed the government to achieve.

The structure of procedural and substantive laws passed by society can do much to determine the extent to which firms are obligated to listen to and accommodate the interests of their various stakeholders. Yet, it is important to understand that the society can act individually in ways that profoundly affect the firm without necessarily passing any explicit laws. Individuals in the society, guided by a shared sense of what constitutes proper conduct by a firm often in relation to their own views of the public interest, can act in their economic roles to shape the conduct of the firm to the ends imagined by the collective idea of what the firm should do.

As investors, they can decide that they are interested in some aspect of the firm's performance above and beyond the financial performance, and make their decisions to buy, hold, or sell based on those views. As employees, they can decide to stay connected to and work energetically for the firm based not only on the size of their paycheck; or their level of effort can be influenced by other aspects of their relationship with the firm such as the nature of the products the firm sells, or the light cast on them among their family and friends by their association with the firm. As customers, they can decide to buy or reject products based not only on the economic aspects of the product, but also on what they think about the conduct of the firm. In short, the political views held by stakeholders can invade the decisions made by firms with potentially important positive or negative consequences purely from the economic actions of those political stakeholders.

These social judgments – the normative views held by the general public, or parts of the public, that shapes their actions as economic actors, the procedural rules that make the firm accountable to various stakeholders for certain aspects of their conduct, and the substantive rules through which society as a whole directs the firm towards the protection of individual rights or the achievement of socially desired results – form an important part of the context in which businesses operate. In important ways, they condition the degree to which the firm's conduct will be viewed as "legitimate." This set does not yet even yet include those political views of stakeholders and the public more generally that are acted upon through more overt and collective political means that do not necessarily entail the formulation and implementation of laws, such as strikes, protests, organized boycotts, shareholder resolutions, codes of conduct, certification mechanisms, and many others.

But these social judgments alone, taken as objective facts in the world of the business strategist, will not precisely determine how firms react to these conditions. As important in determining a firm's reaction to these social pressures is the way that those who lead firms tend to think about the legitimacy and power of these various claims. More importantly for our purposes, it depends on how leaders and managers of firms are advised to think strategically about the degree to which they accommodate these claims in developing their firm's basic strategy.

The reason is simply that the leaders and managers of firms have substantial *de jure* and *de facto* discretion in setting the strategy of the firm. They can choose to accommodate or strain against the external forces that society has erected around them. They can make their actions transparent or try to hide them. In short, private sector executives can, and do, decide to what degree, in what ways, and for what purposes the interests and claims of the various stakeholders will be accommodated in their strategy. There are prices to be paid for these decisions. As part of developing a corporate strategy, a firm has to weigh the consequences of acting or failing to act in accord with the legal, moral, or practical standards that society has constructed for them – either through law, or though the creation of social expectations backed by the threat of economic and political damage to the firm if they do not comply. In short, the firm has to be concerned about the social and political legitimacy of its strategy as well as its economic potential. But the point is that the executives could risk their legitimacy. Whether they are or are not made aware of these risks, and how they balance them is governed at least in part by how they are advised to think about corporate strategy.

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Ideally perhaps, these two levels of analysis would be joined together. The society would have decided how to structure the accountability of private corporations in accord with its understanding of what firms owed individuals and stakeholders associated with its activities, and how it wanted to use the corporation to advance various public purposes, through laws and policies. Those institutionalized social understandings, in turn, would have been built into the practical advice given to corporate managers about how they ought to view and weigh the competing demands of different stakeholders. The expectations of the society would be aligned with the advice given by corporate strategists.

## Shareholder and Stakeholder Views of Strategy Reconsidered

Yet, what we find when we consult the business strategy literature is an important, continuing, unresolved debate between two quite different ideas of corporate strategy that turns precisely on the question of to what degree, in what ways, and for what purposes the strategy of the firm should be tied to the accommodation of the interests of various stakeholders.[23]

