SWP 14/98 VALUE CREATION VERSUS VALUE CAPTURE: TOWARDS A COHERENT DEFINITION OF VALUE IN STRATEGY - AN EXPLORATORY STUDY

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Towards a coherent definition of value in strategy: an exploratory study

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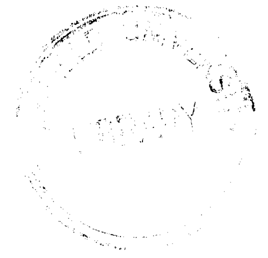
ABSTRACT

Resource-based theory has tended to focus on the development and protection of valuable resources. What determines a valuable resource has received less attention. This paper addresses three related issues concerning value and valuable resources: what is value? how is it created? and who captures? We have tried here to integrate different strands of the literature to address these questions. We first argue that value is subjectively assessed by customers and that value is only realised at the point of sale. Secondly, we argue that the only source of value is labour performing heterogeneously and that value is created if this labour is artfully deployed with other resources. The paper ends arguing that value capture is determined by power relationships between economic actors.



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INTRODUCTION

The resource-based theory of the firm (RBT) (Peteraf, 1993; Wernerfelt, 1984) argues that an organisation can be regarded as a bundle of resources (Amit and Shoemaker, 1993; Rumelt, 1984), and that resources that are valuable, rare, imperfectly imitable and imperfectly substitutable (Barney, 1991) are an organisation's main source of sustainable competitive advantage. However, whilst most of the contributions to this view have focused on the ease with which valuable resources can be imitated, less consideration has been paid to what makes particular resources valuable in the first instance. Most contributors start from an assumption of a resource's value, and then proceed to consider issues of imitability. As Miller and Shamsie recently remarked "after years of interesting conceptual work, we are still at an early stage in knowing what constitutes a valuable resource, why and when" (1996:539). This paper suggests that, in order to progress RBT a more precise and rounded underpinning theory of value is required to help us identify 'valuable resources'.

Accordingly, the paper addresses the following questions: what is 'value'? how is it created? and who captures it? It opens with a review of 'value' in RBT, then, a few reflections about the nature of value are proposed, which in turn leads into a reconsideration of resource-based arguments about value creation. A theory of value generation is set out which concludes that the source of value and hence profits (as the proportion of value captured by the firm) is the artful deployment of labour with other

resources. The paper then addresses the distinction between value creation and value capture. Here it is argued that although value is created by labour in action, value capture is determined by power relationships between economic actors.

An underlying theme of the paper is that appearances often prevent us from identifying the essential relationships between economic actors, and that many of the problems and confusion in mainstream economic theorising stem from the inability to separate these two levels of analysis.

WHAT IS 'VALUE'?

'Value' In Resource-Based Theory

The major contribution of RBT has been the exploration of heterogeneous resource endowments and how these can be the source of advantage if competing firms are unable to imitate these resources (Amit and Schoemaker, 1993; Black and Boal, 1994; Mahoney and Pandian,1992). In most contributions to the school, resources are *assumed* to be valuable (one exception being maybe Wernerfelt (1984) who defines resources as anything which could be thought of as a strength *or a weakness* of a given firm), and attention has been focused on isolating mechanisms that prevent rival firms from replicating the desired resource bundles (Rumelt, 1984). When the issue of valuing a resource is addressed, it tends to be discussed in broad, general terms. The few authors that have attempted to define the term 'valuable' tend to argue that resources are valuable in relation to a specific market environment (Amit and Schoemaker, 1993). To cite Barney a resource is valuable if "it exploits opportunities and/or neutralises threats in a firm's environment" (1991:105). A resource has also been defined as valuable if it either enables customer needs to be better

satisfied (Bogner and Thomas, 1994; Verdin and Williamson, 1994), or if it enables a firm to satisfy needs at lower costs than competitors (Barney, 1986 a; Peteraf, 1993). Barney also suggests that resources are valuable "when they enable a firm to conceive of or implement strategies that improve its efficiency and effectiveness" (1991:106).

Conner (1991) argues that, from a resource-based perspective "obtaining [above normal] returns requires either that (a) the firm's product be *distinctive in the eyes of buyers* (*e.g.* the firm's product must offer to consumers a dissimilar and attractive attribute/price relationship in comparison to substitutes), or (b) that the firm selling an identical product in comparison to competitors must have a low cost position" (1991:132).

