Social capital, reputation, and tacit knowledge: Use of board of directors to create and sustain a knowledge-based competitive advantage

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Abstract

In this paper we build on the growing body of research on social capital, reputation, and knowledge management to develop testable propositions with respect to a firm's board of directors and their use in creating and sustaining a knowledge-based competitive advantage. A firm's board of directors is a specific and unique group of actors available to knowledge-based firms as embodiments of social capital, providers of reputation, and producers of tacit knowledge. The choice of members of this group is a strategic (because of its inherent idiosyncratic character) choice made by the firm. We argue that a firm's board potentially offers a significant source of social capital that can be leveraged with other strategic and non-strategic assets of the company. In addition, a board's reputation is a strategic knowledge asset, that can be leveraged via social capital for strategic consequences. Finally, firms that have mechanisms to use their board's social capital, and leverage it with their employees' social capital will report better strategic outcomes.

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The role played by knowledge in providing a strategic advantage to firms has been of interest to academics and practitioners alike (Conner & Prahalad, 1996; Grant; 2002; von Krogh & Grand; 2002). In recent years, constructs such as social capital and reputation, where such knowledge may be embedded have aided the development and integration of ideas from other disciplines (such as sociology) into mainstream strategy literature (Adler & Kwon, 2002; Nahapiet & Ghoshal, 1998). We focus our attention on a specific group of actors available to knowledge-based firms as embodiments of social capital, providers of reputation, and producers of tacit knowledge – the firms' choice of their board of directors. This paper provides a brief description of some of the propositions driving a multi-country empirical investigation into the strategic and financial consequences of firms' choice of their board of directors. In this paper, we argue that a firm's board potentially offers a significant source of social capital that can be leveraged with other strategic and non-strategic assets of the company. In addition, board's reputation is a strategic knowledge-asset, that can be leveraged via social capital for strategic consequences. Finally, firms that have mechanisms to use their board's social capital, and leverage it with their employees' social capital will report better strategic outcomes.

Theory Development

Social capital is defined as "the information, trust, and norms of reciprocity inherent in one's social networks" (Woolcock, 1998; 153). Another definition that captures the perspective used in this paper is by Portes (1998: 6): "[T]he ability of actors to secure benefits by virtue of membership in social networks or other social structures."

Social capital is convertible to other kinds of capital, such as economic gain (Bourdieu, 1985; Adler & Kwon, 2002). In addition, "social capital can either be a substitute for or can complement other resources" (Adler & Kwon, 2002). In the general context of strategic management of assets, it can substitute for deficiencies in other capital forms (offering ways around mission-critical competencies by leveraging contacts) and complement other capital forms (offering a differential, and hence strategic, leverage opportunities via unique debts (IOUs) embedded in contacts). Whether social capital acts as a substitute or a complement is likely to be moderated by the degree of specialization in the technical core of the firm. As the technical core of the firm becomes more specialized, the use of social capital changes from a substitute to other kinds of capital to a complement for the technical core's specialization. For instance, a start-up firm's technical knowledge base may be so specialized and esoteric that it may take a well-connected venture capitalist's endorsement ("This technology has promise, trust me") to garner financial and supplier resources to bring the technology to the market. In the specific case of a knowledge-based firm, because of a relatively specialized base of skills at the operational level (e.g. technology dominated), we argue that social capital of the board will serve as a complement to, rather than a substitute for, the firm's other,

specialized assets, by legitimizing its technical core, and its business model for a broader set of resource-rich actors.

Proposition 1. Social capital of board of directors complements other knowledge-based assets of a company in providing unique leveraging opportunities to a knowledge-based firm.

Our assertion that the networks of the board embodies reputation, a critical aspect of social capital, which can lead to the development of external resources and relationships for the technology firm is based on the following axioms about reputation. One, reputation is a positive asset that generates competitively advantageous outcomes not available to entities without this asset – for instance, access to superior resources, access to resources at a lower cost, etc. Two, reputation is a positive asset whose value increases incrementally over time, but can depreciate rapidly via actions by the owner of such reputation or attributed to the owner of such reputation. Three, the owner of reputation has self-interest in preserving it, and will exercise complete due diligence by avoiding associating with projects or avenues that may lower its value. Four, reputation can be transferred by association to a limited extent, such that any perceived association of entities without any reputation with owners of good reputation may lead to increased reputation of former. Five, reputation is relative, and therefore good reputation is relatively scarce.

Based on these assumptions, we argue that firms can use the reputations of individual members of the board to develop a reputed board of directors, which, in turn,

can signal the worth of the company to external stakeholders. Because reputation can be transferred to some extent, and because good reputation has positive outcomes, firms without any reputation may seek directors with good reputation. Because good reputation is relatively scarce, it can be assumed that people with good reputation have several offers from companies to join their board of directors. In this scenario, the decision to join a specific board or boards, as opposed to others, is taken deliberately (assumptions two and three above). Thus the decision to join boards of specific companies sends signal to external stakeholders about the internal worth of these companies.

In the context of reputation, the degree of asymmetry between reputation of two parties matters to both parties. Reputations of individual members of the board may transfer to the firm by association, leading to a higher reputation of the firm. Since the firm attracts more reputed members to the board, their presence signals to other stakeholders an approval of business practices and technological strengths of the firm. These stakeholders believe that since reputed members would not be associated with firms that may in fact lower the members' reputation, their association signals that they know more about the firm than other players. This in turn leads other stakeholders to raise their estimate of value of firm's relatively hard-to-value knowledge assets, thereby raising the firm's reputation. The more unknown the firm in the contexts where reputation lowers costs of doing business and enhances revenue opportunities, the greater the benefits to the firm of having a more reputed board of directors. Formally,

Proposition 2a. The more unknown (without reputation) the firm, the more it is willing to pay for the social capital of its board of directors.

