LEADING WITH PURPOSE

The New Corporate Realities

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Preface

This is a book about corporate purpose—the organization's raison d'être—and its effect upon competitive performance, individuals, and executive leadership. It was written for practicing managers and serious students of management who seek to understand the roots of outstanding competitive performance and the leadership required to achieve it.

The concept of corporate purpose has long been central to the ideas of classic and contemporary management thinkers and scholars of leadership, such as Chester Barnard, Christopher Bartlett, Warren Bennis, James MacGregor Burns, Jim Collins, Peter Drucker, Charles Handy, Jerry Porras, Philip Selznick, and Peter Senge. However, despite its importance, corporate purpose has yet to be examined in depth. This book is designed to fill this void.

While the classic management authors generally agree that the corporation's primary purpose is to produce goods and services, not to maximize profits, most recent authors do not argue one purpose is superior to others. This book does and provides the strategic and human reasons why—supported by examples. The book's range is broad—spanning from purpose's effect on the meaning derived from work, strategy, and the way of managing, to the competitive consequences of different ideologies among global competitors, to the philosophical, historical, and cultural roots and psychological effects of different purposes. This comprehensive perspective is designed to aid managers in preventing myopic thinking regarding the purpose of their corporations.

This book represents a confluence of two streams of ideas emanating from my teaching, research, and work as a corporate executive. In essence, I have been concerned about the issues addressed in this book for thirty years. From my work as a corporate treasurer and then as a general manager of a group of business units, I became increasingly aware of how divergent the worlds of the capital markets and product markets can be, and how readily management-imposed financial policies can constrain competitive strategy. From my work on executive leadership, it became clear that central to outstanding leadership is the manager's responsibility to define the organization's purpose in such a way as to provide direction to strategy, to bring meaning to the work of others, to infuse the organization with value, and consequently to stimulate commitment and action. From my work on capital markets, financial policies, and competitive strategy, it became evident that there is often conflict between the policies and processes that internalize a purpose of maximizing shareholder wealth and the strategic actions required to provide customers with sustained value and to achieve long-term competitive superiority. Furthermore, the globalization of business has brought intensified competition from competitors who play by very different rules. Corporate purposes vary significantly across countries as differences in the institutional structure, culture, and government policies shape the relationship between financial institutions and corporations.

The concerns that have propelled this book have intensified in recent years. Today too many companies give lip service to the customers being their number one priority and employees as being their most valuable asset, yet they pursue a purpose of shareholder wealth maximization that subordinates the interest of customers to those of shareholders and treats employees as expendable means to these financial ends. This organizational schizophrenia results in a purpose focused on the capital market (shareholders), which often conflicts with strategies oriented toward product markets and with employees' values. Consequently, many people experience difficulty finding meaning in their work, and most corporations are failing to realize their potential to make people's lives better—the lives of the people who use their products, work within their boundaries, and invest in their future. For "employees" the deep longings of the human spirit—the desire for a life rich in meaning, passion, creativity, and a sense of belonging—are being left unsatisfied. The result is a hollowness of work.

Fortunately, pathfinding American firms have shown a better way:

harmony and wholeness among a firm's customer-focused purpose, strategy, and the values of individual employees unleash considerable human energy and creativity that significantly enhance performance. Their leaders recognize the moral dimension of purpose and the need for courage to make the choices and set the priorities that create strong institutions, even when these acts run counter to prevailing conventional opinion. This book attempts to capture the essence of the thinking behind this pathbreaking way.

The book's central thesis is that a customer-focused corporate purpose provides the key to outstanding performance and to enhancing the lives of those the company serves and of those who serve it. This will be even truer in the intensely competitive knowledge-based markets of the future. At a time when allegiance to shareholder wealth creation is reaching fad proportions, this book provides compelling strategic, managerial, and moral arguments for moving from a shareholder-focused corporate purpose to one focused on customers.

My over twenty years of experience in teaching at the Harvard Business School and the Peter F. Drucker Graduate School of Management at Claremont Graduate University—particularly teaching executives—have reinforced these concerns. I have witnessed how these issues generate vigorous debate and deeply move people as few other management issues do. Managers resonate strongly with these ideas and conclusions, and they long to find environments in which their work can become more meaningful.

It is my hope that this book will enable readers to lead more effectively through a deepened understanding of why the substantive content of corporate purpose makes such a difference. I hope they come away with a richer appreciation of the reasons alternative formulations of purpose have significantly differing competitive impacts; with an enhanced ability to judge the merits of the arguments underlying each of these different purposes and to appreciate their historical and philosophical roots; and with the ability to constructively challenge the many unquestioned, but erroneous, conventional wisdoms supporting the current prevalent American ideology and to comprehend the often subtle link between valued purposes, meaningful work, motivation, and knowledge creation. Ultimately my hope is that as leaders readers will learn how to develop a sense of purpose within their organization that unleashes human creativity and initiative in the service of a noble cause.

The book is divided into four parts. Part I examines how the substance of an organization's purpose makes a profound difference to a firm's competitive performance (Chapter 1) and to the lives of people in the organization. The reasons are grounded in the meaning individuals derive from work that serves valued ends (Chapter 2) and the powerful effect of purpose on strategy (Chapter 3) and the way of managing (Chapter 4). Corporate purpose's importance rests in the fact that it both expresses the organization's most fundamental value—why it exists—and is the end to which strategy is directed. Furthermore, the meaning people find in serving a purpose that embodies a noble ideal increases their commitment and loyalty and, as the boundaries between the self and the cause blur, enhances knowledge creation. In a world in which the coin of competition is knowledge, this linkage has profound strategic implications.