The argument that resources have value in relation to their ability, *inter alia*, to meet customers' needs is consistent within RBT (see Aharoni, 1993; Aaker, 1989; Prahalad and Hamel, 1990, 1994; Williams, 1992). This then begs the question: how do customers judge the extent to which an existing product meets their needs, or whether a new product on the market would better meet their needs? In other words, how do consumers make judgements about the value, to them, of alternative products?

Assessing value

Traditionally when looking at value and consumer behaviour, economists tend to refer to utility theory and to the notion of marginal utility. The theory states, essentially, that consumers spend their income so as to maximise the satisfaction they get from products. Total utility refers to the satisfaction deriving from the possession of a commodity and marginal utility refers to the satisfaction that people receive from possessing one extra unit of a good or the satisfaction lost by giving up one unit. Early neo-classical economists assumed that people were rational (the economic man) and as such assessed systematically

and carefully the different available options before purchasing. However this position has been softened and it is generally held that "by and large, people spend their money on what they expect will give them most satisfaction" (Bach, Flanagan, Howell, Levy and Lima, 1987:92).

The issue then, is how do people develop their expectations, how do they judge the utility they are going to get *i.e.* how do they judge the value of a product? The potential purchaser has to judge how the product's attributes will satisfy his[1] needs. Judgements are made in advance of the consumption of the product, so customers have to make inferences about the range of products on offer based on a variety of cues. Customers' perceptions of the value of a good are based on his beliefs about the goods, his needs, unique experiences, wants, wishes and expectations. In other words, customers assess the overall value of a product on the perceptions of what is received and what is given (Zeithaml, 1991).

Value perception applies to all purchasers and not only to final consumers: the same type of judgement, a subjective judgement is made by a manager when procuring inputs like machines, components and an employee's labour time or by an individual when buying a fridge or a car. In a 'consumer' purchase, such as "I need a car therefore I buy a car", the need may be fairly easy to define. In an organisation the need for a purchase may not be that clear, indeed it could be argued that the 'need' that is to be met with the purchase is 'profit making' (Besanko, Dranove and Shanley, 1996). This seems rational and logical, but it requires the purchaser to have great insight into the cause-effect linkages between resource procurement and the ultimate delivery of profit. More reasonably, the procuring agent has to have some belief that the procured resource will contribute to the profitability

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[1] He (his/ him) is used here to mean she (her).

of the firm, and this belief will be rooted in a wider set of beliefs about how the firm competes, which may be further bounded by an industry recipe (Huff, 1983; Johnson, 1987; Spender, 1989).

Value, or rather perceived value, can be translated into monetary terms: it can be defined as the price the customer is *prepared* to pay for the product, if there was a single source of supply (Collis, 1994). This judgement is based on the assessment of the product's value, coupled with the individual's willingness to pay. These monetary judgements cannot, therefore, be made in isolation from the wider needs and economic circumstances of the customer.

Only in the rare instance of a monopoly supplier, who is cognisant of the customers' valuation, and who can price discriminate will the price the customer is prepared to pay (in what follows this price is termed 'total monetary value') equate to the price the customer actually pays. In all other circumstances, the price paid will be *less* than the total monetary value perceived by the customer. The difference between the customer's valuation of the product, and the price paid is 'consumer surplus'. Expressed differently, the price the customer is prepared to pay equals to price + consumer surplus. Consumer surplus (Bach et al., 1987; Whitehead, 1996) is what consumers colloquially call value for money.

Customers choose the good that will confer on them the largest consumer surplus. The chosen product must therefore be differentiated in ways which are valued by the customer, it must deliver more consumer surplus than alternatives. 'Value for money' can be increased by enhancing the perceived value of the good (and thereby increasing its total monetary value, the amount the customer would be prepared to pay for it), whilst keeping the price at the same level, or by keeping the perceived value constant but reducing the price, or by doing both simultaneously.

The amount of consumer surplus that a customer can enjoy can only be assessed at the point of sale (it is at this point that the customer knows the selling price, he can value the product and decide then whether it is worth buying). Customers can only value what they perceive, this implies for instance that they are unable to value most *inputs* to the production process. This means that customers cannot consciously 'reward' or compensate any inputted resources, or any suppliers of those resources (we take up this point later). We could note here that this is different from other approaches, notably Hunt's, who states that perceived value "depends on (a) the tastes and preferences of consumers in the segment and (b) *the resources that produce* the offering" (1995:323) (emphasis added).

