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# Working Paper Series

## The Institutional Construction of Firms

Richard Whitley

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## Abstract

The nature and economic role of legally constituted firms varies between market economies and changes over time. In particular, the governance of leading firms and how they develop distinctive organisational capabilities vary between institutional regimes and their supporting political-economic coalitions. These characteristics can be combined to distinguish five ideal types of firms that dominate different kinds of market economies. Institutions governing trust and authority relationships, state economic and legal policies, financial and labour markets and skill formation systems affect the development and change of dominant kinds of firms. Growing internationalisation of firms weakens national institutional influences on leading firm characteristics and strategies, especially their constraint of short-term economic opportunism. However, domestic institutions remain critical influences on transnational authority sharing and whether MNCs develop transnational organisational capabilities.

## Keywords

Institutions; Firms; Governance; Organisational Capabilities; Trust and Authority; State Structures and Policies; Financial and Labour Systems; Internationalisation and MNCs

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## Introduction

A major feature of post second world war capitalism has been the successful establishment of different systems of economic organisation in the industrialised market economies. The prevalent ways in which economic activities are coordinated and governed in, for example, France, Germany and Japan, continue to differ greatly from those dominant in the USA and UK, as well as varying considerably between themselves (see, e.g., Amable, 2003; Hollingsworth, 1991; Lincoln and Gerlach, 2004; Schmidt, 2002). It also seems likely that whatever forms of market economy eventually become established in China, they will both differ significantly from those institutionalised elsewhere and also vary in significant respects between different localities within the country (King and Szelenyi, 2005; Krug and Hendriscake, 2007; Wank, 1999).

Despite the claims of some globalisation enthusiasts, these differences are no more likely to converge to a single type of market economy in the twenty-first century than similarly varied forms of capitalism did in the internationalised world economy of the late nineteenth century (Hirst and Thompson, 1996; Kenworthy, 1997; 2005; Koechlin, 1995; Wade, 1996). In particular, the idea that the prevalent American variety of capitalism will come to dominate the world economy by virtue of its superior efficiency, which was widely held in the heyday of Fordism, is as flawed as the notion that Japanese capitalism would sweep all before it, as was popularly thought in the 1980s (Boyer and Durand, 1997; Djelic, 1998; Vogel, 1988).

These continued differences in systems of economic organisation are reflected in significant variations in the nature of leading firms in differently organised market economies. The powers, duties and socio-economic functions of private companies continue to vary considerably between national jurisdictions and over time, as many scholars have shown (see, e.g., Milhaupt, 2003; Roy, 1997). In particular, the extent to which corporate entities combine legal personality, unified authority, limited liability, investor ownership and easy transfer of private property rights - which Kraakman (2001) has suggested were key features of the late 20th century US corporation - is highly variable between differently organised market economies and subject to change as circumstances alter.

This is especially the case for the strategic role of the legally constituted firm, which is often not the key unit of private economic decision making in many economies (see, e.g., Bauer and Cohen, 1991; Hamilton and Kao, 1990; Redding, 1990; Westney, 2001). These variations in the nature and role of firms reflect the contested nature of the dominant corporate form, as well as major differences in the key institutions governing economic activities in different nation states (Dobbin, 1994; Roy, 1997). As a result, the nature, behaviour and role of firms in socio-economic development differ considerably between market economies, and cannot be assumed to converge on a single most efficient type of company.

The recognition that firms vary in their economic role, governance and growth strategies across institutional environments implies: a) that the functions of legally established firms differ between market economies and can change over

time, b) that their governing interests and dominant logics of action cannot be assumed to be reduced to a single slogan such as maximising shareholder value, which means the same in all societies, and c) that how leading firms compete effectively varies according to institutional regimes. These points emphasise the contingent nature of firms as economic actors and the need for comparative institutional analysis of their governance, structure and capabilities in different societies. Such an analysis raises the question of how firms should be conceptualised and understood as collective economic actors.

Firms are commonly understood to be critical economic actors in capitalist societies because they combine financial accountability and control through ownership rights with authority over the direction and use of human and material resources that enables them to develop distinctive knowledge and capabilities (e.g., Kogut and Zander, 1992; Teece, 2000). They constitute the key collective entities through which private property rights owners and their delegated agents, managers, coordinate economic activities to create and appropriate value. It is this combination of authoritative integration and direction of resources through collective routines and procedures, which can be both formal and informal, with private ownership and strategic choices that makes firms crucial actors in market economies (Penrose, 1959; Richardson, 1998). Together with other organisations and associations such as labour unions, inter-firm networks, state and quasi-state agencies and socio-political coalitions, their decisions and activities collectively affect market outcomes and economic development (Whitley, 2007).