To better understand the arguments for a purpose of shareholder wealth maximization, Part II critiques the logic of "shareholder value-based management" and the relationship of the firm to the equity markets (Chapter 5). The validity of extending traditional concepts of property rights to share ownership is explored in Chapter 6, concluding that the separation of stock ownership from the responsibility for and managerial control over corporate actions makes traditional property rights arguments inapplicable to the underlying assets of a corporation. The traditional argument for a shareholder-dominated purpose is based on the assumption it furthers individual autonomy. But in today's corporation, individual fulfillment and the realization of the ideals of individualism are profoundly influenced by the firm's purpose, as shown in Chapter 7. But the people whose sense of self are most affected by the corporation are the employees and customers, rather than the shareholders. Therefore, a constructive individualism rooted in a meaningful customer-focused purpose is advocated—one that enhances self-fulfillment and the creativity and initiative that are the wellsprings of innovation. By challenging many of the conventional wisdoms surrounding the shareholder wealth maximization ideology, the book aids readers in developing their own well-grounded philosophy.

Part III examines the implications of corporate purpose in a global economy, where companies must compete with firms with fundamentally different views of purpose that reflect distinct national histories and philosophical ideas. Chapter 8 explains the realities of U.S. international competitiveness, while Chapter 9 explores the cultural, historical, and philosophical roots of the ideologies that shape the purposes of companies in Germany, Japan, Korea, and other Asian countries. Globalization vastly expanded the playing field, creating a Darwinian struggle for dominance among free-market ideologies. This section helps the reader understand the essence of this struggle and the importance in a global arena of the ability of purpose to retain its significance and motivational power across national boundaries (which a shareholder-focused purpose fails to do).

Part IV explores the implications of corporate purpose for leaders, arguing in Chapter 10 that infusing an organization with a worthy purpose is an essential responsibility of leadership—an act that is at once strategic and moral. In today's environment, it is often an act of courage. As the organization's ultimate end value, corporate purpose provides the foundation for the shared values that define organizational character, raise moral aspirations, and enhance performance.

In addressing these issues, ideas are integrated from a wide range of thought: from strategy, management, and executive leadership to history, cultural anthropology, philosophy, theology, and psychology. These ideas are woven together with examples from leading companies to demonstrate the superior value of a customer-focused purpose.

Acknowledgments

On such a long journey as the one that has led to this book, I owe great debts to the many people who helped me develop and refine my understanding of corporate purpose. I owe a special debt to the students in my classes, whose thought-provoking insights, probing questions, examples from their own experience, and excitement in discussing these issues not only improved the ideas in the book but also strengthened my motivation and commitment to write it.

I benefited greatly from the insights and constructive challenges to my thinking provided by my colleagues at the Peter F. Drucker Graduate School of Management at Claremont Graduate University who read early versions of the manuscript. Peter Drucker not only provided very helpful and practical comments on the manuscript but also maintained a constant interest in my work and gave me important encouragement at critical junctures along the way. I am particularly grateful to colleagues with whom I have cotaught courses on subjects related to the ideas in this book: Mihaly Csikszentmihalyi (with whom I have taught "Leadership and the Making of Meaning"), Vijay Sathe ("The Strategy Course"), and Richard Smith ("Strategy and Finance"). I learned much from each of them. My relationship with Mihaly

Csikszentmihalyi proved particularly fruitful in expanding my thinking regarding the psychological roots of purpose and meaning. Vijay Sathe's continuing interest from the inception of this work, his constant encouragement, and his detailed comments on the original manuscript proved invaluable. The keen and creative mind of Jean Lipman-Blumen, who shares with me the directorship of the Institute for Advanced Studies in Leadership, has never failed to stimulate my thinking; her willingness to share a disproportionate share of the burden of running the institute during "crunch times" greatly aided my ability to sustain my work on the manuscript.

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Introduction: The New Realities of Corporate Purpose

> Perfection of means and confusion of ends seem to characterize our age.
> —*Albert Einstein*[1]

This is a book about the stranglehold an outdated—but, ironically, an increasingly accepted—ideology has on business performance; about the integral link between corporate purpose, competitive advantage, and work that brings meaning and enrichment to lives; and ultimately about the responsibilities of executive leadership to define noble ends for collective efforts. It explores a central truth underlying the creation of great companies capable of exceptional and sustained achievement. The leaders of these companies have long known that providing value to customers—not the maximization of shareholder wealth—is fundamentally why their organizations exist and that this purpose is key to their companies' outstanding performance. This linkage between customer-focused purposes and performance will be even truer in the intensely competitive, knowledge-based global markets of the future.

We live in a new age. Economic and social forces are converging in ways never before experienced by humankind. Throughout the world, the tumultuous pace of change is shaking the very foundation of enterprises. The forces of change are many and each challenges the traditional view of the fundamental purpose of American corporations. The globalization of markets has brought companies with fundamentally different corporate purposes into direct, daily competition. The creation and management of knowledge have become the central sources of competitive advantage, displacing past advantages of capital and labor costs. In America, fueled by concerns over ineffective corporate governance, hostile takeovers, and often-ruthless corporate downsizing, an active debate persists over whom corporations primarily exist to serve. These forces have contributed to a sense among employees that they are expendable parts in a corporate machine. Many feel they have become means to ends they do not value. The result has been an alarming erosion of loyalty among the key source of competitive advantage—the company's people. Consequently, at work many people have turned their focus inward, away from the common good to their own narrow self-interest. Simultaneously, American capital-market institutions are scrambling to exert greater influence over corporate management to assure the shareholders' primacy among the companies' competing constituent interests.

