The Nonmarket Strategy System

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FOR MANAGERS, THE CHALLENGE OF UNDERSTANDING NONMARKET FORCES — GOVERNMENT, INTEREST GROUPS, ACTIVISTS, AND THE PUBLIC — IS FREQUENTLY more difficult than understanding the market environment. The author develops a strategy system of principles, frameworks, and action plans to deal with the issues, institutions, interests, and information that characterize the nonmarket environment. He uses the concept of a rent chain, analogous to the value chain, to show how companies can participate in policy-setting processes and generate leverage to their own benefit.

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Why do some well-formulated competitive strategies run into roadblocks or end up being stalled by government inaction? Why do some strategies produce unintended consequences inconsistent with a company's core values? Why are strategies sometimes criticized by the public and threatened by government action? The causes of these problems are frequently found not in a company's market environment but instead in forces outside its markets. Indeed, for many companies, market success depends not just on their products and services, the efficiency of their operations, their internal organization, and the organization of their supply chains, distribution channels, and alliance networks. Success also depends on how effectively they deal with governments, interest groups, activists, and the public. The forces these parties generate can foreclose entry into new markets, limit price increases, and raise the costs of competing. They can also unlock markets, reduce regulation, handicap rivals, and generate competitive advantage.

These forces are manifested outside of markets but often work in conjunction with them; I refer to them as nonmarket forces. The nonmarket environment consists of the social, political, and legal arrangements that structure interactions among companies and their public. For many companies, nonmarket forces have a major impact on performance; hence these forces warrant the same high level of attention in business strategy as do market forces. A business strategy must help a company navigate in both its market and nonmarket environments and is composed of a market or competitive component and a nonmarket or public component. Managers may understand the market environment relatively well but often see the nonmarket environment as posing different, often more difficult, challenges.

To address nonmarket forces effectively, managers must formulate specific strategies to deal with them. Nonmarket forces and the institutional arenas in which they are manifested are sufficiently different from market forces that they require a nonmarket strategy system for effectively managing interactions with the nonmarket environment. That system, a component of a larger strategy system, consists of a process to structure analysis and strategy formulation, theories and conceptual frameworks to guide that formulation, and issue-specific strategies and action plans. The product of the system is a nonmarket strategy tailored to the company's market and nonmarket environments and integrated with its competitive strategy, core values, and distinctive competencies.[1]

In this paper, I characterize the nonmarket strategy system by identifying a process for management in the nonmarket environment, an approach for moving from guiding principles and conceptual frameworks to action plans in the context of that process, and specific theories and frameworks for managing in the nonmarket environment. Instead of presenting a catalog of theories and frameworks, I use one framework — a rent chain — and the underlying theoretical construct — distributive politics — as an illustration. First, however, I identify a number of differences between the nonmarket and market environments to indicate why nonmarket analysis and strategy formulation warrant a specific approach and careful attention.

The Market and Nonmarket Environments

The nonmarket environment differs from the market environment in a number of ways:

• Markets are an institution through which economic exchange is organized in a system of property rights governed by a unanimity rule. The nonmarket environment includes public institutions, which are characterized by majority rule, due process, broad enfranchisement, collective action, and publicness, i.e., actions are typically in full view of the public.

• In markets, those enfranchised are the participants in economic exchange. In contrast, those enfranchised in the nonmarket environment generally include not only market participants but also government officials, interest groups, activists, the media, and the public. These parties often set a firm's nonmarket agenda.

• Actions in markets are voluntary and produce private benefits. In contrast, actions in the nonmarket environment typically provide public benefits that affect a broader group of parties. For example, congressional legislation affects not only those who lobbied but all to whom the legislation pertains. This means that the free-rider problem is more prevalent in the nonmarket environment than in the market environment.[2]

• In market competition, resource commitment is often the key factor in determining outcomes. In nonmarket competition, votes are often the key factor, but they do not reflect the intensity of preferences the way the commitment of private resources does. That is, where dollars count in the market environment, numbers of constituents (voters) count in the nonmarket environment.

• Some actions prohibited in the market environment are allowed in the nonmarket environment. Collusion among firms in an industry is generally illegal, whereas collusion or cooperation among firms is generally permitted in governmental arenas. For example, trade associations cannot coordinate their members' market activities, but they can coordinate the lobbying by their members on a bill before Congress.[3]

• Performance in the market environment is evaluated in terms of profits generated or value created, whereas those in the nonmarket environment who evaluate company performance use broader dimensions that include ethical principles and concepts of responsibility.

These differences imply that the theories and conceptual frameworks for assessing the market environment and analyzing and formulating strategies must be supplemented with approaches that explicitly take these differences into account.

The market environment is characterized by the number of industry rivals, the ease of entry and exit, cost structures, the nature and rate of technological progress, the nature of demand and dimensions of competition, and the rules of market competition, including antitrust law and regulation.[4] Market analysis focuses on industry structure and performance, distinctive capabilities and competencies, and market segments. The foundations for competitive strategy are provided by the discipline of economics as applied in competitive analysis. The step from analysis to strategy involves, for example, assessing the ability of a company to deal with Porter's five forces, and strategy formulation focuses on selecting generic competitive strategies and choosing specific courses of action.[5]

The nonmarket environment is quite different. It can be characterized in terms of issues, institutions, interests,

> A critical factor in formulating effective nonmarket strategies is viewing the nonmarket environment as endogenous both to market forces, such as technological change, and to the nonmarket activities of firms and other interests.

and information. For example, in telecommunications policy, a specific *issue* is the bill introduced in Congress to allow the Regional Bell Operating Companies (RBOCs) to produce telecommunications equipment by overturning a portion of the Modified Final Judgment (MFJ) that settled the federal antitrust suit against AT&T. The Federal Communications Commission, congressional authorization committees, state regulatory commissions, and the federal courts are the cognizant *institutions* for telecommunications issues.

Interests are individuals and groups with preferences for or a stake in a particular issue.[6] In the case of telecommunications, interests include telecommunications companies, cable TV companies, media organizations, and equipment manufacturers. Consumer, labor, and activist groups are also involved. Interests can be aligned or opposed on an issue. The equipment manufacturing bill was supported by the RBOCs and opposed by AT&T and media organizations.