One consequence of this argument is that value cannot be 'passed on' in the production process: value is perceived by the customer at a point in time, it is assessed at the point of decision to purchase. This applies to all types of purchases, for example, the value of a numerically controlled lathe, a computer, or a truck is also realised at the point of purchase. It is not transferred into the organisation's production or distribution process. It is an accounting convenience to assume that the values of inputs are passed on to customers. In reality many purchased resources do not 'add value' in ways that a customer can perceive. That is not to say that the purchased input was not valued. It was. It was valued by the manager who decided to buy it on behalf of the firm, but as soon as the machine was bought, all its value was realised.

Another implication of this discussion is that any firm, that is able to sell something, is, in the eyes of its customers at one particular point in time supplying a unique and superior package of value for money, i.e. customers at this point in time perceive that the firm allows them to enjoy the largest amount of consumer surplus. From the customers perspective the selected item offers more consumer surplus than any other. For these

customers, the competitors are not supplying an equivalent product/price combination. In this restricted technical sense, each firm is a monopoly supplier to its customers at the time of the sale. Hence, it could be said that any firm that sells anything has a temporal 'competitive advantage'.

Clearly, some customers will have found it quite difficult to make a choice; there may be products on offer which offer very similar amounts of consumer surplus to the chosen product. These suppliers of close substitutes would constitute the direct competitors to the firm. However, products offering significantly lower surplus could not be classed as close substitutes, and are therefore not credible competitors. This view of 'value' helps us define competitors, and hence markets and industries. This may lead to quite different industry definitions from those derived from conventional, product-based approaches. Markets are never static. They exist at a moment in time when a transaction takes place. Indeed, it may be unhelpful to conceive of 'markets' at all as this can imply some permanence or stasis in what is a dynamic, atomistic and continuing evolving set of individual transactions.

HOW IS VALUE CREATED?

Value is realised when a sale is made[2]. Sales are achieved when customers view that a product confers more consumer surplus than other viable alternatives. So firms create value through the production and *sale* of products.

In line with RBT arguments, if all inputted resources are homogeneous, and freely traded, competing firms will produce identical products, incurring identical costs of production. Thus all firms in this market would produce identical amounts of value. This equates with neo-classical perfect competition.

However as argued above, in order for a firm to sell anything, there must be some buyers that rate the firm's offering as providing superior consumer surplus than competing firms'. So even if the prices are identical, in order to make a sale there must be some perceived differences in the products on offer. This might have to do with the product surround rather than the product itself (*i.e.* the product is readily available locally, it is marketed more attractively *etc.*). Alternatively, one can have more consumer surplus because of a lower price, and to sustain lower prices the firm must be able to produce the same products as competitors but *at lower cost.*

This implies that the source of differential consumer surplus must be somewhere within the transformation processes inside the firm. If factor markets are homogeneous, this can only occur if certain resource inputs are capable of performing *heterogeneously* within the production process, otherwise we have to relax our assumptions of perfect factor markets.

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[2] The exchanges of valuable goods that do not involve a monetary transaction are without the scope of most forms of economic enquiry.

Proponents of RBT argue that human or 'cultural' resources are the sources of above normal returns, not purchasable and tradable physical assets (Castanias and Helfat, 1991; Wernerfelt 1989; Barney, 1986a). Inanimate objects are incapable of transforming themselves into anything other than what they are, they need to be activated, worked on before they can contribute to the provision of valued products in. This suggests that the sources of positive differential value derive from the actions of labour (Lado and Wilson, 1994; Pfeffer 1995; Wright, McMahan and McWilliams, 1994). Even though labour may be traded assuming its homogeneity, it has the capacity to be variable in *action*. This implies that labour is the source of firm heterogeneity and hence can be the source of value. However labour can create differential value only if it performs *heterogeneously*. Indeed homogeneous labour[3] working with homogeneous resources can only produce homogeneous products.