Amid this tumult, the traditional sources of senior management's influence—authority and formal management systems—have lost much of their ability to motivate, direct, and control behavior in organizations. In their stead, twenty-first-century leaders will increasingly need to rely on the power of a clear mission, an understood strategy, and shared values to guide decisions and motivate people to achieve outstanding results. Purpose takes on much of its importance precisely because each of these sources of influence requires—indeed is founded upon—a clear concept of purpose. Conversely, leadership's failure to define a clear purpose—or the propagation of a purpose with little value to people within the company, such as the maximization of shareholder wealth—explains much of the tension, conflict, and ambivalence that inflict American companies today.

These realities reflect an age of paradox. Each of the following fundamental yet provocative contradictions is rooted in corporate purpose and will be addressed in the pages that follow:

- Long-term shareholders are *not* best served when a company puts the shareholders' interests above all others. Instead, they benefit most when customers are made the primary reason for the firm's existence and employees are given priority ahead of shareholders.
- Similarly, employees' interests are *not* best served when the corporation's purpose places top priority on their interests. Instead, the highest level of individual development and the greatest happiness are derived from serving ends beyond the self—ends that employees value, that enable them to feel they are "making a difference," and consequently that bring increased meaning to their lives through work.

- The value a company creates for society is not synonymous with its shareholder wealth creation. Most critical for society is the firm's sustained *total* value-generating ability, not the value created for shareholders alone, but also for customers, employees, and communities.

- Maximizing discounted net present value returns on investment is not the same as—and can conflict with—achieving greater competitiveness. Therefore, profits are best treated as a means to competitive advantage, not an end in themselves.

- At a time when the benefits of capital-market discipline are widely touted, the reality is that for most firms the discipline administered by the competitive product market is swifter, surer, more direct, more in harmony with the needs of competitiveness, and therefore more constructive and effective. By paying primary attention to capital market pressures, managers can undermine their company's ability to respond to the more critical competitive pressures emanating from the product market.

- A leader's high moral standards of behavior do not—as is commonly thought—constrain the pragmatic actions necessary to secure outstanding competitive performance. To the contrary, they enhance long-term competitiveness by creating an environment that raises the organization's members to their better selves, thereby enhancing commitment, innovation, and cohesiveness.

This book is dedicated in part to a greater understanding of the implications these paradoxes have for corporate leadership. How leaders respond to the challenges of this new age will profoundly influence people's lives and the competitive performance of organizations.

Although there are persuasive moral and social arguments for moving away from a shareholder-focused corporate purpose, the pragmatic strategic benefits of replacing this purpose with a customer-centered purpose alone are compelling. The strategies of customer-focused companies usually result in a level of competitiveness that significantly outstrips equally capable shareholder-focused rivals. Within the firm, the purpose of maximizing shareholder wealth has failed to energize employees—those individuals whose knowledge and effort create the competitive advantages of today and the future. For many, it has also failed to bring meaning to their work lives. Consequently, there is a bankruptcy of spirit in many American companies. The remedy begins with a purpose that defines ends that people find meaningful and worthy of their commitment.

The pragmatic economic ends of competitive advantage and enhanced wealth creating capacity are inextricably linked to the moral quality of the firm's purpose in two fundamental ways. First, wealth creation, properly defined, is a moral good that should be maximized. But corporations create value for many more people than shareholders alone. Value is received by customers in the form of higher quality and more functional and lower-priced products and services; by employees through their compensation and more secure and meaningful jobs in which they can grow, develop, and find greater personal meaning for their lives; and by communities through the consequences of the firm's economic activities. Measures of corporate wealth creation need to incorporate the impact on all of these constituents.

Second, the competitive consequences of corporate purpose flow in part from the meaning organizational members find in their work and much of this power comes from the moral dimensions of purpose. The knowledge, cooperation, commitment, and hard work of individuals are the stuff from which competitive advantage is formed. When the corporate purpose stands for a cause in which its members believe, it activates their higher motivations and deeper commitment. The result is often heroic contributions to the firm's competitive success.

Understanding the Critical Role of Corporate Purpose

Corporate purpose sits at the confluence of strategy and values. It expresses the company's fundamental value—the raison d'être or overriding reason for existing. It is the end to which strategy is directed. Without a clear purpose that reinforces the organization's other espoused values and gives meaning and direction to strategy, the firm will eventually wither under competitive pressure from companies with purposes that provide greater coherence.

The Role of Corporate Purpose

In turbulent times such as these, corporate purpose can be both a source of stability and an impetus to proactive change. In fact, Lew Platt, former chairman and CEO of Hewlett-Packard, considers instilling an appropriate purpose into the organization to be "the real challenge before every business leader today." At the heart of this challenge is finding "a way to change quickly enough to remain competitive while still giving your people enough continuity that they feel comfortable or, if not comfortable, that at least they're not terrified all the time."[2] A clearly articulated and properly formulated purpose—one that members of the organization understand and value—provides continuity and constancy while placing the need to adapt to changing customer needs at the heart of the company's shared values. Properly defined, corporate purpose should rarely, if ever, change. This permanence of ends provides continuity amid strategic change. Since the purpose is never completely realized, it acts as a powerful antidote to complacency, stimulating the need to change. It can furnish the reason change is necessary; when the purpose is valued by members of the organization, it can do so in ways that are meaningful to those who must implement the change, thus evoking their commitment. However, a vague purpose—or one not valued by the company's people—loses these powers to provide organizational cohesion during times of change.

Corporate purpose defines the contribution management seeks to make to its various constituents—the corporation's owners, employees, and customers and the communities in which the company does business. Corporate purpose specifies a firm's ultimate priority among its responsibilities, be that priority the maximization of shareholder wealth, satisfying customer needs, providing for the employees' welfare, or serving the national or community interest. In this sense corporate purpose is irreducible except for spiritual reasons for the existence of organized human endeavors.