Information is what interested parties know about the relationship between actions and consequences and about the preferences and capabilities of the interested parties. A nonmarket strategy then is the concerted action of an interested party directed at a nonmarket issue that is a subject of competition in the cognizant institutions where information typically plays an important role.

To identify the counterparts to competitive analysis and strategy, consider the issue of telecommunications policy reform. The counterpart to competitive analysis is the analysis of interests, the potential benefits from taking political action such as lobbying and grassroots activities, the costs of taking political action, and the effectiveness of alternative actions. The actions of these interests compete in the institutional arena of Congress, with members of Congress as their focus. The principal disciplinary foundation for this analysis is political economy, and the relevant theory is distributive politics.

The theory of distributive politics is based on a structured pluralism perspective in which interests are recognized as diverse and competing for benefits in the context of institutional arenas. The focus of analysis thus is on the distributive incentives for political action, the costs of collective action, and the constituent connection that links interests to the reelection concerns of members of Congress.[7] In its simplest form, the analysis focuses on the amount of pressure interests are able to bring to bear on members of Congress, and the outcome of an issue depends on the pressure generated by the interests and on the structure and procedures of Congress.[8]

Analysis of the competition over telecommunications policy draws on components of the theory of distributive politics. Those components include the median voter theorem, social choice theory, the theory of rational ignorance, the iron triangle and capture theories of bureaucracy and regulation, strategic trade theory, including protectionist and market opening strategies, the theory of collective action, and the theory of lobbying.[9] The analogs of generic competitive strategies are basic strategies for addressing specific nonmarket issues in the context of particular institutions. The step from analysis to strategy focuses on the choice of actions given the anticipated actions of other interests. That is, the analysis that provides a basis for formulating nonmarket strategies is specific to the issue, the institutional arenas in which it is addressed, the interests likely to be active on the issue, and the information that the interests and the institutional officeholders have about the relationship between actions and outcomes. I illustrate this with examples and elaborate on the framework of distributive politics through a discussion of the rent chain. I also consider the effectiveness of nonmarket strategies in the context of the rent chain.

A critical factor in formulating effective nonmarket strategies is viewing the nonmarket environment as endogenous both to market forces, such as technological change, and to the nonmarket activities of firms and other interests. Competitive analysis typically takes the rules of the game — the regulatory system, for example — as given, whereas the nonmarket strategy perspective views these rules as endogenous and hence the focus of strategy. Robert Galvin, head of Motorola for more than three decades, addressed the use of nonmarket strategies in shaping Motorola's market environment as "writing the rules of the game."

> *The first step in any defined strategy is writing the rules of the game honorably and fairly in a manner that gives everyone a chance with predictable rules. Our company has started industries. We have helped write standards. We have helped write trade rules. We have helped influence policies. We have helped write national laws of countries where we have engaged, always in a respectful way. We have never taken for granted that the rules of the game would just evolve in a fashion that would make for the greatest opportunity. We have incidentally found that in many quarters of the world, our offer to constructively define the rules is reasonably welcomed. With the right rules of the game, one's opportunity for success is enhanced.*[10]

Galvin's point is not that companies dictate the rules of the game but rather that those rules are shaped by the strategies of interested parties and by the governing institutions. Companies such as Motorola and leaders such as Galvin attempt to shape the rules, just as other interested parties do.

Nonmarket Analysis and Strategy Formulation

Nonmarket strategies result from a management process that incorporates knowledge of the market and nonmarket environments, information about specific issues, and conceptual frameworks that guide strategy formulation and implementation. I now discuss a process for addressing nonmarket issues using the example of Levi Strauss & Co., which, in response to changes in its market strategy, faced an inconsistency between its fundamental ethical principles and its relationships with foreign suppliers.

Levi Strauss and Global Sourcing Guidelines

Levi Strauss, a privately owned firm, has integrated the core values of the Haas family into its internal policies and earned a reputation for adherence to ethical principles and concern for its stakeholders. In the 1980s, the company made two important changes in its business strategy. It broadened its product lines, particularly into casual wear, and expanded internationally in both its markets and sourcing. The expansion of its markets and product lines, sales growth in the United States, and pressures for low-cost sources of supply resulted in rapid expansion in the number of offshore suppliers. Levi Strauss quickly found that its garments were no longer coming primarily from its own facilities but from more than 700 foreign suppliers.

Levi Strauss's market strategy of expanding its markets and sourcing globally had generated some complex nonmarket issues. Its problem was how to bring its supplier relationships into congruence with its ethical principles and operating standards. The company was concerned that its suppliers did not meet the standards of its own production facilities. In addition, Levi Strauss worried about possible damage to its brand name from conditions in its suppliers' facilities relating to child labor, prison labor, plant safety, and environmental protection. The company also had concerns about human rights in the countries where its suppliers were located.

A nonmarket strategy is the outcome of a three-stage process: screening, analysis, and choice.

Levi Strauss formed a task force to develop two policies for its global sourcing. "Terms of Engagement" for suppliers focuses on working conditions in suppliers' facilities and covers safety, working hours, discrimination, child labor, dormitories, and environmental protection. "Guidelines for Country Selection" focuses on human rights concerns, political stability, safety of company employees, and legal protection for trademarks and commercial interests.

These two nonmarket policies have affected the company's market strategy in various ways:

• The company has terminated its arrangements with suppliers in Burma because of widespread human rights violations. Also due to human rights concerns, it has decided to withdraw from China over a period of several years. Not only did the decision on China eliminate a low-cost, high-quality source of supply, but it also precluded Levi Strauss from entering China through direct investments in owned facilities.

• Audit teams now visit each supplier annually to assess its facilities' conditions. When they find deficiencies, they tell the contractors to correct them. In the first audits, conducted in 1993, 70 percent of the contractors were in compliance, 25 percent needed improvements, and 5 percent chose to no longer supply Levi Strauss.

