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Enterprise Transformation: Beyond the Agency Perspective

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Agency theory is but one perspective to analyse enterprise transformation (ET). I argue that by overly focusing on this theory, recent research has generated only partial explanations of ET. Therefore alternative theories, such as the resource-based theory of the firm and co-ordination games, should be employed to broaden the theoretical foundations of empirical research, and to deepen our understanding of the process of ET.

¹ This paper summarises the author's recent theoretical research on enterprise transformation based on a presentation at the European Association for Comparative Economic Studies conference, Grenoble. The papers referred to are available from <http://www.econ.cbs.dk/institutes/cees/>

Introduction

The quintessence of the microeconomic transition from the central plan regime to a competitive market-based one is the transformation of enterprises. Researchers in transition economics have focused on the formal changes in the governance of the firms, notably on ownership and on agency relationships, as determinants of restructuring performance. Yet the vast empirical research testing the predictions of agency theory finds that ownership and governance variables explain only a small part of the variation in performance (see Carlin 2000 for review).

Firms have very different roles in socialist and in capitalist societies. Transition fundamentally changed both the rules of the game and performance criteria by which firms are assessed (Meyer 2001). To achieve competitiveness under the new conditions, firms have to change not only their resource configurations and their skill and capability reservoirs, but also the ways of organising themselves, of interacting with the environment, and of relating to members of the organisation. Enterprise transformation (ET) involves change along all these dimensions. Therefore, I propose this process-oriented definition of ET:

“Enterprise transformation is the process of changing an organisation previously adjusted to perform according to the performance criteria and rules of the game of the real existing socialism to perform competitively according to the performance criteria and rules of the game of a market economy”.

To understand this process, it is necessary to broaden the theoretical foundations of ET research. Governance structures are important to explain managerial action, yet firms are social organisations that are incompletely depicted by agency relations and production functions. To better understand them, transition scholars may draw upon related research in

management and international business (reviewed in Meyer 2001).

The Resources of the Firm

Management scholars have complemented, if not replaced, industrial organisation theories with the resource-based view of the firm (e.g. Barney 1991) that grew out of Edith Penrose's (1959) work. This literature analyses firms as bundles of resources that are embedded in individuals and teams, in the firm's internal and external network relationships, in its business processes and in synergies realised between business units.

Recent advances focus in particular on organisational learning, which we apply to ET in Uhlenbruck et al. (2000). Successful strategic transformation requires firstly restructuring the firm's portfolio of assets - including sale or acquisitions. Secondly, resources have to be upgraded through effective organisational learning, which in turn depends on the organisation's absorptive capacity. However, weak institutional systems, turbulent product markets, and underdeveloped factor markets became external barriers to organisational change. Internally, many firms are hindered by outdated product lines, inadequate assets, and management with little experience in competitive market environments. Consequently, firms ought to focus on improving their learning ability by more actively searching for information in the markets rather than relying on established networks. Also, organisational structure and processes should be adapted to improve the efficiency of information processing, and in consequence firms' ability to identify market opportunities and needed inputs. Moreover, managers need to spend significant efforts on integrating new resources with existing ones to be able to recognise and take advantage of synergies.

Moreover, the resources of a firm do not change in a deterministic way, but as an evolutionary process. Hence, in Lieb-Dóczy and Meyer (2000), we use evolutionary theory to analyse firms acquired by foreign investors. Their growth and prosperity depends on their

adaptation to the local environment, their creation of internal *diversity*, and *selection* among its constituent business processes. Organisations evolve, rather than reincarnate themselves overnight, when facing change in their environment or ownership. Post-acquisition management thus requires an active strategy to initiate the processes that will generate both specific solutions for the local context, and enhance global capabilities of the investor.

In Hungarian and East German case studies, we observe that subsidiaries that foster the development of indigenous resources by creatively combining local and imported resources, and by generating new solutions for the local environment through experimentation. Moreover, several of the new subsidiaries contribute to the acquirer's global capabilities through knowledge generation and specialisation of production, and achieve what Birkinshaw (2000) calls 'global mandates'. With their high level of human resources, especially technological capabilities, many East European firms ought to be capable of achieving global mandates, which create more local value added and larger spillovers for the local economy.

However, we observed many investors who focused on short-term efficiency goals and in this way undermined the potential inherent in intangible resources, notably people, of the acquired operation. These companies achieved only the status of a low-cost production or sales unit with few unique competencies.

Co-ordinating Agents

Also the analysis of governance can be enriched by moving beyond the standard agency paradigm. Firms in transition do not exhibit clear structures of control as certain agents are subject to multiple principals, or principals have few mechanism of control available. Privatisation often created mixed forms of ownership with shareholders such as investment funds, employees or governments acquiring substantial but not controlling stakes in the

equity of the firm. In addition, non-owner stakeholders, such as work councils or local authorities, have some degree of bargaining power to influence decision processes.

A prime task of managers at the helm of enterprises is thus the co-ordination of stakeholders. Agency theory points out that non-co-operative behaviour and conflicts of interest will lead to sub-optimal outcomes. To avoid these, leaders thus have the crucial task of designing and implementing strategies that not only strengthen the competitive position of the firm, but are supported by co-operating stakeholders. The leader has to select the most appropriate strategy, and, to secure its implementation, has to co-ordinate the activity of the stakeholders that provide resources to the firm. They, or at least a critical mass of them, have to be convinced of the path to pursue.

Even without conflict of interest, co-ordination is not a simple task. Experimental research has shown that even co-operative games frequently fail to be co-ordinated on the Pareto-optimal outcome. Although all stakeholders would become better off, they may still fail to co-ordinate their individual routines accordingly. For instance, cognitive barriers inhibit the understanding of the structure of the game and of other players' likely actions.

In Meyer (2000), I argue that leaders can overcome such co-ordination failure and move the organisation to the higher level equilibrium. The switch to the superior equilibrium requires players to change their *beliefs* about other players. Recognising new strategic options does not suffice because players do not know if other players have the same information, nor when the others will switch. Agents have to believe that others will pursue the new routine. They will only act if they share 'common knowledge'² on the structure of the new game, and the timing on the change over to the new routines. Without common knowledge higher-level Nash-equilibria may never be achieved. A leader can facilitate the strategic change by

² Common knowledge refers to a situation where A knows that B knows that A knows that B knows, and so on, i.e. *all agents know that others also share the knowledge*, inclusive the fact that everyone else knows it too.

designing incentive compatible routines and by creating a common knowledge concerning their implementation, e.g. through public speeches and example.

In other words, ET in transition economies requires radical changes not only at the organisational level, but for each individual related to it. *To induce any agent to change his behaviour, he not only needs to learn the new routines, but he has to form the belief that other agents will also change their routines in such way that his new routine will make him better off.* The leader of the organisation has a central role in solving such co-ordination problems.

Conclusion

This short paper challenges the pre-dominance of agency theory as the intellectual foundation of ET research. While the ideas suggested here need further development, I hope to have stimulated research with a broader theoretical base to enrich our understanding of ET. This research would also broaden the range of potential policy instruments. Agency research emphasises the importance of clear governance structures and institutions that support governance mechanisms. Yet where such governance structures are not feasible, other approaches are necessary. Leaders are crucial to manage strategic change, which implies that training and selection leaders should take a central role. Moreover, policy ought to influence the institutional environment such as to encourage organisational learning, experimentation and the development of new capabilities. Future research may make these suggestions more specific.

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