Needless to say, the full power of corporate purpose is rendered when it is aligned with the essential nature of man's being. Purpose can bring an uplifting moral quality to a company's mission. In doing so, it appeals to the organizational members' higher instincts, unifying their personal aspirations and their work and unleashing greater initiative and commitment in service of corporate ends.

By defining the basic end values for which a company stands—the values that bind the members of a company together—corporate purpose is at the core of what Richard Pascale and Anthony Athos call the "superordinate goals" that define "the overarching purposes to which an organization and its members dedicate themselves." These "spiritual or significant meanings and shared values" provide "the guiding concepts" that unite people within an organization in a common cause.[3]

What Should the Purpose Be?

To provide these benefits, not any formulation of purpose will do. Its substance matters critically.

Contrary to widely held belief, the *ultimate* reason we create businesses is not to make a profit. Profit is a necessary factor for producing product and services and for creating wealth—a means not an end in itself. Nor is the ultimate purpose to make a product or service. One must ask, "Why make a profit or provide a particular product or service? Does it make any difference to corporate performance whether the answer is creating wealth for shareholders, satisfying the needs of customers, providing people with satisfying and fulfilling work, or serving society or the nation?" This book's thesis is that the answer makes a profound difference—a difference to corporate performance, to human satisfaction, and to the wealth of society.

To be more effective than alternative formulations of purposes, the chosen corporate purpose should do the following:

- Provide the greatest focus on achieving competitive advantage
- Lay the best foundation for achieving harmony among the purpose, strategy, goals, and shared values
- Motivate managers to create the maximum level of total value—not just value for one particular constituent
- Heighten the motivation of members of the organization, subordinating narrow self-interest to corporate ends and enhancing the firm's ability to create knowledge
- Be seen by employees around the globe as a worthy and meaningful end to serve, and serving this end, potentially raise employees' moral aspirations
- Promise to enhance the legitimacy of the corporation's actions in society

Only a purpose of serving customers' interests, followed closely by attending to the needs of employees, satisfies each of these criteria.

A customer-focused purpose is aligned with both the strategic needs of the competitive product market and the employees' welfare. It provides the foundation for strategies and objectives directed toward winning in global markets and the quality of ends that can rekindle people's commitment to their work. An ultimate corporate purpose of maximizing shareholder wealth does none of this as well as does a customer focus.

The choice of this raison d'être and its reflection in action deeply influence competitive strategy. The selection of the customers' needs as the dominant priority vitally affects the outcome of critical, character-defining corporate decisions that shape strategies, commit resources, and build core competencies. In a world of global competition among firms with differing views of purpose, this sense of ultimate priority is of critical importance to competitive success.

The most common purpose of American companies—to maximize shareholder wealth—is threatened with competitive obsolescence by a purpose that places the highest priority on the long-run health of the enterprise and on serving the needs of customers, and in this way best serving society. This is not a new idea. Leading management thinkers have long recognized the importance of purpose. Classic management scholars, such as Chester Barnard, Peter Drucker, Philip Selznick, and Kenneth Andrews, never lost sight of the centrality of purpose. For them, purpose is at the core of effective management. It has both a moral and a pragmatic business dimension. In the 1970s Peter Drucker observed that a company's purpose "must lie outside the business itself. In fact, it must lie in society since business enterprise is an organ of society. There is only one valid definition of business purpose: *to create a customer*."[4] In other words, corporations fundamentally exist to produce goods and services that serve the needs of present and future customers better than competitors do. Drucker considers purpose the starting point in understanding what a business is. He sees corporate purpose as critical to successful performance, concluding, "That business purpose and business mission are so rarely given adequate thought is perhaps the most important cause of business frustration and failure."[5]

Chester Barnard was one of the first management thinkers to articulate a comprehensive view of the importance of purpose to effective management. To him the formulation of purpose is one of three essential executive functions—and critical to the other two (providing a system of communication and securing the efforts essential to the organization's success). The purpose of any organization, he believed, is service to its customers. By providing the "objective of cooperation," this purpose becomes "the coordinating and unifying principle" in organizations, guiding individual actions.[6] When people believe in the cause defined by the purpose and believe in its feasibility, purpose becomes a powerful stimulus to individual willingness to cooperate and contribute effort to the organization. To Barnard, "An objective purpose that can serve as the basis for a cooperative system is one that is *believed* by the contributors (or potential contributors) to it to be the determined purpose of the organization. The inculcation of belief in the real existence of a common purpose is an essential executive function."[7] Common purpose gives meaning to the environment, is a powerful force for coherence among activities throughout the organization, and motivates individuals to forgo immediate self-gratification to further the aims of the organization. It is essential to effective and efficient corporate performance.

Philip Selznick, in his pathbreaking work on leadership, concluded that defining institutional purpose, "building purpose into the social structure of the enterprise," and consequently "transforming a neutral body of men into a committed polity" are central tasks of leadership.[8] The "institutional embodiment of purpose" shapes "the 'character' of the organization" by "joining immediate goals to ultimate values."[9] To him, there is "no sharp division between the tasks of defining mission and embodying purposes. Each entails a self-assessment, an appreciation of internal pressures and external demands. This self-knowledge leads to the formulation of truly guiding aims and methods."[10] When organizational purpose reflects the values of individual members, the organization becomes "infused with value." It becomes valued for itself and the ends it represents. Consequently, the individual's daily activity becomes filled with meaning and purpose. The result is deep commitment and loyalty and a readiness to defend the organization because of the values it embodies.