• The company has struggled with additional issues, such as how far down the supply chain its policies should extend and how to deal with the effluents from the many small laundries that wash finished goods.

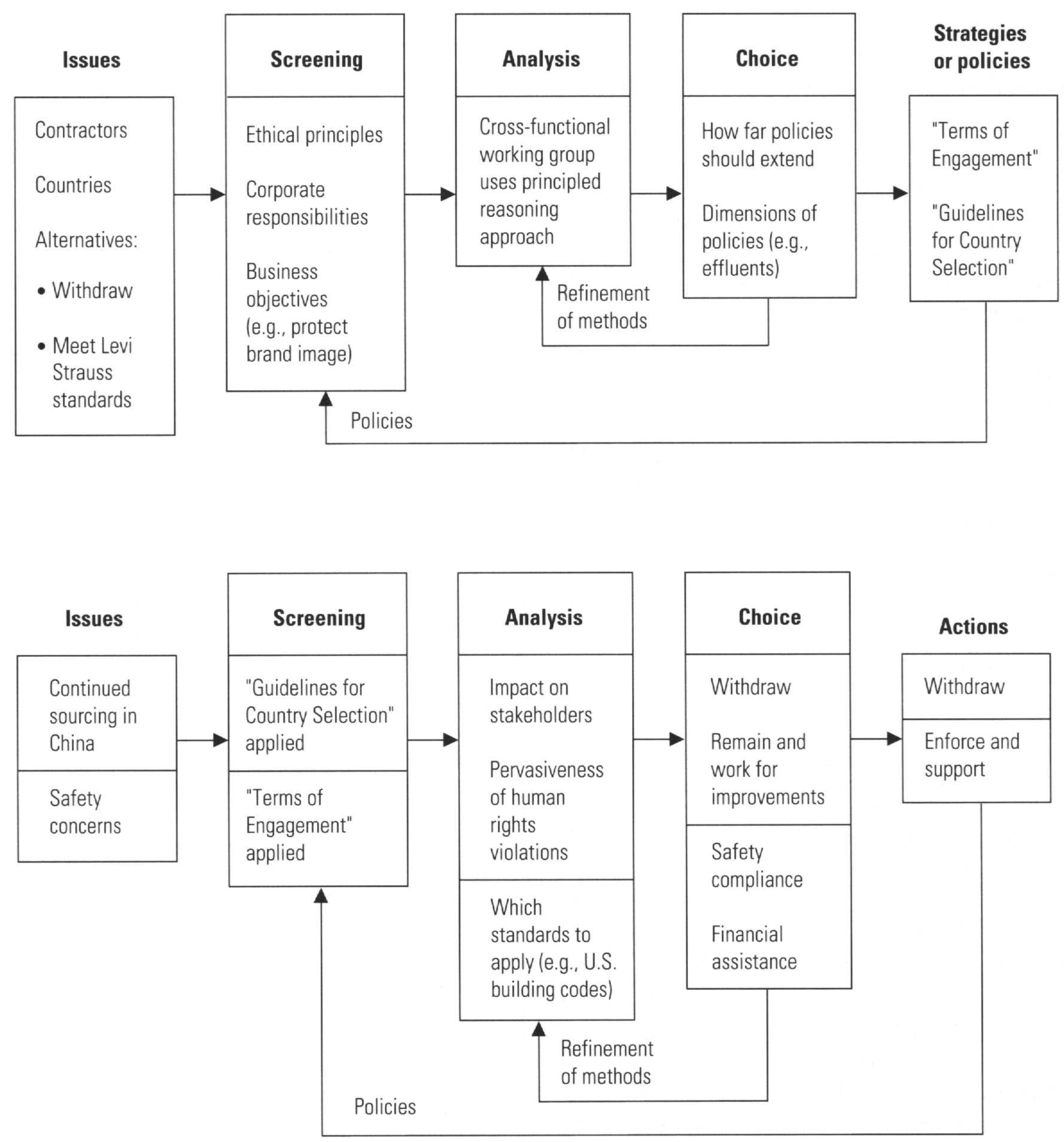
In this example, a market strategy generated nonmarket issues that required an integrated response in the form of policies to bring suppliers' facilities into compliance with the firm's core ethical principles and to replace discontinued suppliers. The result was a nonmarket strategy that brought Levi Strauss's market strategy into congruence with its core ethical principles. Implementation of this strategy means higher costs and some inevitable deterioration in competitiveness. For some Levi Strauss executives, the higher costs are simply the price of abiding by its ethical principles. For others, the costs are the price of protecting its brand name from adverse publicity about its suppliers' practices.

Strategy Formulation and Implementation

A nonmarket strategy is the outcome of a three-stage process: screening, analysis, and choice (see Figure 1). This process yields specific strategies — concerted actions that identified individuals or units are to take — and policies that guide managers in addressing market and nonmarket issues. The policies can be rules to follow or principles to help managers reason about which actions to take in particular situations.

In this three-stage process, managers first use policies such as the "Terms of Engagement" to screen out strategy alternatives and actions inconsistent with the policies and hence the company's business strategy. Next, managers analyze the remaining alternatives to predict their likely consequences, taking into account the anticipated strategies and actions of other parties and the interests of the cognizant institutional officeholders. Finally, managers can evaluate the consequences in terms of the company's objectives and fundamental principles. The result is a strategy for addressing a specific issue in the market or nonmarket environments and policies that managers can use in the screening stage to address issues as they

Figure 1 Levi Strauss & Co.'s Global Sourcing Guidelines



arise. This process also provides opportunities to refine the methods used in evaluating strategy alternatives.

In developing its policies, Levi Strauss addressed issues pertaining to contractors and countries and considered alternatives ranging from complete withdrawal to requiring contractors to meet U.S. building codes (see the top section of Figure 1). At the screening stage, the company applied fundamental ethical principles in addition to its business objectives. At the analysis stage, it applied its "principled reasoning approach," which took into account stakeholder interests. At the third stage, the company formulated recommendations and chose among alternatives. The choices involved decisions about how broad policies should be: Should they cover effluents from laundries? Should the policies extend to fabric producers or only to cutting and sewing operations? The process resulted in the two policies I described above.