How can we judge which sources of heterogeneity are valuable? There is ample evidence of firms with strong cultures, with powerful and idiosyncratic 'ways of doing things' that have failed (Peters, 1988). Indeed 'organisational inertia' (Collis, 1991) and most of the blockages to strategic change seem to stem from the embedded routines and culture (that in effect have become 'core rigidities' (Leonard-Barton, 1992) of the organisation. It is the *judgements* about how labour should heterogeneously perform that are the ultimate source of differential value, i.e. it is the *artful deployment* of labour, with other resources, that it is the source of value. In other words it can be argued that it is the skill in knowing *what* resources to deploy, what resources to combine and how, and the judgements about what values should be attached to products, and for what markets, that is

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[3] Some skills are generic, some abilities deliver output that are measurable and that can clearly be imitated such as, to cite just a few, physical strength, speed of typing or report writing skills.

the source of value differentials. This skill is often referred to as business acumen or entrepreneurial flair, and to use Miller and Shamsie's vocabulary (1996) it is a 'systemic knowledge-base resource' or to use Black and Boal's (1994) a 'system resource'. As this entrepreneurial resource is typically hired in any established business, artful deployment could be regarded as a qualitative variant of hired labour. We shall refer to this source of differential value as *the artful deployment of resources.* It is a quality within the firm that enables it to differentiate its products, and/or to lower its relative costs. *So when a sale is made it is the result of a temporal advantage created by the actions of heterogeneous labour, artfully deployed.*

To highlight this point and to refer to the idea of 'core competences' of the firm (Prahalad and Hamel, 1990), core competences are *not* the source of differential value. It is the artful deployment of competences, not the competences *per se,* that matters. The same argument applies to other 'valuable resources' like brands, or reputations. A brand is only a source of profit if it is artfully deployed. This can be seen in cases where a brand has enjoyed a resurgence under different management (Rowntree's confectionery brands under the management of Nestlé; Miller beer under the management of Philip Morris). In many respects this is in the spirit of what Penrose wrote in 1959 (and highlighted recently by Tsoukas (1996) and by Grant (1996) emphasising that what mattered was coordination so far as to achieve knowledge integration): "it is never the resources themselves that are the inputs to the production process, only the services that the resources can render" (1959:25).

Artful deployment is the skill of entrepreneurship. Blaug remarks upon "the strange disappearance of the entrepreneur from the centre stage of economic theory" (1985:459). The entrepreneur is treated in most mainstream texts as a fourth factor of production, behind land, labour and capital. The arguments advanced here would place the

entrepreneur, or more precisely entrepreneurial behaviour (Lumpkin and Dess, 1996), at the heart of the value creating process. The Austrian school (Jacobson, 1992; Kirzner, 1992), and Schumpeter (1912) in particular, take a similar view. Schumpeter (1912) places entrepreneurship and its connection with dynamic uncertainty at the centre of economic inquiry, viewing the entrepreneur as the source of all dynamic change in an economy.

So far we have concentrated on trying to understand what value is, and how it is created. To summarise: value is perceived by the customer and all purchases are subjectively assessed, even purchases of resource inputs. Moreover, in order for a firm to make a sale a customer must perceive that the firm offers more consumer surplus than competing firms. Hence all firms that sell anything possess a temporal advantage. Value or consumer surplus is created by the artful deployment of the heterogeneous actions of labour with other resources.

ARTFUL DEPLOYMENT OF RESOURCES

Artful deployment can have both explicit and tacit aspects. Explicit artful deployment encompasses entrepreneurial flair, the ability to spot a business opportunity and knowing how to exploit it. It includes differential capabilities in resource procurement (so maybe the firm can buy cheaper), resource deployment (we manage, combine our resources more efficiently), and value creation (we know how to make and sell better products).

Tacit artful deployment refers to a situation where resources are being deployed in effective and efficient ways, but this skilful performance is not the result of a consciously developed set of rules or the result of a clearly understood organisational routine (Nonaka, 1991, 1994; Reed and DeFillipi, 1990). The firm just happens to be doing the right things,

it does not know exactly what causes its success. In other words the relation between its actions and its performance is causally ambiguous (Lippman and Rumelt, 1982). This could be due to chance, or to deeply embedded cultural know-how that no single individual is able to explicitly recognise or articulate (Nelson and Winter, 1982; Spender, 1994). So to refer again to Barney's (1986b) argument, special insights into the future value of a strategic resource would be an example of explicit artful deployment; luck or good fortune may be an example of tacit artful deployment.