Purpose clarifies which decisions are critical and informs how these decisions should be made. Critical decisions, in Selznick's view, are those that define the character of the organization, its values, and the mission to which it is committed. The two purposes of serving customers and maximizing shareholder wealth embody different values and therefore mold different organizational character. Because of its ambiguous nature, a purpose calling for the "balancing constituents' interests" gives little form to organizational character.

Kenneth Andrews (who was the spokesman for a larger group of individuals concerned with general management and strategy at the Harvard Business School in the 1960s and 1970s) links corporate purpose to the moral aspirations of the members of the organization. He concludes that purpose should define the "human needs the organization would find satisfaction in serving."[11] For Andrews, as for Drucker, corporate purpose does not reside in maximizing shareholder wealth.

Similarly, W. Edwards Deming, in his seminal work on quality, followed the simple principles of putting the customers' needs first and placing the product before profits. For Deming, quality comes from people who believe in the corporate ends and are entrusted to work positively for the common good.

Common themes run through the reflections of these leading management thinkers. To be effective and to be a stimulus to competitive behavior, the members of the organization must believe the corporate purpose; it must be built into the social structure of the enterprise; and it must be capable of transforming a "neutral body" of people into a committed group and to direct their actions. To achieve these objectives, the corporate purpose must be clear, consistently implemented, and constantly reinforced. It must be one in which people have faith and see value—as the organization's ultimate value, it must possess a quality capable of eliciting belief and defining the organization's character and direction.

Yet even though the central importance of corporate purpose has long been recognized, it receives inadequate attention in practice and management research. What is taught in most, if not all, American business schools represents indoctrination into an unquestioned ideology of maximizing the shareholders' wealth. Although the central role of purpose is often acknowledged in courses on strategic management, the focus quickly digresses to teaching about economic goals, competitive strategies, and rubrics for maximizing the return on investment with little attention to the purposes served. However, the intensity and nature of the new competitive forces are of necessity rekindling attention to corporate purpose. Recent studies of companies with outstanding performance records—studies by leading thinkers such as Christopher Bartlett, Sumatra Ghoshal, Charles Handy, James Collins, and Jerry Porras—have placed purpose back at the center of management thought.

Purpose and the New Realities of Competition

The global currents of change buffeting corporations are enhancing corporate purpose's importance to competitive success. The following five trends are particularly powerful:

1. The coin of competitive advantage is rapidly evolving to knowledge.
2. Loyalty and commitment are increasingly essential to knowledge-based competitive advantage.
3. The sources of managerial influence are changing.
4. Firms with different concepts of corporate purpose are competing head to head.
5. Returns on investment are under competitive pressure.

Each one of these trends is changing the face of competition and collectively will determine competitive advantage in the twenty-first century. Corporate purpose directly affects an organization's ability to respond constructively to each of these currents.

The Coin of Competitive Advantage Is Rapidly Evolving to Knowledge

The terms of competition are dramatically shifting. Technological advancements have caused the labor-cost advantages of the past to give way to capital- and knowledge-based advantages. Even in the low-wage developing world, rising living standards and the substitution of capital for labor have eroded labor-cost advantages. As capital advantages are transformed into highly automated plants filled with complex computerized equipment that replaces labor, not only do labor-cost advantages diminish, but also the knowledge possessed by the fewer remaining workers becomes more important. Even in industries in which capital has not significantly replaced labor, global companies can rapidly move their manufacturing facilities to countries with low labor costs. The substitution of capital for labor and the rapid access to low labor costs mean that competitive advantages based on lower labor costs are fleeting. More important, as access to capital has become more and more equal throughout the developed world, intellectual capital has supplanted financial capital in competitive importance. Capital retains its competitive importance more from management's willingness to invest than from the availability of capital. Capital availability itself is unlikely to provide sustainable advantages in today's world.

Labor is an indigenous, tangible resource, which at any point of time is pretty much a given. Capital, on the other hand, although tangible, is not indigenous. The decision to procure and commit capital is the result of human decisions influenced by cultural beliefs, institutional relationships, and management's values, beliefs, and priorities. Consequently, the capital advantages go not just to companies from countries with a lower cost of capital; even more important, those firms willing and able to invest capital efficiently—often at lower returns than those of their competitors—capture the advantages. Purpose affects the willingness to invest. A company driven to maximize shareholder wealth will carefully restrict investments to those with returns above the cost of capital. However, companies with purposes to serve customers, to serve the national interest and/or employees (such as many European and Asian companies), or to serve society in general will be motivated to make investments to promote growth with less emphasis on the level of the financial returns from these investments. When they do so, they often capture the investment initiative from their shareholder-focused competitors, with significant competitive consequences.

This is exactly what happened in the semiconductor industry in the 1980s and early 1990s, as Japanese and then Korean manufacturers outinvested U.S. producers. In 1975 all of the world's leading merchant producers of integrated circuits were American. However, within a decade, Japan's share of the world semiconductor market passed that of the United States. The rapid Japanese market share increase in semiconductors came largely at the expense of U.S. manufacturers. Initially, American firms attributed the Japanese gains to unreasonable pricing (dumping charges were filed) and to their investment in projects offering little prospect of a reasonable return. Slowly, American producers became aware that Japan enjoyed another critical advantage—a knowledge-based advantage. Japanese superiority in manufacturing processes, which generated substantially fewer defective chips, could not be replicated by investment alone. Whereas American firms could quickly adapt to building world class "fabs," gaining comparable skill in the actual manufacturing processes took years. Consequently, by 1989 only one American company remained among the world's top ten producers. By 1994, as U.S. firms gained greater process skills, three more American companies had climbed back into the top ten, and five of the top ten firms were Japanese and one was Korean. The U.S. semiconductor market share, aided by American dominance in high-value microprocessors, exceeded Japan's for the first time since 1985. By the mid-1990s, Korean firms, led by Samsung, had gained world leadership in memory chips, after a prodigious investment campaign.