Once Levi Strauss had developed its policies, it dealt with two specific issues: (1) whether to continue to source in China and (2) how to address safety issues in suppliers' factories (see the bottom section of Figure 1). The screening stage involved ruling out alternatives inconsistent with the two policies. Analysis centered on the impact of alternatives on stakeholders as well as on specific concerns, such as the pervasiveness of the human rights violations and the application of U.S. building codes. The company then chose between withdrawal and constructive engagement in China and which safety improvements to require in the factories. It specifically decided to withdraw from China over several years and support contractors in improving safety in their factories.

The Nonmarket Strategy System

A process for addressing nonmarket issues, exemplified by the Levi Strauss case, is part of a broader set of approaches that constitute the nonmarket strategy system. That system is composed of a company's approaches and actions in interacting with its nonmarket environment. The system can be visualized as a pyramid with conceptual frameworks at the peak and issue-specific action plans at the bottom (see Figure 2).[11]

Conceptual frameworks help managers reason about the environment, the company's organization, and the relationship between actions and outcomes. They represent core competencies and form the basis for both market and nonmarket analysis and strategy formulation. They include processes and analysis techniques, such as the competitive analysis of industries, political analysis, and the principled reasoning approach Levi Strauss uses.[12]

Conceptual frameworks provide principles that guide analysis and strategy formulation. Lobbying, as the provision of information of two generic types — constituency and technical — is an example of a conceptual principle. Constituency information pertains to the consequences that policy alternatives have for public officeholders' constituents. Technical information pertains to the relationship between alternatives and consequences. Effective lobbying then focuses on providing constituency and technical information that identifies the linkages between a company's interests and legislators' and other public officeholders' interests.

The second level, a company's core strategies, includes its mission and core values, approaches to dealing with government (e.g., forthrightness), reputation building and maintenance, and specific objectives. The core strategies include the company's market strategy, which identifies its lines of business, its markets, and its organizational structure. These core strategies also include nonmarket strategies such as forthrightness and openness to the public and government, adherence to normative principles, and acceptance of responsibilities. Levi Strauss's "Terms of Engagement" and "Guidelines for Country Selection" were guided by core strategies embedded in the processes the company employs in formulating policies.

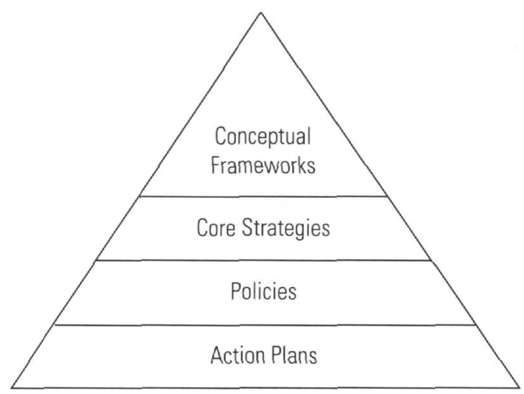
The next level consists of the policies, such as the "Terms of Engagement," that guide the company's managers in their delegated activities. These policies are one product of the strategy process I discussed earlier; they coordinate and direct delegated actions in accordance with the company's core nonmarket strategies and objectives. Examples of policies are strict compliance with environmental laws, an aggressive affirmative action policy, pollution reduction, responsible political participation, and support for free trade. Managers apply these policies in the screening stage of the nonmarket strategy process.

The final level of the pyramid consists of specific implementation or action plans for addressing nonmarket issues. A nonmarket strategy may be implemented, for example, through lobbying by company executives or helping suppliers improve the safety of their factories.

Merck and Pharmaceutical Price Controls

The nonmarket strategy of Merck & Co., Inc., in the early 1990s helps to illustrate the layers of the strategy pyramid. Merck's principal conceptual framework is sound public policy for the long run, e.g., a pricing policy that focuses on the trade-off between public preference for lower drug prices today and the understanding that higher prices provide incentives and investment funds for R&D for new pharmaceuticals. Furthermore, the company understands that drugs are cost-effective treatments, particularly when they substitute for hospitalization. Roy Vagelos, chairman and CEO of Merck, noted, "If cost-effectiveness were the final arbiter of pricing decisions, most pharmaceutical prices could justifiably be much higher than they are."[13] Vagelos and Merck understand, however, that

Figure 2 The Nonmarket Strategy Pyramid



such realities are not determinative in a nonmarket environment filled with interest groups and with a government running a large budget deficit.

Merck's core strategies include, on the market side, heavy investment in developing new drugs and, on the nonmarket side, development and maintenance of public confidence. Another core nonmarket strategy is locating facilities in particular countries to increase its bargaining position on pharmaceutical prices. In most countries, drug prices are regulated, so Merck must address the price control issue in virtually every country in which it markets. Indeed, Merck chose to locate research facilities in Japan and establish a joint venture in Brazil partly to provide access to the regulatory and price-setting systems in those countries. Those choices represent issue-specific implementation plans.

> The rent chain is a framework for formulating strategies to address distributive politics issues.

Another core nonmarket strategy is Merck's policy of moderating price increases by pledging publicly that prices of existing drugs will not increase by more than the rate of inflation on a weighted average basis. Merck announced this policy in 1990 in the midst of congressional discussion of legislation to reduce government expenditures for drugs. More specifically, Merck "announced a goal of keeping future price increases within the rate of inflation in the United States and of generally limiting price actions to one per year, given stable market conditions and government policies that are supportive of innovation."[14]

An example of a policy was Merck's pledge to discount drugs in exchange for formulary approval, i.e., a trade-off between price moderation and the drug's availability in hospitals and clinics. Pharmaceutical firms offer price discounts to large purchasers but not to Medicaid programs, even though Medicaid accounts for about 10 percent of pharmaceutical sales. Under its Equal Access to Medicines program, Merck offered state Medicaid programs the same discounts it gave the Veterans Administration. In exchange, Merck sought broadened eligibility (Medicaid formulary approval) of its drugs for use in those programs. The Merck offer was partly a response to the nonmarket pressures on pharmaceutical companies and partly an effort to forestall pending legislation. As a result of Merck's action and imminent congressional consideration of legislation, the Pharmaceutical Manufacturers Association adopted a contrary policy opposing "proposals to tie the availability of prescription drugs to the willingness or ability of companies to grant discounts or rebates."[15]

As part of the deficit reduction effort, the Omnibus Budget Reconciliation Act of 1990 contained Medicaid Prudent Pharmaceutical Purchasing provisions that took effect in 1991. The provisions required pharmaceutical firms to give state Medicaid programs the lowest price offered elsewhere.[16] The legislation also ordered state Medicaid programs to make a broader selection of drugs available, the "equal access" policy that Merck had sought. Merck had played an important role in setting the legislative agenda and shaping the environment of the pharmaceutical industry.