In all firms there are probably elements of explicit and tacit artful deployment. In old established firms, where the original founders have long since left the scene, artful deployment may consist of some cultural momentum built up over the years (Fiol, 1991). The more tacit the artful deployment the more secure the firm is in one sense: if the firm's management do not understand what makes them successful, then others are less able to imitate them. As Lippman and Rumelt (1982) argue causal ambiguity "acts as a powerful block on both imitation and factor mobility" (1982,420) but the *management* of the firm becomes riskier. If we do not know what causes success, we may inadvertently change something that is critical (*e.g.* through delayering, downsizing, or the crude imposition of business process reengineering). Similarly, if we are not knowledgeable of sources of past success, and of impediments to future success, we cannot know either what to change, or what to change it to.

So, because of causal ambiguity, it could be that the demise of firms is more to do with not knowing exactly what to change and what to change it to, than with any structural, or cultural rigidities. It takes a confident and knowledgeable executive to challenge and change embedded routines. Executives 'generated' through the firm's culture may not be able to do so, it is difficult for an insider to realise what he, or his firm as a whole, takes

for granted. For this reason, executives that emerge from within are unlikely to be fully aware of, to explicitly know the sources of artful deployment, and hence are likely to be unable to manage its evolution. This may partly explain why, when faced with a downturn in performance, the typical 'knee-jerk' reaction is to cut costs (Bowman and Ambrosini, 1996). Cost cutting hardly ever constitutes an artful deployment of resources. It is often a programmed response to a crisis, taken without taking into account the true sources of the firm's current and possible future profit.

Moreover, if tacit deployment is at the origin of the firm's advantage then, crude cost cutting runs the risk of destroying the very sources of future profitability. There are cases where the incumbent executives, 'managerially' competent but lacking flair and insight, are incapable of making the difficult entrepreneurial decisions required, or other cases where quite the wrong understanding of the source of advantage obtained, as when Coca Cola launched their new formula Coke.

Tacit artful deployment is enacted in the special way certain tasks get performed: the way a particular salesman sells, or a designer designs. So tacit artful deployment is most likely to be performed by hired employees. Whereas the archetypal entrepreneur is an individual with insight, marshalling land, labour and capital for the greater good of society, in practice entrepreneurial behaviours are performed by hired managers. So whether artful deployment is explicit or tacit, it tends to be performed by hired employees.

Having set out an explanation of value, and its creation, we now turn our attention to the capture of value.

WHO CAPTURES VALUE, AND WHY?

Peteraf distinguishes between the existence of rents and economic profits: "the existence of Ricardian rents is not sufficient for the firm to earn above average returns....If the resource is not owned by the firm and the firm cannot appropriate some of the rents only the resource owner will benefit" (1994:156). This neatly juxtaposes the difference between value creation and value capture. Resources may be capable of producing positive value differentials, but if the resource owner is able to capture this value and the owner is not the firm, firm profitability is not affected.

Despite this important distinction between creation and capture, most contributors to the resource-based school focus their attention on barriers to imitation at the level of competing firms, rather than on the problems of retaining value *within* the firm. Their main concern is with the processes of capturing value from customers. Rumelt's isolating mechanisms (1984), Dierickx and Cool's (1989) time compression diseconomies to imitation, and the increasing returns to the cumulative magnitude of the stock of the input, and Lippman and Rumelt's (1982) causal ambiguity are all addressing the problems of value capture from customers. But, as Peteraf (1994) points out, there is no benefit to the firm if the value captured from customers is lost through resource suppliers bidding up the price of their resources to the point where they capture the differential value won from customers.

Porter (1991) highlights the issue of value capture in RBT: "successful firms are successful because they have unique resources. They should nurture these resources to be successful. But what is a unique resource? What makes it valuable? Why was a firm able to create or acquire it? Why does the original owner or current holder of the resource not bid

the value away?" (1991:108). Barney's (1986b) response to this last question is to suggest that, in strategic factor markets, firms competing for strategic resources have different expectations about a resource's value. As a result they will be prepared to pay different amounts for the resource. The "special insights into the future value of strategies" (Barney 1986b:1232) that the bidding firm has, enables it to acquire valuable resources at low prices; or alternatively, through good fortune ('luck'), the firm happily discovers that a resource has considerably more value than anticipated when it was purchased.

We argue that value capture from customers is determined by the bargaining relationships between the firm and the customer. The presence of close viable substitutes reduces the firm's ability to capture value in the form of high prices; because the customer can exercise choice this enhances his bargaining power.