Today, knowledge provides the primary source of sustainable advantage. Competitors can quickly replicate capital-based advantages. Capital migrates readily across national boundaries and from firm to firm. Seeking low labor costs, global companies can choose to site or source production anywhere in the world, tapping the physical dexterity, effort, and endurance of the world's best workers. Only knowledge-creation abilities have difficulty transferring across corporate boundaries.

Most service and manufacturing businesses are essentially knowledge-based businesses. In all businesses, the activities requiring greater levels of knowledge to stay competitive are many and varied: the plant worker's skill in operating numerically controlled machinery and in originating cost-saving and quality-enhancing ideas; the salesperson's know-how in creatively identifying, communicating, and serving customer needs; the researcher's expertise in developing new products and processes; and the manager's ability to cope with ambiguity and uncertainty in directing, coordinating, and motivating fellow workers to achieve excellence. The force that drives costs lower and increases the functionality and quality of the products and services is the application of the knowledge of the firm's members at all organizational levels. In manufacturing and service businesses alike, the knowledge advantages go to those with the most highly skilled, committed, and effectively coordinated people.

This shift in competitive advantage raises issues of how best to gain and trap knowledge within a firm. Not all forms of knowledge provide equal competitive advantages. Knowledge gained by individual experience and training is often skill oriented. These skills and the people who possess them can migrate rather quickly in response to economic incentives. Knowledge that provides the most sustained source of competitive advantage does not migrate easily to other companies. It is either protected by government action, such as patents, or infused in the organization's social structure and possessed collectively by many of its members, such as proprietary production processes. Knowledge gained from collective experience—from working together in groups—becomes institutionalized within the group and transfers slowly and with difficulty. No one person knows what the group as a whole knows; often much of the uniqueness of this institutionalized know-how concerns the process by which the group learns and creates new knowledge. This "embedded knowledge" cannot be obtained through reverse engineering, pirating of employees, consultants, or books.[12] As Joseph Badaracco has shown, it can be developed only over long periods of time, and this learning takes place within numerous individuals and is woven into the social fabric of the organization.

The future belongs to those with the greatest ability and willingness to deploy capital, to create and leverage knowledge, and to realize the latent potential of their employees. The nature of a corporation's purpose directly influences the firm's motivation to develop these abilities.

Loyalty and Commitment Are Essential to Knowledge-Based Competitive Advantage

The increasing importance of knowledge to competitive performance requires the company to have the ability both to attract talented people with new ideas and to maintain continuity in relationships among individuals within the organization. It also demands that individuals give more of themselves—their intellectual skills as well as physical effort and a willingness to constantly improve their skills through education and training. Ironically, just as the commitment, initiative, and loyalty of employees are increasing in competitive importance, America is experiencing a serious weakening of the traditional bonds of loyalty and commitment between employees and their companies.

For many Americans, work no longer provides the meaning to their lives it once did. In many ways this is a consequence of management's reactions to intense capital-market pressures, which have caused shareholder interests to be placed ahead of those of customers and employees. Hostile takeovers, senseless mergers, corporate downsizing, and an intensified emphasis on the creation of shareholder wealth as the aim of work (particularly as manifested in a preoccupation with near-term earnings) have caused many people to feel betrayed by the organizations to which they have dedicated significant portions of their lives. In companies where this has happened, the demoralized employees clearly do not share knowledge or learn as readily as the committed membership of otherwise equal competitors. Corporate purpose has turned hollow and meaningless, giving rise to cynicism regarding senior management's motivations and abilities and to estrangement from work. In addition, these companies risk their potential competitive advantage walking out the door, siphoning off valuable knowledge and breaking up knowledge-creating groups.

Corporate purpose can play a critical role in attracting high-caliber people and in reinvigorating feelings of loyalty. Purpose imbued with a quality that organizational members find worthwhile and meaningful can command loyalty and commitment—the company embodies ends that are personally valued and deserve promotion and defense. Such a purpose can even help justify necessary corporate actions—such as layoffs—that could otherwise tear at the fabric of loyalty.

The Sources of Managerial Influence Are Changing

The dizzying pace of change, rapid technological innovation, the increasing complexity of doing business, and the rising intensity of competition require a significant rethinking of traditional ways of managing. The past heavy reliance on authority of position and on professional management systems is no longer adequate to guide decentralized decision making and to motivate people. These techniques of professional management must give way to an increasing emphasis on the alignment of corporate purpose, mission, and shared values. When purpose imbues mission and values with a quality and moral tone, they become sources of powerful motivation, direction, and organizational coherence.

Firms with Different Concepts of Corporate Purpose Are Competing Head to Head

The increasing homogeneity of markets throughout the world and the rapid spread of technology have created truly global industries. Daily, competitors from different cultures collide with one another in the marketplace. No longer do American companies have unquestioned dominance over world trade, dictating the rules by which worldwide competition takes place. Nor do they continue to enjoy the luxury of competing almost exclusively with other American companies—companies guided by essentially similar views of how to compete and sharing the same shareholder-focused view of corporate purpose.

Not only has the playing field been vastly expanded, but today's competitors also play by a variety of rules, including how the game is scored. These divergent ideas about how to win in today's markets often result from domestic differences in ingrained beliefs and values and the structure of the institutional relationships among government, business, and financial institutions. In part this reflects varying beliefs about what the ultimate purpose of corporate activity is.