This view of firms as privately owned authoritative coordinators and directors of human and material resources suggests a number of dimensions for analysing how they vary between institutional environments. These can be combined into two major sets of characteristics that can be used to distinguish between the kinds of leading firms that become established and dominant in differently organised market economies. First, those dealing with issues of ownership, control and direction, commonly referred to as governance concerns. These distinguish between the varied kinds of groups and interests that dominate firm decision making and set strategic priorities. The second deal with the processes involved in coordinating and managing resources to create and maintain distinctive organisational capabilities that provide each firm with competitive advantages.

The comparative institutional analysis of firms studies how these characteristics differ between dominant companies in market economies that are governed by different kinds of institutional arrangements, especially those concerned with authority and trust relations, the organisation and policies of the state and related political structures, including the legal framework within which firms are constituted and regulated, access to capital and the development and use of skilled labour. In the next section of this chapter, I shall describe these characteristics of leading firms in more detail, and then suggest how they could be used to identify five distinct ideal types of firms that have been prominent in a number of major industrialised economies since the Second World War. Subsequently, I shall describe the major features of dominant institutions that influence how firm governance and capabilities can be expected to vary

between differently organised economies, and then suggest how they do so. In the final section I shall consider how the increasing managerial coordination of economic activities in different countries and institutional contexts through multinational companies are affecting these connections and can lead to the creation of novel kinds of transnational firms.

## **Key Characteristics of Firms in Market Economies**

### **a) Firm Governance**

It is common in the Anglophone literature on corporate governance to focus on the relationship between shareholders and top managers, and the way that the growth of managerial autonomy resulting from increasingly dispersed shareownership in the largest companies has led to a disjunction between owners' interests and those of salaried managers (Berle and Means, 1932; Blair, 1995; Marris, 1964, but see also Gadhoun et al., 2005). As shareholdings in some of the leading firms in the stock market dominated economies of the UK, USA and similar societies have become more fragmented in terms of the proportion owned by individuals and families over the 20th century, the connections between ownership and control of private firms have frayed to the point of invisibility and the strategic direction of these companies is more and more in the hands of its senior salaried employees. While this view was very much the product of the US corporate economy in the mid-twentieth century where senior managerial autonomy and tenure were greater than they subsequently became and hostile takeovers more difficult to accomplish (Lazonick and O'Sullivan 1996; O' Sullivan, 2000), the concern with the conflicting priorities of investors and managers remains dominant in much work on corporate governance in economies with these kinds of financial systems (Gugler et al., 2004).

However, this concentration on agency problems between investors and principals and managers as agents tends to ignore the broader context of corporate governance, especially the role of political conflicts and interests in structuring the legal and financial framework governing corporate forms and preferred growth strategies (Dobbin, 1994; Fligstein and Choo, 2005; Roe, 2003; Roy, 1997). It also neglects "the governance of the process through which resources are developed as well as utilised in the economy" (O'Sullivan, 2000: 58) and fails to consider the numerous industrialised economies in which control of large private firms is substantially concentrated in the hands of a small number of owners, banks and other groups, such as many in Europe and Asia (Barca and Brecht, 2001; Gadhoun et al., 2005; Gugler et al., 2004). In such economies, a key governance issue concerns the rights of minority shareholders in the face of controlling owners' manipulations rather than managerial autonomy from owners' interests.

More generally, the governance of private firms in market economies involves a much wider range of interests and issues than shareholder control, including "the whole set of legal, cultural and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are

allocated" (Blair, 1995:3). In particular, the comparative study of the governance of firms needs to consider how dominant interest groups and institutions influence the construction, direction and development of major companies in different jurisdictions in such ways that their behaviour and economic consequences vary. While this clearly involves issues of ownership and control, it also includes the impact of various kinds of employees, suppliers, customers, competitors and other business associates on firm management and behaviour.

The relative influence of these groups, and how it is exercised in the pursuit of different purposes, varies between differently organised market economies, as well as changing over time, in ways that affect how leading firms develop distinctive competitive competences, as is exemplified by the 20th century histories of German and Japanese companies (see, e.g., Aoki and Dore, 1994; Mosk, 1995; Odagiri, 1994; Streeck and Yamamura, 2001; Sorge, 2005). A useful way of comparing patterns of firm governance, then, is to contrast the relative impact that different interest groups and institutionalised structures such as capital markets are able to exert on the strategic priorities and decisions of dominant firms in different kinds of society.

Beginning with the degree and type of ownership influence on strategic managers, at least four separate situations can be distinguished in terms of the relative directness of owner involvement in firm direction and management and strategic managers' autonomy in determining priorities and growth strategies. First there is the archetypal owner-controlled firm in which majority owners directly control the day-to-day operations of the business and those that work for it. In this situation of direct owner control, salaried managers are clearly highly constrained by owners and their interests dominate.