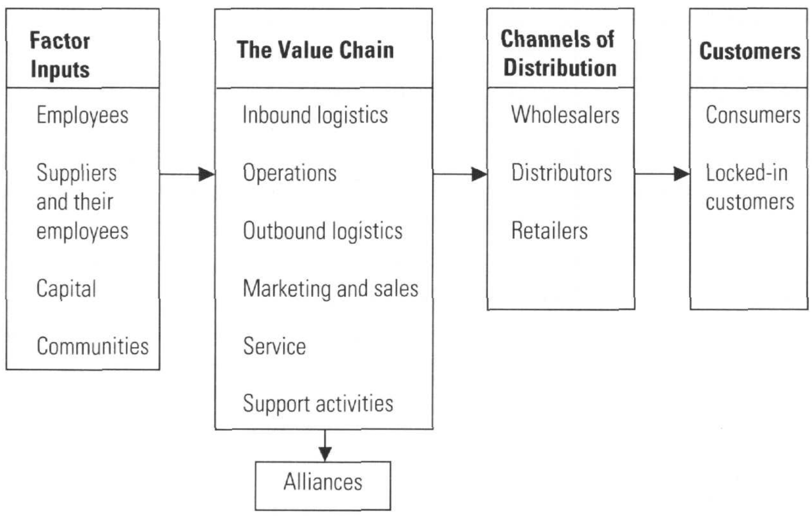
An example of a specific action plan was the negotiation on discounts and formulary approval with California's Medicaid program (Medi-Cal). California sought discounts beyond those given to Medicaid programs. The state ultimately enacted legislation, effective in 1993, that requires a 10 percent discount on all drugs purchased under Medi-Cal, in addition to the mandatory 20 percent federal discount.

The Rent Chain

Porter's value chain is a conceptual framework that identifies the stages of a firm's operations that create value for its owners.[17] Since nonmarket strategies, like market strategies, are also directed at creating value, there is an analogous concept for nonmarket strategies that I refer to as the rent chain. It is a framework for formulating strategies to address distributive politics issues. It identifies the incentives and basis for influence in the nonmarket environment. It also provides a basis for generating coverage of legislative districts to build a decisive coalition in majority-rule institutions.

A rent is a surplus, and the rent chain's significance stems from incentives to protect and increase rents. For a company, a rent differs from a profit because of sunk costs. The R&D costs of a new drug are deducted from revenue in computing profits, but once those costs are sunk, rents exceed profits by the amount of the sunk costs. Rents also are earned by factors of production, which, from the company's perspective, are not counted in its value chain. A company's employees earn a rent if their wages and benefits are higher than what they could earn in alternative employment. When jobs are threatened by a nonmarket alternative, employees thus have an incentive to protect their rents. For example, in 1994,

Figure 3 The Rent Chain



telecommunications reform legislation died in the Senate because the Communications Workers of America sought provisions to expand its members' job opportunities by allowing the RBOCs to provide long-distance service. Labor unions also are strong supporters of protectionist measures when their members' jobs are threatened by imports. Suppliers, distributors, retailers, and customers can also earn rents, which motivate them to take nonmarket action. Importers of foreign goods, for example, typically oppose protectionist measures.

A rent chain can be extended through alliances. To the extent that alliance partners derive rents from their participation with a company, their interests will be aligned with the company's. Conversely, when a company enters an alliance with a rival, the rival may no longer be an opponent in the nonmarket environment. Because rents are earned by the factors of production, in supply and distribution channels, by customers, and by alliance partners, the rent chain is larger than the value chain (see Figure 3).

The outcome of many nonmarket issues is ultimately determined by the distribution of costs and benefits that flow from the alternatives addressed by public institutions. The basic principle of distributive politics is that the greater the rents affected by a nonmarket issue, the greater the incentives to act to protect or increase those rents. The basic principle of the rent chain is that a company can increase the aggregate amount of action and extend the coverage of legislative districts by enlisting the participation of those earning rents. The relationship between policy alternatives and those rents is then the link to strategy. In the case of issues addressed in legislative institutions where the constituency connection is important, success requires a majority to enact legislation or a blocking coalition to preserve the status quo.[18] The likelihood of success on such issues is increasing the amount of political action and the number of legislative districts in which actions originate. The rent chain framework is intended to increase the effectiveness of a company's strategy by focusing on both these dimensions. The framework is also a basis for organizing a concerted effort to affect the outcome of a nonmarket issue.

Building the needed majority for an alternative depends on congressional members' preferences; in their simplest form, those preferences reflect constituents' interests as well as personal policy interests. The key to success on a distributive politics issue is thus to show a majority of legislators that the alternative benefits their constituents and/or serves their policy interests. An affected constituent's personal statement is the most effective demonstration; the next best is evidence that the alternative the company or other interest prefers will benefit constituents. The former depends on the constituent's benefits and costs of taking political action, such as lobbying and grassroots activities. The latter is effective to the extent that employees, suppliers, and distributors in the rent chain are affected, thus giving the company an opportunity to represent their and its own interests before legislators. Grassroots political strategies are based on these factors; lobbying also draws strength from the effect of alternatives on constituents' rents. A successful strategy thus involves showing a majority of legislators how the company's preferred alternative also helps their constituents or serves their personal policy interests.