These differences significantly affect the terms of competition, and thus corporate performance, as firms with divergent concepts of their ultimate ends battle over the same markets. For example, if a company's purpose is to maximize shareholders' wealth, it will most often seek to maximize returns on investment to serve this aim. This practice can necessitate the curtailment of product development or market penetration initiatives that promise long-term competitive benefits but generate inadequate discounted rates of return on investment today. In essence, the needs of the product market are subordinated to the needs of the capital market. However, if the purpose is to serve the needs of customers, employees, or the national interest (as is the case for many international competitors), then reinvestment in R&D, cost-reduction projects, or more efficient distribution beyond the point of optimal returns (as measured by the capital markets in terms of discounted present value *today*) might be required. In this case, the reward will be improved market share and strengthened core competencies, but not necessarily increased returns. Of course, profits remain critically important, not as an end, but rather as means to serving the customer and as a measure of the firm's efficiency and effectiveness in doing so.

One of the great competitive strengths derived from a customer-focused purpose is the dominant focus it places on the product markets. This purpose brings a harmony and coherence to strategies, goals, and values throughout the organization. Outstanding leaders use this laserlike focus to derive competitive benefits by developing capabilities, fostering commitment and initiative, and deploying resources in ways not possible when strategies and operational goals must be rationalized with a capital-market purpose.

These different corporate purposes reflect different views of a corporation's role in a free-market economy. With the triumph of capitalism over socialism, the focus of the debate has shifted to which of the competing forms of capitalism will emerge victorious in the future. For reasons of economic logic and human motivation, capitalist societies that direct their enterprises' primary attention to the product market rather than the capital market will be the victors. Companies focused principally on shareholders, rather than customers and competitors, will be at an increasing competitive disadvantage in the future.

Returns on Investment Are Under Competitive Pressure

Coinciding with the development of this new game is a downward pressure on return on investment caused by a global influx of capital investments—many of them producing returns American managers would consider far below their standards. In the global fight for increased market share, the continued deployment of more capital at lower returns will accelerate the shift to knowledge- and capital-based competitive advantages. This will create an acute competitive dilemma for firms espousing a purpose of maximizing shareholder wealth—how to achieve high returns in a declining-return environment populated with competitors willing to make competitiveness-enhancing investments at returns that erode near-term shareholder wealth.

These pressures have already begun. Since World War II the United States has faced three waves of attack from foreign competitors. First came the Europeans led by West Germany. Next came Japan. Then came the third wave—the Asian Tigers consisting of Korea, Taiwan, Hong Kong, Singapore, and Malaysia. On the horizon is the threat of a fourth wave that has the potential to swamp the three preceding ones—China. In 2000 the five Asian Tigers, if combined, represented the United States' largest trading partner in goods outside of NAFTA ($233 billion of trade); Japan was second at $212 billion, and China was third at $116 billion. Also in 2000, the U.S. trade deficit with China reached $83.8 billion, surpassing Japan to become America's largest deficit trading partner.

China poses a particularly vexing competitive challenge. The combination of exceptionally low wages and a high propensity for capital investment produces an economy with exceptionally fast export growth. During the 1990s, Chinese exports grew at a rate of 14 percent per year.[13] Because of the enormous population, for the foreseeable future China has a nearly perfectly elastic labor market with an essentially unlimited supply of people willing to work for little more than three dollars per day. This alone gives Chinese goods a considerable advantage over those produced in developed countries in the East and the West. In addition, China has invested at a dizzying pace. In the late 1990s, its manufacturing capacity was estimated to be nearly double its actual production.[14] This overcapacity resulted in a flood of low-priced Chinese goods on the world market ($184 billion worth in 1998), forcing the prices down in competing countries. Not only has this reduced inflationary pressure worldwide, but also for many of China's closest competitors, such as Thailand, Indonesia, Korea, the Philippines, and Malaysia, it has necessitated a devaluation of their currencies and helped trigger the "Asia Crisis" of the late 1990s.

Except for China, these waves of foreign competition are all made up of basically capitalist countries. Yet when compared to the United States, each of these countries has fundamentally different cultures, financing conventions, and corporate relationships with their sources of capital and with the government. For example, Confucian thought heavily influences each of these Asian countries. Accordingly, many of their companies emphasize the importance of loyalty and the harmony of individuals and institutions with the needs of the broader society. A sense of duty to family and society is often deeply rooted in the corporate psyche. The consequence of these differences is divergent views of corporate purpose. In practice these differences result in varying beliefs that define the relationships of the firm to society, elicit differing intensities of commitment to the organization's ends, and determine the level of return on invested capital that is deemed necessary and appropriate. Companies with a demonstrated willingness to invest capital at lower returns than those deemed acceptable by U.S. firms have dominated each of these waves of competition. In fact, for many of these companies, return on investment measures have little influence on investment decisions.

The result of these successive waves is twofold. First, more capital is entering the world marketplace, as the major Asian countries save and invest at a prodigious pace. Second, different corporate objectives across countries, which are facilitated by, and in many cases driven by, contrasting views of the purpose of corporations, have led to an increasing number of strong competitors that place growth and market share goals ahead of returns. In our increasingly global society, when highly competent and efficient firms are willing to invest large amounts of capital at returns that are low by American standards, the simple law of supply and demand means that returns will be under downward pressure throughout the world. In this environment, a competitor whose purpose shackles its willingness to invest and its ability to motivate employees will be at a severe disadvantage.