Second, ownership - or at least control over major blocks of shareholders' votes - may be more remote from everyday managerial decision making, yet still concentrated enough to influence greatly overall strategic priorities and the selection of top managers. Such concentrations of shareownership blocks are usually large enough to lock dominant investors into the fate of individual companies so that they cannot exit easily and are necessarily "committed" owners. Where banks and other financial organisations control large blocks of shares, as in much of postwar Germany, they too can function as committed owners in this sense, although their preferences may be more oriented to growth goals than some family owners. Managers are here often able to exert considerable autonomy in day-to-day decision making but can become quite constrained when major strategic issues arise, such as those involving mergers and acquisitions and major restructuring of corporate units.

Third, market based forms of owner control refer to a situation of fragmented beneficial shareholdings where each individual investor controls a diversified portfolio of shares in different companies and focuses more on the overall performance of such portfolios than on the fate of any single firm. In principle, this dispersion of shareownership should grant managers considerable freedom of action, as discussed in the managerial revolution literature. However, where short term control over the management of shares has become concentrated in

the hands of a few fund managers and their advisors who are regularly evaluated in terms of their short term performance, and capital markets are relatively deregulated and large and liquid enough to support strong markets for corporate control, capital market constraints on managerial actions can be considerable. It is therefore useful to distinguish between strong and weak varieties of capital market constraint on managerial strategies.

Turning next to consider the relative influence of other groups on firm direction and strategic choices, two major ones can be distinguished: employees and business associates. In this context, the constraining effects of employee interests go beyond the legal requirements of consultation and co-decision making that have become established in some European countries to include the more general influence that results from strong labour unions and institutionalised patterns of cooperation with employees. Such cooperation is especially important when firms depend on highly knowledgeable and skilled staff to improve their products and services continuously, to anticipate customer needs and invest in the development of new competences. The more dominant institutions in a society encourage this dependence, the more employee interests - or at least those of the key staff - constrain what strategic managers can do and how they do it.

The third set of constraints on managerial autonomy in setting strategic priorities and directing activities arise from membership of different kinds of business associations and other organisations. Companies are often encouraged to join powerful trade associations and employers' groups that restrict their ability to pursue independent strategies, especially in the more corporatist societies of continental Europe and Japan (Crouch, 1999; Sorge, 2005; Streeck and Schmitter, 1987). In the past some of these have organised cartels that have been supported by the legal system (Herrigel, 1996) and many continue to play a substantial role in standardising contracts and organising inter-firm relationships (Casper, 2001). As Hall and Soskice (2001) emphasises in their dichotomisation of liberal and coordinated market economies, such strong business and employers' associations are important features of the latter that restrict firms' short-term opportunism.

In broad terms, these two sets of constraints on top managers' freedom of action can be expected to encourage corporate growth at the expense of short-term profitability goals. Both employees, including most managerial ones, and business partners benefit from expansion of the existing business, and are more likely to support and be actively committed to incremental innovation that builds on existing competences than to radical discontinuous change that threatens existing skills. Competence enhancing diversification will be preferred to competence destructive strategic shifts when such constraints are strong.

A fourth set of influences on firm behaviour stem from state support of favoured industries and companies, as well as the pursuit of specific public policy goals in sectors such as defence and health through what Ergas (1987, see also Doremus et al., 1998) termed mission-oriented technology policies. However, these are more conveniently regarded as instances of political and public bureaucratic steering and encouragement of particular strategies in specific



national and/or regional jurisdictions rather than as integral parts of firm governance, although clearly the role of the state more generally is a key factor in determining the constitution and behaviour of leading companies in a political economy. Since the structure, policies and practices of different states incorporate the legal definition of property rights and their enforcement, the rules governing market boundaries and behaviour, and distributional regulation, they are better considered as part of the business environment that strongly affects firm development and actions.

While these three aspects of firm governance can be combined in many different ways that are affected by broader features of the business environment, some combinations seem more likely than others. In particular, extensive employee and business partner constraint seems more likely to occur with committed ownership than where there is a strong market for corporate control and fragmented shareownership because hostile takeovers and associated pressures for short-term financial returns in the latter situation will limit the influence of employees and business partners and their willingness to invest in developing firm-specific competences.

#### b) Developing Organisational Capabilities

In considering how firms develop different kinds of competitive capabilities in different market economies, a major variable concerns owners and managers' use of authority to integrate and direct economic activities. As many discussions have emphasised, the authoritative direction and integration of economic activities is a key feature of firms. Hamilton and Feenstra (1997: 56), for instance, claim that firms, and economic organisations in general, are "above all authoritative organisations that structure relationships according to established rules of conduct" in which participants recognise that they are bound to the authoritative norms of the organisation, and there are coercive means to enforce collective rules.

The ability to direct employees to undertake specific tasks through delegated authority from private property rights' holders is central to the organisational development of distinctive collective competences, not least because the flexibility that employment agreements provide enables managers to organise economic activities in different ways for varied purposes, and to change these to suit altered circumstances (Richardson, 1998). This flexibility facilitates the management of increasingly complex and uncertain activities, particularly innovation. As Lazonick (1991; Lazonick and West, 1998) and others have suggested, the planned coordination of a specialised division of labour has enabled firms to build distinctive organisational capabilities for developing process and product innovations on a continuing basis.