In one view – the "shareholder view" of corporate strategy – the CEO is seen as being morally and legally responsible exclusively to one stakeholder – the *shareholder*. The central importance of the shareholder as the principal whose goals must be considered primary in the formulation of corporate strategy idea is built partly on a moral and legal idea that makes the owners of a firm the important "principal" whose interests are to be served by managers who are understood to be the "agents" of the "principal."[24] But it is also built on the idea that creating such a relationship between owners and managers is consistent with the creation of an economy that will achieve the "greatest good for the greatest number." In this conception, it is the relentless drive of the shareholders for sustained financial performance, and the faithful pursuit of their interests by corporate managers, that ensures an economy that is efficient not only in finding better ways to produce products and services for which markets currently exist, but also in finding new products and services that can respond to new or different needs of consumers.[25] Since this system is both legally appropriate and economically efficient, we ought to be willing to stick with it, and run our corporations on the basis of this discipline – not muck around with goals and objectives other than producing long run profitability, and with trying to use the firm to advance social purposes that it is not particularly good at producing.

In a second view – the "stakeholder view" of corporate strategy – the CEO is seen as being at least practically, sometimes legally, and perhaps even morally responsible to a much wider group of stakeholders. In this view, the CEO's job is not just to meet the demands and interests of the shareholders; it is to find a "sustainable deal among all the firm's stakeholders."[26] That "sustainable deal" is one that would honor reasonable claims from the large number of stakeholders, and allow the organization to pursue its purposes with the least controversy and the most good will from all.

Of course, these different ideas about corporate strategy can be reconciled even at the logical, and even more easily at the practical level. At the logical level, for example, even a strict shareholder view of corporate strategy would give room to managers to accommodate the interests of stakeholders other than shareholders if these other stakeholders could throw up roadblocks or create difficulties for the execution of the firm's economic strategy and its creation of value for shareholders. Thus, a firm being guided by someone holding a strict shareholder view of corporate strategy would pay enough attention to satisfying the needs of customers to encourage them to pay a premium price, to continue buying, and to recommend the product to their friends. Similarly, a firm so guided would give its employees enough respect, money and care to show up to do the work, even if that required more discussion, more explanation, more bargaining, and higher wages than the firm hoped to pay. A firm guided by a strict shareholder theory might also commit itself to acting lawfully, and to contributing something of benefit to the public so that the managers could carry on focusing on the firm's economic strategy, and not be distracted by concerns about law suits, or demonstrations, or remonstrance from their spouses and children at the breakfast table.

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[23] This tension has hardly been resolved with respect to business strategy for corporate responsibility. See, among others, David P. Baron, "Private Politics, Corporate Social Responsibility and Integrated Strategy," *Journal of Economics and Management Strategy*, 10(1), 2001; A.K. Reichart et al, "Corporate Support of Ethical and Environmental Policies: A Financial Management Perspective," *Journal of Business Ethics*, May, 2000; B.M. Ruf, "An Empirical Investigation of the Relationship between Change in Corporate Responsibility and Financial Performance: A Stakeholder Theory Perspective," *Journal of Business Ethics*, July 2001; and Sandra Waddock, "Responsibility: The New Business Imperative," *Academy of Management Executive*, 16(2), 2002.

[24] See Michael C. Jensen, *Foundations of Organizational Strategy* (Cambridge, Mass. Harvard University Press, 1998). Also John Pratt and Richard Zeckhauser, *Principles and Agents: The Structure of Business,* Harvard Business Publications, 1991.

[25] Jensen, *Foundations of Organizational Strategy*

[26] We are indebted to Professor Joseph L. Bower of the Harvard Business School for this formulation

Conversely, it is very likely that many of those who embrace the "stakeholder" view of corporate strategy do so not because they think the company has equal, or even any compelling moral or ethical responsibilities to all the stakeholders. They may embrace and recommend the concept primarily on the practical grounds that it is necessary to attend to the interests of stakeholders if one is going to sustain the enterprise over time and achieve its economic goals. Thus, if someone with a strict shareholder view of her moral responsibilities as a corporate strategist allows concerns about stakeholder reactions to her plans to enter her calculations, and if someone with a stakeholder view embraces that view less because she believes that the firm has moral as well as legal and prudential reasons for accommodating those interests and more because of the power of these other stakeholders to make trouble for the firm, the two concepts can be quite easily reconciled. Indeed, it is logically possible that those guided by a shareholder model might choose a strategy that is identical to that chosen by a person holding a shareholder view. This would occur when they both admitted the practical importance of accommodating the interests of shareholders, and judged those interests similarly.