This is precisely what is happening. Spurred on by national governments, further motivated by the threatened entry of China into key industries, and facilitated by a lesser importance placed on return on investment, companies in many of these countries have captured international market share from American manufacturers by pursuing "substandard" investments. If this trend continues—and there is little to indicate that it will not, with China (and eventually possibly Eastern Europe, Russia, India, Latin America, and others) looming in the background—then the return on manufacturing investments will continue to experience downward pressure.

These declining returns have been accompanied by increasing pressure on American managers from U.S. capital-market institutions. The pressure is for financial performance—usually near-term performance. But in many cases (similar to the past experience in automobiles, machine tools, consumer electronics, and memory chips) higher returns today can only be bought with the declining investment and market shares that erode tomorrow's competitiveness and returns because of decaying product differentiation and waning scale and scope economies.

The strongest manifestation of this capital-market pressure is encompassed in what is euphemistically called "the battle for corporate control." This term in itself indicates the fundamental importance of the stakes. The hostile takeover is the most visible form of this "battle." But it is also being played out more subtly in shareholder activism, particularly in the efforts of some large public-sector pension funds to have a greater influence over management decisions.

Purpose and Competitive Change

Although often unrecognized, a common element influences the effect each of these five forces has on the competitiveness of individual corporations. It is corporate purpose. The choice of purpose deeply affects a company's response to these competitive forces and determines the degree strategies and goals diverge from those of rivals driven by different purposes. The increasing significance of both capital and knowledge to competitiveness highlights the importance of corporate purpose. Purpose will determine whether and to what degree returns on capital will be subordinated to actions designed to better serve customers and consequently to achieve greater competitiveness. Furthermore, purpose can be a stimulus to commitment and a source of motivation for employees, causing them to work harder and smarter and more creatively. Since employees possess the knowledge-based core competence of most firms, the competitive benefits are obvious. A corporate purpose that embodies ends that employees consider worthwhile—a purpose that infuses an organization with the belief that the aim of its product or service (and thus of the employees' work) is to satisfy valued human needs—has the power to bring greater meaning to employees' work and thus to their lives. It is a simple fact that few people find personal meaning in enhancing the wealth of usually remote, faceless, ever-changing shareholders. However, other ends, such as directly serving human needs—particularly the needs of customers and fellow employees—can be related tangibly to individual effort at all organizational levels.

The Future Purpose of American Corporations

Despite the vast economic and social changes of the last quarter century, most Americans continue to view the marketplace, and our corporations' role in it, in much the same way as we did in the 1950s and 1960s. But the world has fundamentally changed, and so must our response to it.

We stand at a moment in history poised to make a fundamental shift in our thinking about corporate purpose. The "constellation of beliefs, values and techniques" shared by managers and the public at large is in a state of change.[15] Our traditional explanations of strategy and competitive behavior are proving inadequate. Discontent and dissatisfaction with the current state of affairs is widespread. Opinions and actions in response to this state are becoming polarized. This discontent and polarization, coupled with the evolving competitive forces, provide the ferment for change. At the core of the changing paradigm is a new emerging purpose for American companies.

Although global competitive pressures have intensified the need for a changing view of corporate purpose in American companies, the reality is that a customer-focused purpose also leads to outstanding performance for companies facing primarily domestic competition. As we shall see in subsequent chapters, such a purpose provides (1) the product-market focus essential to the formulation of more competitive strategies; (2) a constellation of goals reflecting key measures of marketplace performance that differ significantly from the capital-market–focused goals flowing from a purpose of maximizing shareholder wealth; (3) an increased willingness to deploy capital; and (4) ends that bring greater meaning to the work of organizational members, that act to merge their narrowly defined self-interests with corporate ends, and that enhance their abilities to create knowledge. It also enables leaders to manage by granting greater autonomy to subunits and with less restrictive management control systems. People can more readily be entrusted to do what they believe is right when a clear shared purpose and the strategy, goals, and policies into which the purpose is translated guide them. The result is the unleashing of human creativity and initiative—and the new knowledge that these forces are capable of developing—in the service of common purpose.

Failure to adapt to these realities of tomorrow's competition will extract heavy penalties. Those enterprises with leaders who recognize and act in anticipation of these changes will achieve a competitive edge over those that do not. History has shown that those companies that anticipated major social change at the beginning of the significant social movements of our day—be they civil rights, women's rights, environmental protection, or product safety—have generally fared much better than those who have been reluctantly dragged into accepting the legitimacy of these movements. The same will be true for the purposes driving competitors in the global marketplace of tomorrow. The victors will be those companies that proactively clearly define and consistently reinforce an ultimate purpose that promotes more competitive strategies and embodies values their members share.

A number of outstanding American companies have shown the way. Among their number are Hewlett-Packard, Johnson & Johnson, and Wal-Mart. Each of these industry leaders has a corporate purpose that focuses on serving customers' needs coupled with a commitment to create an environment of personal growth and development for the people who make up the company. These ends combine to create highly effective organizations with outstanding long-term competitive and financial performance.

Conclusion

The formulation and defense of corporate purpose is a central function of leadership. The "visible hand" of management[16] must harmonize the self-interests of employees, customers, and society so that they reinforce one another. Under a shareholder-focused purpose, all too often these interests conflict, dissipating energy into the friction of adversarial relationships. The leader is responsible for defining a purpose that has a significant positive effect on corporate performance, on employees, on the satisfaction of human needs, and thus on society. Considerable power is unleashed when the purpose of corporate activity is in harmony with the higher aspirations of employees. When corporate purpose unites these higher aspirations with collective organizational efforts, it takes on a moral quality and becomes a force that enables individuals to achieve their own higher purposes. The human spirit is lifted and human potential expanded. When this occurs, individuals exhibit intense loyalty and commitment to the source of this meaning—the company.