In some cases, competition among interests on an issue results in a compromise achieved through bargaining or by making enough changes in the legislation to obtain the votes of pivotal congressional members. Greater coverage of legislative districts increases the bargaining position of supporters and may also influence the preferences of pivotal legislators. Extending the value chain concept to include all those who earn rents through their relationship to the company is the foundation for such a strategy. The effectiveness of actions generated through the rent chain depends on various factors, including number of people affected, magnitude of the consequences of alternatives, and coverage of political jurisdictions.

Brazil's regulation of pharmaceutical prices illustrates how rents provide a basis for nonmarket strategies in the pharmaceutical industry. To influence the price-setting process, some companies have located their operations in Brazil. This creates rents in Brazil, which facilitates the companies' participation in the regulatory process governing pharmaceutical prices. Similarly, a pharmaceutical company may locate R&D facilities in Japan to improve its relationships with distributors, its ability to participate effectively in pharmaceutical approval and price-setting processes, and its interactions with physicians and hospitals.

The rent chain can thus have two types of productivity. First, it can give a company the opportunity to participate in public and consultative processes. Second, it can provide the basis for generating leverage. In a country where government policies control market opportunities, and regulation and administrative directives are pervasive, the productivity of locating part of the rent chain there can be high. Merck chose to locate operations in both Brazil and Japan. In contrast, in a country with open markets and comparable treatment for all companies, the nonmarket productivity of locating part of the rent chain there may be small. In such a case, market considerations are likely to dominate.

These examples pertain to the rent chain's configuration, which frequently centers on the location of facilities, suppliers, and alliance partners. Although the rent chain can be configured to provide varying degrees of nonmarket productivity, doing so may affect its market productivity. Locating research facilities in Japan may be more costly than concentrating research in the United States but may be necessary for effective participation in Japan's administrative and consultative processes. A company thus has to trade off the productivity of rent and value chains on both market and nonmarket dimensions. This trade-off depends on the significance of market and nonmarket forces for performance.

The Rent Chain and Concerted Action

When a company's rents are affected by a nonmarket issue, the rents of other components in the chain may also be affected. A price increase for a component used in production benefits the supplier and harms the purchaser, so their interests are opposed. On many nonmarket issues, however, interests are aligned, as when the nonmarket issue affects demand for a company's products. In this case, the company, its suppliers, and its distributors may all benefit from an increase in volume. Interests are then aligned along the rent chain, and hence there is a potential for concerted action. In this section, I use the concept of the rent chain to assess that potential.

When there is alignment of interests along a company's rent chain, the potential for concerted action is vertical. When Motorola sought entry into the cellular telephone market in Japan, its rent chain from its other operations in that country was a basis for concerted action. In addition, its business partners, which purchase transmission station equipment and hand-sets, had aligned interests and incentives to act in concert with Motorola.

A nonmarket issue can also affect the rents of an industry or sector, and, in that case, the potential for concerted action is horizontal. The telecommunications sector accord between the United States and Japan was intended to open the Japanese equipment market to foreign suppliers, including Motorola, and provided the potential for concerted action through the rent chains of equipment manu-

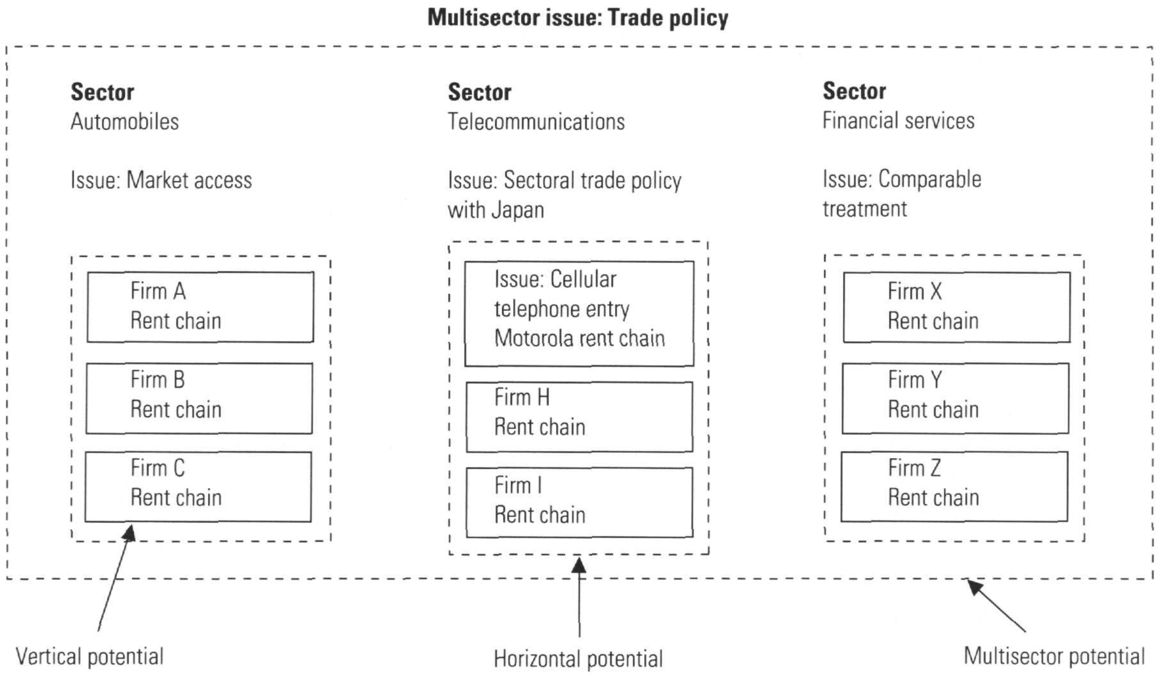
When there is alignment of interests along a company's rent chain, the potential for concerted action is vertical.

facturers. The Clinton administration's attempt to open the Japanese automobile and parts markets to foreign suppliers is another example. A horizontal potential for concerted action thus encompasses components of a set of vertical potentials.