Despite the possibility of logically unifying the two views, we think an important psychological and organizational difference remains between them. And it lies primarily in the "legitimacy" that those who lead private organizations give to the claims of the different kinds of stakeholders. The different views of the legitimacy of these claims, in turn, probably have an important effect at the margin about the strategy that is pursued by the firm. And arguably we live in a world where differences at the margin can have dramatic consequences.

To someone who holds a shareholder view, the ordering of the stakeholders' interests as claims on the organization is very clear. The shareholder comes first; customer comes second. Employees are further down on the list. And way down on the list are the claims made by governments, communities, and the moral sentiments of the wider public.

Indeed, in the heated politics of the day, these last claimants are often viewed as making *illegitimate* demands on the firm, not *legitimate* ones. And the overwhelming impulse is to want to deny, undermine, and resist them as inappropriate intrusions into the proper operations of the firm. It is wrong for these outsiders to try to shift the focus of the firm from its proper purposes, and to constrain or undermine the authority of the managers to focus the firm on its most important function. From this perspective, the firm's strategists can easily think it is entirely legitimate for business to resist being extorted by illegitimate claims being made against it. It is even justified for the firm to call on the police powers of the state to protect its rights and resist the claims made by various stakeholders. The natural goal becomes to use every (legal) device they can to protect the interests of the shareholders against the interests of the other stakeholders. What they should yield to these interests is only what law and prudence requires of them, nothing more. And if they are uncertain about how much they should yield to stakeholders other than shareholders, their moral duty is to err on the side of advancing shareholder interests against the others. They should not sacrifice the interests of their principals lightly, or set damaging precedents that could encumber the firm for the future. Their job is to preserve as much autonomy, and as much of the economic returns as they can for the owners and shareholders.

> "At the practical level, it is always hard to know whether one has given just enough of the firm's productive capacity to stakeholders other than shareholders to sustain their co-operation so that the shareholder wealth can be maximized, or whether one has "given away the store" out of faint-heartedness, or an insufficient understanding of one's own rights, or a foolish attempt to use the firm for purposes other than what it was intended."

The stakeholder view, in contrast, seems to take as a starting point the broader more expansive view of the responsibilities of the corporate strategist. In this conception, corporate strategy has to begin with an appreciation of the interests that many have in what the firm does. It could also include recognition that the corporation is a public organization, and that it has been given special public advantages, not simply an extension of individual property rights. As a result, it may be under some obligation to meet some social purposes. The corporate strategist then has to recognize that the direct economic claims that the various stakeholders can make on the firm, and have enforced through existing laws, represents only the minimum kind of claim that ought to be considered in imagining the kind of relationships it wants to have with these various actors in the future. The strategists following the recommendations of the stakeholder view of corporate strategy have to understand that the ability of the various stakeholders to influence the firm is far broader than their capacity to act only through markets and through existing law. They can act through the force of public opinion and social norms that begins to shape economic and political decisions. And they can act by passing laws that create real legal claims on the firm.

Beyond these practical reasons to be concerned about stakeholders and the economic, legal, and political power they represent, is a moral idea that such claims might deserve to be honored and embraced rather than scorned and resisted. After all, it remains true, even in a liberal society, that business has to understand itself at least in part as a social institution that aims to make life better for individuals and for the collective, and that the stakeholders who have interests in business are an important part of the collective. All this leads the strategist relying on the stakeholder view to accommodate the interests of a wider group of stakeholders to a greater degree than a strategist holding a shareholder view would do.

Whether this tolerance comes about as a consequence of a different kind of prudence in structuring relationships for the long run advantage of the firm, or comes from a genuinely different view about the rights of various stakeholders to make claims against the firm as a matter of law and morality, may remain unclear. Indeed, it may be hard for anyone to judge this matter. At the practical level, it is always hard to know whether one has given just enough of the firm's productive capacity to stakeholders other than shareholders to sustain their co-operation so that the shareholder wealth can be maximized, or whether one has "given away the store" out of faint-heartedness, or an insufficient understanding of one's own rights, or a foolish attempt to use the firm for purposes other than what it was intended. How much has been given away is a matter of "business judgment" rather than science or accounting.