The availability of close substitutes reduces prices and increases consumer surplus. The ease with which other firms can compete with close consumer surplus offerings will depend upon how easily they can amass the resources required to replicate, imitate or surpass the firm's position. The more unique the resources employed by the firm, the easier it is for the firm to bid up its prices and capture more value. These resources are the source of heterogeneous value creation. Moreover, as we argued earlier, they cannot be commodities themselves *i.e.* homogeneous and freely traded. Only resources capable of heterogeneity can be a source of heterogeneous value creation, and, the only resource capable of this variability is labour.

How much of the captured value is retained by the firm? This depends upon the bargaining power of the resource suppliers: if suppliers are cognisant of their resource's value-creating contribution and they can 'hold up' the firm, then they are able to capture a larger share of value (Kotowitz, 1989; Williamson, 1975). Porter argues as follows:

"..valuable resources, in order to yield profits to the firm, have been acquired for less than their intrinsic value due to imperfections in input markets" (1991:108).

Note that it is quite possible that a resource supplier captures a proportion of value far in excess of that resource's true, essential, contribution to the value creation process, and, of course, some resource suppliers will find themselves capturing far less value than they actually created, because of their weak bargaining power. This is a powerful example of the difference between essence and appearance. We shall now examine the differences between the appearance and the essence of relationships between the firm and two factors of production: suppliers of labour and suppliers of capital.

Value Capture: Suppliers of Labour

Although the actions of certain types of labour are the sole source of differential value (Pfeffer, 1995), the value that this labour creates is not usually captured by the sellers of the labour. This is because of the nature of the market for most types of labour. If it is in abundant supply, *i.e.* there are many very close substitute suppliers, then the bargaining power of the seller of labour is negligible. However, although both the seller and buyer of labour may perceive that the purchased contribution is homogeneous, as we have argued, the labour in action in the specific context of the firm becomes heterogeneous (Conner, 1991). This masks the true contribution of labour. It also explains why labour *power* is the resource that is sold by the employee; labour is sold in a form which disguises its variable contribution. The employer contracts to hire labour hours, a fixed amount that can be priced (per hour, day, week, month *etc.*). Once hired, the variable contribution of labour is manifested. So what was in appearance a contract to supply a fixed amount of labour, becomes in essence an opportunity for the employer to extract a variable amount of value.

Hold up does not occur usually because the contribution of specific labour is obscured. Tushman and Nelson explain that "technological change operates to fragment work, deskill labour, and reinforce the power of the existing bureaucracy" (1990:1). The division of labour and the globalisation of production render it almost impossible to draw links between the actions of the individual seller of labour and a value generating output. As Blaug explains: "the employment contract under capitalism is in fact 'incomplete' in the sense that it stipulates the rate of pay for labour, and the hours of work of labour, but fails to lay down the intensity or quality of the labour that is to be performed. Given the character of productive processes, it is only rarely that it is possible to attribute output to individual workers; hence time wages are much more common than piece wages" (1985:243). But the contract to supply labour power is *necessarily* incomplete. Leaving deliberately vague the contributions of the seller of labour power allows other interpretations of the essential relationships between the employer and the employee.

There are circumstances where the seller of a particular type of labour is particularly aware of its uniqueness and is conscious of the lack of perceived close substitutes. Examples would be movie stars, top sales people, and maybe some professors! In these cases the seller of labour is in a strong position to bargain up the price of their labour.

However in many cases the contribution of sellers of labour is not easily visible. It is notably the case for individuals that work as part of a team, where the combined result of individuals' contributions is greater than the sum of each contribution. This means that value is created by the team and not by the individuals as such. It is difficult for an individual seller of labour to see and show that his contribution is a differential ability. So, there is a difference between essence and appearance. The appearance is of the seller of

labour being grateful for the job offer. The essence of the relationship is almost the reverse. Without the contribution of labour, the firm's owners do not make profits. Hence, the essential relationship is the labour seller donating profits to the firm owner(s). So to summarise, it is the nature of the employment relationship, the trading of labour power not labour output, and the appearance of homogeneity of labour power that enables the firm owners to capture value created by the sellers of labour power. Maybe is it worth commenting that according to Aoki (1990) in Japanese corporations the value contribution of employees is seen in balance with that of resource suppliers, this could indicate that a shift from appearance to essence, i.e. to true relationships, may be possible.