The systematic organisation and control of activities through employment agreements encourages the production of common knowledge and skills that are specific to each company. By working together in organised ways, employees develop distinctive routines, understandings and collective abilities that enable the firm as an organisation to generate novel kind of capabilities that provide distinctive competitive competences (Metcalf and James, 2000). It is

perhaps worth pointing out that such authoritative direction need not always be imposed by a managerial hierarchy, but can be achieved through delegated powers from workers as in some professional service firms and employee owned companies.

However, the extent to which such authoritative integration and direction does in fact generate distinctive collective knowledge and competences varies greatly between firms and institutional contexts. In particular, they differ in how much employees and others involved in the firm's affairs, such as suppliers and customers, contribute to problem solving and improving performance, as many comparisons of German, Japanese and US companies have indicated (Aoki, 2001; Casper, 2000; Cole and Whittaker, 2006; Soskice, 1999). Such contributions depend both on managers seeking them and on employees being committed to developing firms' distinctive capabilities, sometimes at the expense of improving their own individual skills. Two important ways in which owners and managers can elicit high levels of employee involvement in joint problem solving activities, and commitment to the improvement of firms' collective capacity to deal with complex issues, are to share substantial amounts of authority with them and to provide long term organisational careers.

Authority sharing here involves property rights holders and their agents delegating considerable discretion over task performance - and sometimes task organisation - to skilled employees, and encouraging them to contribute to product and process improvements. It varies in the degree of such delegation, i.e. the amount of discretion exercised by subordinates, and its scope, i.e. the range of activities and decisions over which discretion is exercised. While these aspects are often positively correlated, it is clearly possible for managers to delegate high levels of discretion over specific, narrowly defined, tasks without extending it to more general features of the work.

Where the scope of authority sharing is low, the span of discretion is quite restricted to limited aspects of how tasks should be performed, while greater levels of authority sharing mean that employees are often involved in the selection, organisation and allocation of tasks as well as having considerable discretion over how they are conducted. In such cases, they may also be expected to contribute to departmental and wider problem solving, often being assessed in terms of their contribution to overall firm performance.

Such intra-organisational delegation of discretion to employees is sometimes complemented by external authority sharing with suppliers, customers and competitors in varied inter-firm networks, especially when there are strong institutional constraints on short-term opportunism. In both instances, firms are thereby enabled, in principle, to learn from the knowledge and experiences of their employees and business partners. On the whole, then, the greater is the degree and scope of such authority sharing, the more firms should be able to integrate different kinds of activities and types of knowledge in dealing with complex problems, and to develop new routines and knowledge.

Long term commitment to a firm's success through contributing to its specific knowledge and capabilities is additionally encouraged by offering organisational

careers for those who demonstrably make such contributions on a continuing basis. By tying personal futures to the growth of the employing organisation, and making credible commitments to maintain employment across the business cycle, such careers intensify employee commitment to the improvement of collective competences, even if that limits their visibility on external labour markets. Where, on the other hand, employment is seen as being vulnerable to market and technological shifts, as well as to changes in ownership, skilled workers will be more concerned to improve their position on external labour markets by enhancing their own personal knowledge, reputation and skills than on sharing knowledge and opportunities with short term colleagues.

Authority sharing and organisational careers are interrelated in the sense that providing the latter for some employees involves a considerable amount of the former. It seems most unlikely that owners would offer relatively long term commitments for managers and skilled workers if they were not prepared to delegate substantial levels of task autonomy to them. While, then, firms that do not provide long term careers for employees can vary in the degree of authority sharing they implement, between for instance owner controlled firms in many developing economies and project based firms in Silicon Valley (Bahrami and Evans, 1995), those that do offer organisational careers for at least some groups of staff are also likely to delegate considerable task autonomy to them.

Considering next the different kinds of collective capabilities that firms develop through the authoritative coordination and direction of resources and activities, useful distinctions can be drawn between three major kinds: coordinating, learning and reconfigurational (Teece et al., 1997; Dosi et al., 2001). Coordinating capabilities refer to the ability of companies to integrate different activities and knowledge through organisational procedures and thereby realise economies of scale and scope. While all firms integrate economic activities through unified authority structures to some extent, their capacity to achieve such economies varies considerably as Chandler (1990) amongst others has emphasised. In particular, the ability to coordinate new developments across departments and divisions can differ greatly between companies.

Such capabilities are often developed by strong managerial hierarchies that systematically control and direct a range of activities through formal rules and personal supervision. However, effective integration should be greater when key employees are both knowledgeable about the work and competences of colleagues in different departments and divisions and are committed to working with them to achieve overall organisational objectives. Accordingly, long term organisational membership and experience of working in different parts of the firm seem likely to improve such integrating capabilities, especially when these are characteristic of a wide range of employees as in many large postwar Japanese companies (Aoki, 1988; Koike, 1987).