As a result, it is possible for many who are operating in accord with a stakeholder view of strategy to claim to be operating with a strict shareholder view of strategy, and to insist that the gifts they have handed out to other stakeholders are really the minimum that was necessary to keep the enterprise moving along its shareholder wealth creating path. It is in the uncertainty about exactly how much company wealth should be given away to secure the co-operation of other stakeholders, and in the discretion of the CEO in making this decision, that a stakeholder view of corporate strategy might survive even in a world that had rejected this view in favor of the shareholder view of corporate strategy.

But, one must also recognize that shareholders who become suspicious of the claim that a CEO is following a shareholder strategy even when giving away a great deal to other stakeholders have many opportunities to express or act on their dissatisfaction. They can simply dump their stock (the exit option). They can complain about management's decisions through various channels including but not limited to shareholder meetings (the voice option). They can sue the company's managers for negligence. Or, they can even organize a hostile takeover on grounds that the existing management and its strategy are wasting the productive value of the firm, perhaps by giving away too much of the firm's wealth creating potential to other claimants and other purposes. So, in an important sense, there is a demanding market test of whether a firm's management is giving too much to stakeholders.

Given this formidable array of options, it might not be surprising if corporate executives shaded their decisions in the direction of a shareholder view of corporate strategy, or couched their stakeholder view of corporate strategy as practically the best method of achieving the correct goal of maximizing shareholder wealth. It would take a brave corporate executive to embrace the strict view of stakeholder strategy in which the company was seen as having very strong moral and legal, as well as practical interests in meeting the demands of stakeholders other than shareholders – particularly when the relevant group of stakeholders reached beyond customers and employees to include government, local communities, and the general public. To put the assets and capabilities of a corporation at the disposal of these "outside," "non-economic" actors would seem, to many, to be a violation of their moral and legal duties as well as a sure path to personal failure.

No doubt, it is for these reasons that the idea that the corporation had to make room for the concerns of these varied stakeholders has never quite been fully integrated into the concerns of those who write and teach about corporate strategy. Everyone knows those demands are hanging out there. Everyone knows that they are practically important in determining the long run profitability of an enterprise. But no one knows quite how to include the broader set of stakeholders in a disciplined calculation of corporate strategy. There is room only for the economic factors that allow a firm to be successful, which includes some but not all of the claims of the other stakeholders.

Suppose, however, that business embraced a view of corporate strategy that recognized the importance of building legitimacy and support with groups other than customers and shareholders, and through actions that had economic consequences, but were not necessarily guided solely by the market pre-occupation with financial returns. If one embraced the idea, that as a practical, legal, and moral matter, businesses had to earn a right to continue operations in the social and political world as well as the economic world – that is, that they had to work to produce legitimacy and support from government, local communities, and the general public as well as from investors, customers, and employees – then we think that the tension between the shareholder and stakeholder view would begin to be resolved more successfully than it now is, and that many of the practices that business has actually embraced might turn out to be more rationalized and understandable than they now are.

Although business has not embraced a strict stakeholder view of corporate strategy, one that views the production of legitimacy and support from the social and political world as the dominant idea of corporate strategy, it has in fact invested in activities and operated for a long time as though it knew that this was an important function to be fulfilled. Indeed, if one were to look in a modern corporation for the particular activities that could be understood primarily in terms of their capacity to produce legitimacy and support for the firm, one could find a large number and variety. One would see a corporate counsel's office that spent a large part of its time understanding and explaining the implications of new laws so that the firm would not become vulnerable to civil or criminal prosecution. One would see a government affairs staff whose job it was to stay alert about pending regulations affecting the company, and working with other companies to take political action to ward off damaging and to advance favoring legislative action by governments at all levels. One would see a public affairs staff that was pre-occupied with promoting an image of the company as a good employer and good citizen to the public at large. One could see that the company spent a great deal of time consulting with local communities when entering and departing a community, or paid a significant economic, social, and political price for failing to do so. One might see corporate philanthropy managers or perhaps even corporate responsibility officers, and so on.

The only conclusion we can draw from these observations is that even though (most) corporations have not systematically integrated the strategic idea that they have to secure legitimacy and support from actors other than customers, investors and employees, they nonetheless act as though this was important. Yet, precisely because they have not yet fully integrated this function into the formulation of their strategies, they have not yet learned how to execute and evaluate these strategies in the best possible way. The craft knowledge of building legitimacy and support in business that is of the same quality as the craft knowledge, for example, that is associated with marketing, with production process engineering, or with finance, is still being developed.