Proposition 2b. The more unknown (without reputation) the firm, the more it can benefit from the social capital of its board of directors.

The benefits of a board's social capital are higher to a firm using a higher level of knowledge assets. In other words, the level of knowledge assets deployed, and their importance in the strategic consequences for the firm, moderate the importance of the board's social capital. This is because (as is well documented in extant literature, e.g. Teece, 2000: pp 20-22)) in the context of high knowledge assets, the cost of building contractual safeguards is extremely high, due to inefficient markets in trading of knowledge (leading to exposure to opportunism risks of various kinds). The social capital of the board however can help identify partners and parties that can be trusted without extensive contractual safeguards. Since these partners value their membership in the network, and derive benefits from it, they have incentive to comply with the uncertain terms of trade rather than risk being shut out of the network by cheating.

Proposition 3. The higher the level of knowledge assets the firm deploys, the more it can benefit from the social capital of its board of directors.

Tacit knowledge, social capital, and strategy. Tacit and private knowledge provides a more sustainable basis for designing a strategy than explicit and public

knowledge (Zack, 2002; Nahapiet & Ghoshal, 2002). Social capital networks that have stronger rules for membership, and that create significant tacit and private knowledge, are more valuable than networks that are relatively open, and produce knowledge that is public and explicit. Networks that are able to monitor and police their members are better than networks that have no mechanisms to ensure compliance with network's expectations. The latter generate more free-riding, and as a result, reduce incentives to produce for everybody. Networks with better reputation have incentives to monitor and police their members. Our assertion is that as people become part of more exclusive and desirable networks, they themselves become more exclusive, surrounding themselves with buffer resources (staff as well as relative "reclusiveness") to avoid being solicited for more social capital ("friendship") offers.

Knowledge based companies can, of course, also rely on their employees to sustain membership (and the associated rewards) of being in an organizational knowledge network. They can utilize the social capital of their knowledge workers to draw on the resources of such a network, even actively supporting social capital maintenance activities (such as employee socials, parties, and retreats). A firm's employees at different levels offer a collection of social capital for the firm in a variety of domains. For instance, a high-tech firm's engineers may have a network of connections in the technology field, built over the years via similarity in education, aspirations, careers, and socialization via institutional (such as industry and alumni associations) and non-institutional (such as friendships based on similarity of interests and values) mechanisms. Two factors impede employees from becoming a significant source of social capital. One, the opportunity cost of the time of a firm's employees (time can be spent either

inside the firm, or outside the firm in maintaining and repairing social capital) means that employees' social network is likely to be functionally narrower, and penetrable with relative ease (and hence strategically less valuable). Two, employees are more invested in the hierarchical relationship with the firm, which are characterized by obedience to authority (implying asymmetrical exchange) and explicit terms of exchange. On the other hand, development of social capital requires exchange of one-of-a-kind favors and gifts in a symmetrical exchange, where terms of exchange are tacit (Adler & Kwon, 2002). However, Woolcock (1998) points to the dangers of having such an internal-focused social capital. Focus on such high internal linkages, without any extensive external linkages "will create a situation where internal solidarity is likely to be detrimental to the actors' integration into the broader whole," leading to "Not Invented Here" (NIH) syndrome and "fragmentation of the whole," (Adler & Kwon, 2002: 32). Customization of favors, and a symmetrical and tacit exchange are the conditions required for production of private and tacit knowledge – the knowledge that is strategically useful. Since the board of directors is not encumbered with an employment relationship with the firm, we assert that the networks of board of directors of a technology based, and more generally knowledge based firms offers a unique, and strategically valuable social capital. Firms that are able to deploy it better may fare better in a strategic sense. First, firms typically have a wide pool of people with a diverse set of skills who could serve on the board – however, because the firm is looking for a significant network to tap into that does not overlap its current network, very few people actually qualify (hence there is an implicit strong membership requirement). Second, because of the advantages conferred on the firm due to their association with the firm,

board members of good quality are in high demand, and short supply – they have incentive to be discreet. This may enable the firm to have access to social networks that confer unique and strategic advantages. Third, the social network of carefully selected board of directors provides the external social capital that reinforces and leverages the internal social capital of a firm's internal knowledge network. Indeed, Woolworth (1998) posits that the best results, in an organizational sense, are obtained when firms balance high internal social capital with a concerted effort to build and sustain high external social capital structures.

The above discussion leads to the following two propositions:

Proposition 4a. Firms that use the social capital of their board to access resources will report more durable competitive advantage than firms that do not use the social capital of their board.

Proposition 4b. Firms that report high social capital both internally (employees social capital accrued via firm's internal knowledge management systems and policies) and externally (via boards with high social capital) will report more durable competitive advantages than firms that score high on only one of the social capital sources – internal or external.

Conclusion

In this paper we build on the growing body of research on social capital, reputation, and knowledge management to develop testable propositions with respect to a firm's board of directors and their use in creating and sustaining a knowledge-based competitive advantage. A firm's board of directors is a specific and unique group of actors available to knowledge-based firms as embodiments of social capital, providers of reputation, and producers of tacit knowledge. The choice of members of this group is a strategic (because of its inherent idiosyncratic character) choice made by the firm. We argue that a firm's board potentially offers a significant source of social capital that can be leveraged with other strategic and non-strategic assets of the company. In addition, a board's reputation is a strategic knowledge asset, that can be leveraged via social capital for strategic consequences. Finally, firms that have mechanisms to use their board's social capital, and leverage it with their employees' social capital will report better strategic outcomes.

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