Some nonmarket issues affect more than one industry, and, in that case, the potential for concerted action is multisector. The Clinton administration's effort in 1994 to reach a trade agreement with Japan on specific sectoral import targets for a number of industries, including autos, telecommunications, and financial services, was a multisector issue. Multisector potential for concerted action can encompass the horizontal potential of several sectors, which, in turn, can encompass the vertical potentials arising from the rent chains of the companies in those sectors. These potentials are thus nested (see Figure 4). Which level in this nesting is relevant is determined by the nonmarket issue, as the three trade examples illustrate.

The nonmarket productivity of the rent chain depends on the nature of the issue. When the issue is entry into the cellular telephone market in Japan, the relevant (vertical) rent chain is that of Motorola and its joint venture partner (see Figure 4). If the issue is a telecommunications sector accord with Japan, the relevant (horizontal) rent chains are those of U.S. equipment manufacturers, which include Motorola in cellular equipment, AT&T in switches, and defense contractors in communications

Figure 4 The Potential for Concerted Action



satellites. If the issue is a multisector trade accord with Japan, the relevant (multisector) rent chains are those of all the present and potential exporters in those sectors. Indeed, the U.S. trade negotiation process regularly includes exporters in consultation and policy processes as well as in trade delegations.

Figure 4 focuses on directly aligned interests, but coalitions can also be composed of interests that are seemingly quite different yet work together to the advantage of each. The telecommunications equipment manufacturing bill was opposed not only by AT&T but also by newspapers, cable TV companies, and information services companies, which wanted the legislation to fail because passage might have made other aspects of the MFJ likely targets of legislation. The coalition was able to have greater impact than the sum of its parts because its members acted in parallel, even though they were potential rivals in numerous business areas. Similarly, the RBOCs formed a coalition to overturn the MFJ, even though they recognized that if their efforts were successful, they would soon be competitors.

Some groups have both aligned and conflicting interests, depending on the issue. Semiconductor Industry Association members include both manufacturers of semiconductors and their customers. The members agreed to file a Section 301 petition to open the Japanese market to foreign semiconductors, since it was not harmful to any members and benefited many. The members, however, disagreed on Motorola's proposal for a tariff on semiconductor imports. The interests of semiconductor manufacturers and users were in direct conflict on that proposal.[19]

The nature of the issue also determines how companies address it (see Table 1). Multisector issues are most likely to be addressed by peak associations such as the Chamber of Commerce, the National Association of Manufacturers, and the National Federation of Independent Business (NFIB), and by industry or trade associations, to the extent that the issue has different effects across industries. Often a peak association works for efficiency, as in the support of liberalized trade. Horizontal or industry-level issues are addressed by industry associations as well as individual companies. If an issue has differentiated effects, a company typically pursues competitive advantage. Vertical or single-chain issues often affect a company's competitive position in its industry, and its efforts are then directed at preserving or enhancing competitive advantage. Next I discuss the relationship between the scope of issues and the organization for addressing them in the case of health care reform and the pharmaceutical industry.

Health Care Reform

The Clinton administration's failed attempt to restructure the U.S. health care system and the various congressional alternatives potentially affected a broad set of interests and generated intense group activity. Peak associations such as the NFIB opposed proposals that required universal health insurance coverage for all employees. A number of the proposals included measures affecting the pharmaceutical industry and attacked the industry for high prices and high profits. Although the overreaching nonmarket issue was health care reform, for the pharmaceutical industry, the principal issue became price controls. Various price control alternatives surfaced, ranging from a consultative system similar to Canada's, to mandated discounts for retail pharmacists, to an increased Medicare discount.

To address the price control issue as well as the associated nonmarket forces, the industry's basic nonmarket strategy was to emphasize new drug discovery and the incentives needed for R&D. The industry association focused on the discovery theme and subsequently added "Research" to its name. The Pharmaceutical Research and Manufacturing Association undertook lobbying and public information activities stressing that the discovery of new drugs would be jeopardized by price controls. The industry also sought to mend its relationship with the Clinton administration by supporting other legislation sought by the administration.

In addition, biotechnology firms exerted concerted effort on specific issues, such as a Medicare discount on biotechnology drugs. Several major pharmaceutical companies also formed a coalition, Rx Partners, that conducted media tours in sixty-five cities and, through a political consulting firm, hosted breakfasts for members of Congress.

Individual companies launched public education campaigns similar to those of Rx Partners. Bristol Myers held 350 meetings with community groups and lobbied extensively in Congress. Many companies conducted advertising campaigns about new drug discovery. Companies also hired various well-connected political consultants and lobbyists and stressed the beneficial therapeutic value of existing drugs. Concerned about measures that would increase the Medicare discount and extend discounts to retail pharmacists, several pharmaceutical companies allied with major customers that were already receiving large discounts and feared that a mandated discount would be smaller than what they were currently receiving.

Table 1 Issues and the Organization of Interests

	Peak Organizations	Trade and Industry Associations	Individual Company
Multisector Issues	For Efficiency	For Benefits	
Industry-level Issues		For Benefits	For Advantage
Company Issues			For Advantage

Commitment and Nonmarket Strategy

Ghemawat defines strategy as commitment-intensive choices.[20] He argues that these choices have the greatest potential to determine a company's future opportunities and thus are central to its overall strategic options. In his view, commitment is associated with choices that are not easily reversed, as in the case of investing in fixed assets that are not readily tradable. Most assets, however, have some degree of tradability. Companies can spin off units, sell divisions, close facilities, withdraw from markets, and reduce work forces. These actions may be costly, but they are generally feasible. Commitment-intensive choices thus are measured by how costly they are to reverse.

Nonmarket strategies frequently do not involve as extensive a commitment of fixed and nonfungible assets as do market strategies.