To return to Barney's (1986b) arguments concerning strategic factor markets, even where all competing firms are aware of the value generating capability of labour, the price of that labour is not bid up because it is in relatively abundant supply. It is only where certain types of labour are perceived by buyers *and* sellers as distinct and heterogeneous that a bidding process ensues (*e.g.* transfers of football stars).

It is important to note here that we are not making any distinctions between different classes of labour. Whether the labour power being sold is unskilled, skilled, managerial, involving physical work or 'knowledge' work is not important. The important relationship is between the seller of labour power and the purchaser of that labour power. The purchaser is the firm owner (or the shareholders), who may use hired agents (managers) to recruit, direct and control employees. Further, as we argued earlier, not all labour adds to total value. Some labour is employed in activities that are solely concerned with value *capture*, not value creation. Examples would be supervisory activities (to extract more value from the employee), and negotiating with resource suppliers (to secure lower input costs).

Value Capture: Suppliers of Capital

In mainstream economics texts the suppliers of capital capture a share of value either in the form of interest payments, or in the form of dividends or growth on their equity shareholdings. Various theories have been advanced to explain how and why these suppliers of capital receive their share of value. Samuelson and Nordhaus neatly, though perhaps inadvertently, summarise the confusion: "to the economist, profits are a hodgepodge of different elements" (1985:660).

Profits are viewed: as implicit returns (rents, rentals and wages due to resources owned by the firm); as a reward for risk bearing (default risk, and pure statistical risk); as a reward for innovation and enterprise; as monopoly returns (the excess return gained by someone who has market power) (Samuelson and Nordhaus, 1985). Similar lists are proffered by other texts (*e.g.* Baumol and Blinder, 1985). McGuigan, Moyer and Harris (1996) add friction theory ("the inability of our economic system to adjust instantaneously to changes in market conditions" 1996:7) and they also add that profits are rewards to exceptional management skills. Profits have also been explained in the past as rewards for abstaining from current consumption.

In most mainstream texts there is no attempt to evaluate these competing theories of profit. They are typically dealt with in an additive way. In other words, all these theories are deemed to be correct in that they 'explain' different portions of profit. This projects a very confused picture.

A common theme in these theories is the need to explain profits as some sort of reward for something that is done for the good of economic society. Who consciously gives the reward is unclear, as the only source of cash to fund the rewards flows from customers.

Perhaps they are rewarding on behalf of society. Nonetheless, even if we accepted the notion of profits as a 'reward', and if we agreed that it was paying customers that conferred the reward, how can this come about? Customers can only reward what they perceive. They only usually perceive the finished product, the resources that were combined to deliver it are usually invisible, so they cannot be consciously rewarded. Moreover, are we rewarding the resource itself (the machine), the owner of the resource (the 'firm', or the shareholders?), the money capital that was loaned to buy the machine (loan finance), or the person who loaned the money? The notion of an inanimate object being rewarded is fairly absurd, but this does not trouble some economists.

Within resource-based theory the language used takes the form of 'rents' rather than 'profits' (Rumelt, 1987). If we were hoping for some more clarity in this stream of contributions we would be disappointed because the meaning of 'rent' differs across authors (Schoemaker, 1990) and for instance, Peteraf (1994) lists ten different types of rents: pure economic, quasi, appropriable quasi, Ricardian, land, inframarginal, efficiency, differential, entrepreneurial, managerial.

Do we need to distinguish between capital that is advanced as an equity stake from that advanced in the form of fixed interest earning debt? Both suppliers of capital can capture a share of value; the difference is the lender of debt knows his share in advance. For instance firm owners can borrow all their capital from banks, which is why interest can be regarded as a deduction from the 'profits' of enterprise (Blaug, 1985). So the financing structure has an impact on value capture, but does it affect the creation of value? This largely depends on the ability of the firm to fund investments itself. The entrepreneur who is self financing concedes no portion of value to external parties (shareholders or lenders),

so it is only where the entrepreneur deems it necessary to invest at a rate that cannot be sustained from his own funds that external fund providers enter the picture.

This explains a seeming paradox in our argument. We suggested that sellers of labour are usually unable to capture much value because they are perceived by both parties as selling a homogeneous commodity in abundant supply (labour hours). But if we apply the same argument to suppliers of capital, how is it that they are able to capture value? Suppliers of money capital are providing a completely homogeneous resource. Indeed there is nothing more homogeneous than cash, it is an essential quality that money must possess.