Organisational learning refers to the ability of a firm to develop new knowledge of its processes, products and markets, and incorporate that knowledge into its practices and strategies. It involves the codification, diffusion and application of new understandings developed by individuals and groups throughout the organisation, so that routines and procedures are continuously being updated in

a process of cumulative improvement (Nonaka and Takeuchi, 1994). The critical feature of this capability is its organisational nature by which firms continuously develop new knowledge collectively and adapt to changing circumstances by incremental, competence enhancing innovations.

This again depends on encouraging employees and others associated with the operations of the firm to develop and share their knowledge with colleagues, and the development of systematic routines to ensure that valuable knowledge is incorporated into new processes, products and services. On the whole, the more owners and managers share their authority with a wide range of skilled workers and reward their contributions to improving firm performance, the more effective such organisational learning is likely to be. Thus, where long term membership of the firm is largely restricted to managerial employees, as in the dominant US corporation described by Chandler (1976; 1990) and others (O'Sullivan, 2000), such organisational learning is likely to be less widespread and effective than in their Japanese equivalents that extended such commitments to many male manual workers (Fujimoto, 2000).

Reconfigurational capabilities also involve innovation, but in a more radical, rapid and discontinuous way, such that core competences and skills become transformed, as when pharmaceutical companies developed new drug discovery methods that incorporated the knowledge and skills of biologists (Casper and Mataves, 2003; Gambardella, 1995), IBM turned itself into an IT services firm, and Corning Glass became a fibre optics company. Of course, in the extreme case of such changes, the whole firm becomes so transformed that it may be doubted whether it is still the "same" company, but most reconfigurations involve the restructuring of resources and redirection of activities into new technologies and markets, often with new skills and knowledge bases, rather than the wholesale destruction of existing organisational competences and administrative routines.

The ability to undertake such reshaping of a firm's activities and resources implies a capacity to recognise significant changes in its environment and alter what it does and how it does it accordingly, even if this means dropping significant lines of business and entering quite new ones that are known to be risky. The main contrast with organisational learning capabilities concern the more rapid and radically discontinuous nature of reconfigurational ones, which are typically more competence destructive than enhancing.

### **Ideal Types of Firms**

While these characteristics of firm governance and organisational capabilities can be combined in a number of different ways, some patterns seem more likely to be empirically common and stable than others. For example, employers' commitment to long term organisational careers are unlikely to be highly credible when firms are liable to be taken over and restricted, or when authority is concentrated in the hands of the owner-manager and his or her immediate family. Equally, family controlled firms are unlikely to develop strong coordinating capabilities unless they delegate some authority to salaried managers and are able to make credible commitments to providing

organisational careers for them. In considering the distinctive kinds of organisational capabilities developed by firms that have dominated many industrialised economies since the end of the Second World War, we can distinguish at least five ideal types that combine different patterns of governance and authority sharing to generate contrasting capabilities. These are summarised in table 1 and will now be discussed.

#### **TABLE 1 ABOUT HERE**

Opportunistic firms represent the classic entrepreneurial enterprise built around the knowledge and skills of its owner-manager with few commitments to employees or business partners. Such firms tend to be highly responsive to short term business opportunities, often changing their processes, products and customers rapidly as circumstances alter. The archetypal Chinese family business in Hong Kong and other parts of Pacific-Asia exemplify this kind of company, whose key resource is the capacity of the owner to seize opportunities as they arise, maximising flexibility and minimising commitments to particular personnel, suppliers or capital machinery (Enright, 2000; Redding, 1990).

Integrating routines and systematic procedures coordinating different activities are rarely highly institutionalised in such firms, and so their capacity for realising economies of scale and scope in the Chandlerian manner is limited. Similarly, organisational learning through continual incremental improvement of such routines and patterns of behaviour will be restricted where it threatens entrepreneurial initiatives. Reconfigurational capabilities, on the other hand, could be considerable in the sense of being able to rapidly change products, markets and technologies - albeit not those involving complex and expensive capital resources. However, given the limited organisational specificity of such firms' capabilities - as distinct from those of the owner-manager - such abilities are more individual than collective.

Specialised network firms also have limited managerial coordinating capabilities and are often run by their owners, but depend much more on the knowledge and skills of their employees, sharing considerable authority with them. They are additionally more likely to engage in common activities with business partners in collaborative networks and cooperate with a wide range of external agencies. Coordinating capabilities are here restricted by most firms' relatively small size and specialised focus. However, learning within the enterprise should be greater as staff are encouraged to work together for common purposes, often with high-powered incentives such as stock options. Such learning may well involve external partners and knowledge producers as well when labour markets are fluid and access to specialised skills relatively easy.

Reconfigurational capabilities will also be facilitated by active external labour markets and low levels of commitment to staff when market and technical uncertainty are high. However, in more established and stable labour markets where knowledge and skill development changes at a slower rate, they will be more restricted, as in many industrial districts that specialise in particular industries.