Nonmarket strategies frequently do not involve as extensive a commitment of fixed and nonfungible assets as do market strategies. The closest counterpart to a fixed asset is the firm's reputation for adhering to certain principles. Levi Strauss's "Terms of Engagement" and "Guidelines for Country Selection" are examples of the company's degree of commitment. On one hand, if human rights conditions in China were to improve, Levi Strauss could quickly reverse its decision to withdraw from China, particularly because its withdrawal is occurring in stages. Even if human rights conditions did not improve, a Clinton administration decision to grant permanent Most Favored Nation status to China could lead the company to reconsider its decision. On the other hand, its commitment to safety, health, and working conditions standards seems irreversible, given Levi Strauss's principles and its policies for its own facilities. The company is wrestling with the issue of how to apply its pollution abatement standards to the small laundries that wash finished goods. Extending its policies to laundries, fabric manufacturers, and others in the supply chain would increase its commitment and make reversal costly.

Another way to generate commitment is to institutionalize a policy, thus making it costly to change. Levi Strauss established an internal country review process that uses information from various public sources, such as United Nations and U.S. Department of State publications, along with its own assessments. It also formed audit teams to inspect each supplier's facilities and working conditions and recommend improvements. For Levi Strauss, changing course would require changes not only in policies but also in an institutionalized process.

In contrast, some nonmarket strategies are relatively easy to reverse. An RBOC can abandon a strategy to overturn a provision of the MFJ through the courts and switch to lobbying for a bill to transfer jurisdiction to the Federal Communications Commission. There are, however, ways to establish commitment. One is to state a policy publicly, making reversal costly. Merck, for example, committed publicly to a policy limiting price increases to the inflation rate. Even though this policy was announced as contingent on "government policies that are supportive of innovation," rescinding its policy could generate a substantial political backlash.

Conclusion

For many companies, success in their nonmarket environment is critical for success in their market environment. An effective business strategy thus must have both market and nonmarket components. Companies often see the nonmarket environment as more complex than the market environment partly because market participants are not the only ones enfranchised to participate and also because decisions are made in public institutions. To deal effectively with nonmarket issues, managers need a nonmarket strategy system that brings together knowledge of the environment and the forces that shape it with the company's objectives and competencies. The nonmarket strategy system is composed of conceptual frameworks, core strategies, policies for guiding managers in their delegated decision making, specific action plans, and processes for bringing the components together.

The rent chain is an example of a conceptual framework; it provides a foundation for affecting issues characterized by distributive policies and identifies which issues are addressed at the level of peak organizations, industry associations, and individual companies. The nonmarket strategy system produces strategies and specific action plans for addressing nonmarket issues and guiding a company in both its market and nonmarket environments. Since the market and nonmarket environments are interrelated, the strategies resulting from this system must be integrated with market strategies. ◆

References

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D.P. Baron, "Integrated Strategy: Market and Nonmarket Components," *California Management Review*, Winter 1995, pp. 47-65.
2. The free-rider problem is present when a potential beneficiary from a policy alternative prefers not to work on its behalf because it knows it can free-ride on the efforts of others. See:
M.J. Olson, *The Logic of Collective Action* (Cambridge, Massachusetts: Harvard University Press, 1965).
3. The Noerr-Pennington doctrine protects collective action of a political nature from the antitrust laws.
4. Other important factors in strategic management include organizational design and managerial processes.
5. M.E. Porter, *Competitive Strategy* (New York: Free Press, 1980); and
M.E. Porter, *Competitive Advantage* (New York: Free Press, 1985). See also:
S.M. Oster, *Modern Competitive Analysis*, 2nd ed. (Oxford: Oxford University Press, 1994).
6. Institutional officeholders are best viewed as a part of their institution rather than as interests, even though they may have personal policy preferences.
7. D. Mayhew, *Congress: The Electoral Connection* (New Haven, Connecticut: Yale University Press, 1974);
Olson (1965); and
M.P. Fiorina, *Congress: Keystone of the Washington Establishment*, 2nd ed. (New Haven, Connecticut: Yale University Press, 1989).
8. Baron offers an exposition of this framework and a detailed analysis of the issue of the elimination of tax credits on foreign leases used by Boeing in the sales of commercial aircraft. See:
D.P. Baron, *Business and Its Environment*, 2nd ed. (Englewood Cliffs, New Jersey: Prentice-Hall, forthcoming).
9. See Baron (forthcoming), chapters 5-8.
10. R.W. Galvin. "International Business and the Changing Nature of Global Competition" (Oxford, Ohio: Miami University, speech, October 1992).
For analyses of aspects of this strategy, see:
D.B. Yoffie, "Motorola and Japan" and "Motorola and Japan: Supplements I, II, III" (Boston: Harvard Business School, 0-388-057, 0-388-058, 9-388-059, 1988); and
Baron (forthcoming): 410-411, 492-493, 505-507.
11. The pyramid indicates that there are relatively few conceptual frameworks and relatively more, respectively, nonmarket strategies, policies, and issue-specific action plans.
12. For the treatment of specific conceptual principles, see:
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D.B. Yoffie, "Corporate Strategies for Political Action," in Marcus et al. (1987): 43-60; and

D.B. Yoffie, "How an Industry Builds Political Advantage," *Harvard Business Review*, May-June 1988, pp. 82-89.

13. P.R. Vagelos, "Are Prescription Drug Prices High?," *Science*, 24 May 1991, p. 1083.

14. Ibid. This policy drew praise from the Senate Special Committee on Aging, "The Drug Manufacturing Industry: A Prescription for Profits" (Washington, D.C., U.S. Senate, Staff Report, 1991), p. 15. In 1993, when the Clinton administration stepped up criticism of pharmaceutical prices and profits, Merck offered a new plan to limit price increases.

15. *New York Times*, 22 May 1990.

16. The Congressional Budget Office estimated that the extension of discounts to the Medicaid programs would reduce expenditures by $3.3 billion over five years.

17. Porter (1980).

18. A majority is always sufficient to defeat a bill, but enactment can require more than a majority, as in the case of overcoming a filibuster in the U.S. Senate or achieving a qualified majority in the Council of Ministers in the European Union.

19. Yoffie (1988).

20. P. Ghemawat, *Commitment: The Dynamic of Strategy* (New York: Free Press, 1991.

Reprint 3717