## Legitimacy for Firms in Politicized Environments

This has become a particularly urgent issue for business now for one very important reason. Throughout the world, business has gained standing as an institution with great capacities relative to government. This has occurred initially from a claim that business could produce the greatest good for society if it was less encumbered by the social judgments enshrined in laws to which governments were supposed to produce compliance. This view expanded so that it increasingly was argued that business, or at the very least business models, would be able to deal more efficiently with social problems than government could – partly because business' goals were clear, partly because business was more disciplined on performance, partly because business was less corrupt, and partly because business had better tools at its disposal. The result has been that government has been discredited and disempowered as an actor that society could rely on to deal with important public problems.

At the outset, this may have felt good to business because it increased both their status and their discretion to operate in the world. Finally, the iron grip of government had been relaxed, and they could get on with the important job of producing economic value, which was close enough to social value that one did not really have to worry much about the difference.

But the eclipse of government has created a new problem for business. In the past, when social and political actors generated demands for the achievement of certain goals that they were either unable or unwilling to produce for themselves, they often organized and addressed their concerns to government. If they went to private companies to deal with issues like poverty, or ill health, or unemployment, the companies could say that they were not competent to deal with these issues. They would say that the issue would have to be addressed through politics and government. What government was good at was hearing and adjudicating these political and legal claims made by a part of the collective trying to represent the interests of the whole, or a particularly needy and/or deserving part of the whole. They would then do whatever government decided they needed to do to contribute to the solution of the problem.

Once politics through government are discredited, however, these demands for social justice or environmental sustainability do not go away. They simply decide to shift their focus. And the focus inevitably turns to the powerful group that has, or is perceived to have, resources to deal with the problem (and, incidentally, in the course of gaining power vis-à-vis government claimed that it would be able to deal with important social problems by creating economic wealth). As a result, these groups come at private corporations making demands that corporations produce social goods above and beyond the production of privately consumed goods and services, jobs, and returns on investment. In an important sense, CEOs are now being asked to sort out and respond to a set of urgent social demands that used to be handled through politics and government. And, needless to say, given that they were previously sheltered from these demands, and encouraged to think that they were making the appropriate social contribution when they made their businesses profitable, obeyed the law, and contributed philanthropic dollars, the CEOs are unprepared to think about whether and how (and which ones!) of these pressing demands should be met. And, however good they are, corporate public affairs staffs can hardly operate as a legislature that is prepared to vet the conflicting demands coming at the corporation.

## III. Conclusion: Legitimacy and Support as a Key Element of Business Strategy

In conclusion, building social and political legitimacy has always been an important part of becoming a successful business. It is becoming even more important as the capacity of government to give business the protection it needs by claiming credibly that a company has met the obligation of acting as a good citizen as long as it meets its legal obligations has declined in many parts of the world, collapsed in some, hardly existed in others, and the direct demands on business have grown.

Yet, this important work has been left off the map in most discussions of corporate strategy. It is the kind of work that could come to the fore and be more successfully integrated into strategic business thinking if it was better understood that business more systematically needed to develop legitimacy and support from stakeholders beyond investors and customers, and understood that in an important respect, government can act as a device for limiting and focusing the moral, legal, and social vulnerability of business. Companies need a license to operate. They need to be responsive to those who grant them that license. They need this particularly in a world where they can no longer claim to be 'good corporate citizens" by showing that they behave lawfully and philanthropically.

These observations about the (increasing) importance of social legitimacy and political support become some of the most important reasons that businesses have to attend to issues of "corporate responsibility" – not only as they define it for themselves, but as others define it for them. The strategic triangle offers a simple and yet powerful heuristic for business strategists to address social legitimacy and political support. But its other two corners – organizational capacity and public value – potentially also provide further guidance for business. In particular, notions and experiences with determining and measuring public value might be useful to businesses in their quest to improve the 'triple bottom-line'. More generally, the claim that any successful organization must ensure that there is an alignment across its (public) value proposition, organizational capabilities, and sources of support and legitimacy is one that is likely to hold for profit making businesses as much as governmental agencies and non-profit organizations.

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