Larger firms with more systematic and formal procedures for coordinating different activities and an administrative structure for planning them can be distinguished in terms of their prevalent pattern of ownership and control, on the one hand, and their willingness to share authority and gain employee commitment on the other hand. The combination of market owner control and limited employer-employee commitment is exemplified by the dominant US corporation for much of the twentieth century, according to Chandler (1990) and others (e.g., O'Sullivan, 2000). Many of these companies had a fragmented shareholder base and developed a large managerial infrastructure for coordinating different activities through formal routines that generated considerable economies of scale and scope. While remote owners delegated considerable authority to salaried managers, these usually did not expect the bulk of other employees to contribute to problem solving or the improvement of organisational capabilities. Organisational careers similarly tended to be restricted to the managerial ranks. This type of firm can be characterised as an isolated hierarchy since most authority was vested in the managerial hierarchy and they operated as integrated administrative structures amidst predominantly arm's length market relationships.

However, the extent of strategic managerial autonomy from capital market and other pressures varies in such firms. As O'Sullivan (2000) has emphasised, changes in the structure of household finances, the rise of institutional shareholdings and macro-economic shifts in the 1970s encouraged both a concentration of fund management in the USA and some other stock market dominated financial systems, and demands for greater returns on equity shareholdings (see, also, Blair, 1995; Lazonick and O'Sullivan, 1996). In the last quarter of the twentieth century, these pressures have intensified the market for corporate control in such economies and restricted the ability of top managers to implement long-term development plans. They have also reduced the longevity of organisational careers for many managers and the overall level of employer-employee commitment in such companies.

The investment in managerial integration of activities characteristic of these types of firms means that they should have considerable coordinating capabilities, although the limited scope of authority sharing and careers can be expected to restrict the willingness of most staff to invest in the improvement of cross-functional and cross-divisional linkages at the expense of enhancing their own specialist skills. Similarly, while managers may be keen to improve performance through incremental innovation and learning, other employees of isolated hierarchies have fewer incentives to do so and the high level of job insecurity can be expected to inhibit their enthusiasm for changing technologies and work routines. In terms of commitment to, and identification with, the company, then, medium to long-term membership tends to be limited to the managerial hierarchy in such firms, as are firm specific knowledge and competences.

On the other hand, the relative weakness of authority sharing and employer-employee commitment should enable senior managers to carry out quite radical transformations of their activities and resources and so enhance their

reconfigurational capabilities. Such unilateral decision making also, of course, allows the managerial elite to ignore conflicting information and signals from the changing environment, as seems to have happened in the cases of Rubbermaid and Quaker Oats in the 1990s (Helfat et al., 2007).

More committed forms of ownership and control include those where shareholdings - or more often perhaps control over votes - are concentrated in the hands of an individual, family or trust, and/or where firms are effectively constrained by banks, insurance companies and similar providers of "patient" capital in relatively illiquid capital markets. While these controllers may well have varied strategic priorities and preferences regarding authority sharing, they are all locked-in to the fate of individual companies, at least in the short term, and cannot easily trade their property rights. This means that they can make credible commitments to organisational careers for some employees over the medium term and build strong firm specific capabilities through high levels of employer-employee interdependence.

Variations in the degree and scope of employer-employee commitment enable us to distinguish between two types of such firms: centralised hierarchies and collaborative hierarchies. In the first, authority is concentrated in the hands of the dominant share or vote controller and his or her closest colleagues who are often family members, with little delegation to other employees, or to external business partners. Rather authoritarian management styles are here often combined with paternalistic commitments to long term employment for many white collar workers that are made more credible by high levels of state support, particularly through subsidised credit for rapid expansion. Many of the South Korean *Chaebol* have exemplified this kind of firm in the postwar period (see, e.g., Amsden, 1989; Bae, 1987; Kim, 1992; Janelli, 1993).

In the second kind of committed owner-controlled firm, authority and career commitments are much more widely shared, both with a wide range of employees and with external business partners and agencies. As a result, commitment to the continuous improvement of firm specific knowledge and capabilities is much more likely to be widespread, as in many large Japanese firms in the postwar period (see, e.g., Aoki, 1988; Fruin, 1992; Fujimoto, 2000).

Centralised hierarchies should be able to develop considerable coordinating capabilities through the central direction of activities and people by the top management, often aided by a powerful planning and control office that integrates operations and new developments across divisions through highly formalised procedures and intensive personnel management (Amsden, 1989). However, this degree of central control means that most organisational learning will be accomplished by the managerial elite of such firms. Little initiative and contribution to organisational problem solving is expected of other employees, and it is rarely rewarded when it does occur.