Using arguments about resource substitutability, suppliers of a completely homogeneous resource should capture equal and very low amounts of value. If they receive more than some minuscule return this must derive from their bargaining power. But again, if they supply a commodity, how can they bargain up the price of the money they lend? It must be *not* because the resource supplied is heterogeneous (because it isn't); it must be because it is in controlled supply. Owners of spare cash that can afford to risk are usually facing a sellers' market. So although the physical contribution of money capital is homogeneous, its restricted supply gives its owners power to capture a share of the value created by the firm.

RBT focuses on *economic* profits (rents). These are profits that are in excess of those levels that are deemed 'normal'. Normal profits include returns to suppliers of capital (*i.e.* interest payments). These rewards to suppliers of capital must be sufficient to persuade the owners not to take their capital elsewhere. However, super-normal profits can only be defined relatively, whereas profits could be defined absolutely (they are either realised or they are not realised). Here we get another source of confusion. Because super-normal profits are a relative concept, we need to have some benchmark to assess them against. The

concern initially amongst industrial economists was to assure themselves that allocative efficiency across society was being achieved. This theorising relies on the neo-classical assertion that an efficient allocation of resources occurs where price is equated with marginal cost. Any market structures where this does not persist are *ergo* inefficient, hence to find these markets we need to define the boundaries of an industry. We also need to be able to measure firm performance in a way that reveals exploitative levels of profit. Often the convenient industry definitions chosen for these industry studies are product driven, but they would not necessarily make sense in our subjectively defined market environments.

Thus, with regard to suppliers of capital, the essence of the relationship with the firm is that they supply a completely homogeneous resource, which is not capable of generating value. However because the resource they provide is in scarce supply, they are able to bid up the price of capital and capture larger proportions of value. The appearance is that suppliers of money capital create value. This is compounded ideologically with the notion of risk, and 'rewards' for risk bearing. But there are few *personal* risks involved, even if the investments yield nothing. The *money* is risked, the person who loans or invests it usually has other sources of income, and a varied portfolio of investments.

CONCLUSION

The contribution of this paper is an integration of several extant bodies of theory into a coherent explanation of value creation and value capture. We have tried to clarify a theory of value, and by distinguishing between the creation of value, and the capture of value it has developed further insights into the resource-based perspective. We argued that value is subjectively assessed by the customer and that consumer surplus is the criterion used by the

customer in making purchase decisions. Entrepreneurial skill is required to identify and produce valued products at low resource cost. We have also suggested that when a firm sells to a customer a temporal advantage situation prevails and, if costs are skilfully managed profits result from this situation. Resources *per se* are not the source of profits; it is their artful deployment that mobilises them to exploit market opportunities in cost efficient ways that is the source of temporal monopoly profits.

Markets are dynamic and unpredictable. As information becomes more widely available, competitors can expand their domains at the expense of the firm, through imitation, or by exploiting new innovations. This implies that artful deployment is a dynamic skill, which helps the firm to adapt to changing conditions. Where artful deployment is tacit the firm is at risk of either unwittingly destroying a source of value, or by its inability to know what to change, and what to change it to.

Although artful deployment is the source of value, bargaining relationships determine the capture of value. Profit is value captured by the firm. This includes pure profit (economic profit), supranormal profit, and interest. Although heterogeneous labour in action produces valued products which are the source of profits, the suppliers of this resource capture only a fraction of the value they create.

The strength of the preceding arguments lies in the fact that economic decisions are made on the basis of knowledge which it is reasonable to assume each actor might possess. The value of products is assessed subjectively, based on the buyer's perceptions of his needs and the extent to which alternative products might meet those needs. Decisions about the procurement of inputs into a production process are based on beliefs about the usefulness of the resource in the value creation process.

These propositions are in contrast to other forms of theorising. Neo-classical economics requires us to assume that entrepreneurs are cognisant of their firms cost curves, and the demand schedules of the customers in a market place. Transaction cost economics suggest that decision makers are aware of the relative costs of performing activities within hierarchies, or to establish market-based contractual arrangements. Experience of managers and executives operating in the real world strongly suggests that these assumptions may not hold. Despite some progress which has inched the theory of the firm closer to reality *e.g.* the contributions of Simon, and Cyert and March, vast tracts of economics activity in universities seems to hold to unrealistic neo-classical or quasi-neo-classical theorising.

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