Reconfigurational abilities, on the other hand, should be considerable, with few constraints on top management's powers to restructure firms' resources and operations, as is illustrated by the *chaebols* rapid movement into new industries at the behest of the state during Korea's postwar industrialisation (Amsden,

1989; Fields, 1995; Kim 1997; Woo, 1991). However, as in the case of isolated hierarchies, such unilateral decision-making also enables large-scale mistakes to be made, as became more evident in Korea in the 1990s when state constraints were loosened and the level of support reduced. In general, it is arguable that the combination of highly personalised and centralised authority with an extensive highly educated white collar labour force characteristic of many centralised hierarchies is unsustainable in the long term, especially without domestic market protection and other forms of state support.

Collaborative hierarchies, in contrast, are more constrained by employee groups and external business partners, including business associations. This encourages strong growth goals and employee investment in ensuring effective coordination of the firm's operations and new developments. Because many staff have long term commitments to the firm's expansion, they should be more willing to develop firm specific knowledge and skills by, for instance, accepting inter-functional and cross divisional transfers than would those in less collaborative companies. As a result, the integrative capabilities of these kinds of firms can be expected to be considerable. The widespread practice of moving general employees between departments and divisions in many large Japanese companies at the behest of the central personnel department, which typically assumes responsibility for managing their careers for the long-term health of the firm, exemplifies such commitment (Graham, 2003; Jacoby, 2005). For similar reasons, the organisational learning capabilities of this kind of firm should be considerable as staff have every incentive to contribute to the growth of the company (Aoki, 1988; Clark, 1979; Dore, 1996).

However, radical reconfigurational capabilities are likely to be constrained by these commitments, especially when they threaten to become competence destructive. Growth strategies will be based more on developing current knowledge and skills than on acquiring quite different ones. This is not to say that over time such firms cannot transform themselves by moving into new technologies and markets, as did many Japanese cotton manufacturers in the early twentieth century, but this will be achieved more through related diversification into, for instance, artificial fibres, than by major disposals and acquisitions of quite different resources (Nishida and Redding, 1992). The relatively slow adoption of biology-based methods of drug discovery by many Japanese pharmaceutical companies compared to their major UK and US competitors can in part be attributed to the greater level of employer-employee commitment in the former firms, as well as to differences in national scientific and regulatory systems (Kneller, 1999; 2003; Thomas, 2001).

## **The Institutional Structuring of Firm Characteristics**

### **a) Key Institutional Features**

These kinds of differences in the governance characteristics and development of organisational capabilities of leading firms in differently organised market economies reflect variations in their dominant institutions. In this section, I summarise the key features of these institutions that affect the kinds of firms that become dominant and how they can be expected to do so. While their



strength depends, *inter alia*, on the continued support and cohesion of major socio-political coalitions (Amable, 2003), including the owners and managers of key industries, and so can change over time, most features of the institutional environment of firms in the established industrial capitalist societies are relatively stable and cannot easily be altered by any single interest group or firm.

This is especially so for the more general institutions such as the overall predictability and reliability of the legal system and its protection of various kinds of private property rights, norms governing authority relationships, and the nature of the financial and labour systems (Whitley, 1999; 2007). These institutional arrangements impinge upon, if not indeed actually structure, relationships between: a) investors and managers, b) employers and employees, and, c) competitors, suppliers and customers.

The key features of dominant institutions that affect the nature of behaviour of firms can be summarised under four main headings: a) the norms governing trust and authority relationships in a society, b) the nature and policies of the state in constituting, regulating and supporting economic actors, c) the conventions and rules governing access to, and the use of, financial capital, and d) the nature of the skill formation system and of the regulations and norms governing the employment and management of people. There are nine major features of these institutions and agencies that are particularly important influences on firm governance and the development of capabilities, which are listed in table 2.

## TABLE 2 ABOUT HERE

Considering first the institutions governing trust relationships between economic actors, these are crucial to the establishment of industrial capitalist economies, especially the extent to which the formal procedures and structures organising transactions, and economic activities more generally, are regarded as reliable and trustworthy. Where trust in formal institutions is so low that owners feel unable to rely on the legal system, accounting conventions and formal mechanisms to control the behaviour of customers, suppliers and employees in predictable ways, they will be reluctant to develop substantial commitments to people with whom they do not have strong personal bonds of loyalty and reciprocity.

Such low levels of trust are often associated with predatory states and unpredictable financial systems. In states where political elites are unwilling to allow the growth of large concentrations of privately controlled capital and/or seek to extract substantial amounts of surplus for their own benefit, owners are faced with a highly uncertain political and economic context in which personal connections are often the only reliable means of ensuring trust and predictable behaviour. The legal system in such countries is either very limited in its ability to resolve disputes, or liable to render capricious and unpredictable judgements.

Many industrialising countries, and those undergoing radical institutional change such as the former state socialist societies of Eastern Europe in the early 1990s, exemplify this kind of institutional context (Fafchamps, 1996; Humphrey and

Schmitz, 1998; Menkhoff, 1992; Whitley and Czaban, 1998; Whitley et al., 1996). When business owners do develop alliances and partnerships in such economies, these are usually based on personal ties, and are family-like if not actually based on close kinship links, as in Taiwan and other Pacific-Asian societies (Gates, 1996; Hamilton, 1997; Hamilton and Kao, 1990). They also tend to be quite limited in scope, so that owner-managers are not exposed to high levels of risk by such shared commitments.

Authority relationships in these kinds of particularistic societies are often *paternalistic* in the sense that political and other leaders typically justify their superiors' positions in terms of their greater wisdom and ability to look after the best interests of their subordinates, analogously to parental roles in families (Beetham, 1991). Generally, such paternalist ideologies encourage strong central control and low levels of delegation.

Alternatively, authority may be justified in terms of more formal and procedural norms governing the selection of leaders and how they exercise discretion over subordinates' activities (Eckstein and Gurr, 1975). Such formal justifications of subordination can be further divided into two types: *contractarian* and *communitarian*. This distinction focuses on the extent to which authority rests upon widespread and diffuse appeals to common interests as opposed to highly specific and narrow agreements between discrete and separate contractors. Communitarian forms of authority imply relatively high levels of mutual trust and commitment, with shared understandings of priorities and interests, and often rely on expertise as a key quality of superordinates, while contractarian authority tends to presume more adversarial relationships and a dominant pursuit of self-interest. The former seems to have become institutionalised in some Scandinavian and continental European countries, while the latter is found more in Anglophone societies (Lodge and Vogel, 1987).

The role of nation states in organising market economies has, of course, been extensively analysed in many comparative studies (see, e.g., Amable, 2003; Crouch and Streeck, 1997; Schmidt, 2002; Weiss, 2003). From the point of view of explaining variations in forms of firm governance and prevalent ways of developing organisational capabilities, three features of this role seem particularly important.

First, there is the extent to which the state is able and willing to play an active role in coordinating economic development and supporting particular industries and firms. Active promotional states (Evans, 1994) vary in how much they dominate and direct firms' strategies, and reward or sanction their outcomes, in ways that affect dominant firm behaviour. In *dominant developmental states*, businesses are highly dependent on state policies and actions, to the extent that political risks often outweigh market ones. Less directive states, like perhaps the post-1950s Japanese one, pursue developmental policies in a more collaborative way through policies of what Samuels (1987:8-9) has termed reciprocal consent. Others, such as many Anglophone states, have neither the wish to, nor the capability for, actively co-ordinating economic processes but focus on a more regulatory approach to managing economic development.

Second, states differ in their toleration of, and support for, intermediary groups and associations between individuals, firms and the state that play a significant role in coordinating economic developments. These groupings include trade associations, employers' groups and labour unions. This feature can be summarised as the degree of *state support for intermediary organisations*. Some European states, for instance, appear unable to tolerate such groupings while others, like the German and Austrian, seem to positively encourage their formation and to develop quite strong corporatist forms of intra- and inter-sectoral organisation (Schmidt, 2002). Clearly, interfirm co-operation, alliances and cartelisation will be easier in the latter sets of states than in the former.

Third, there are significant differences in the extent to which states directly or indirectly regulate market boundaries and entry and exit, in addition to setting constraints on the short-term opportunism of economic actors. They are here termed the extent of *formal segmentation of markets*. In many countries, for instance, states regulate which sorts of organisations can offer financial services and how they can sell them, as well as where they can do so. Similarly, licences to undertake certain trades are often only issued by national and local state agencies when appropriate skill certificates have been acquired. In other countries, such powers are sometimes delegated to industry associations and quasi-statutory bodies. This affects the intensity of competition, mobility of resources between markets and flexibility of firms.

The key feature of financial systems for firm governance and the development of organisational capabilities concerns the market for corporate control. The combination of liquid capital markets, legal and other restrictions on managers' ability to develop strong defensive measures against hostile takeovers, and fragmented shareholdings in outsider-based financial systems can result in a strong market for corporate control that limits investor-manager commitments and reduces the credibility of long term career incentives (O'Sullivan, 2000; Tylecote and Conesa, 1999). Where capital is impatient and volatile it is difficult to convince skilled employees to become committed to the long-term development of a particular firm's organisational capabilities.

In contrast, credit-based financial systems are characterised by relatively small and illiquid capital markets and much greater concentrations of shareholder control over large companies. Here it is much more difficult to transfer ownership and change direction radically, especially if significant proportions of firms' shares are held by strategic investors and/or are effectively controlled by top managers, as is the case in many European countries (Barca and Becht, 2001) and Japan (Sheard, 1994).

Lastly, the skill formation systems of market economies vary considerably in ways that, together with labour market institutions, affect the kinds of skills developed, managerial policies and organisational commitments. In particular, the *effectiveness of the public skill formation system* in training large numbers of workers in practical skills that are valued by employers, usually because they have been closely involved in providing training and setting standards as in the "German Skills Machine" (Culpepper and Finegold, 1999), influences both

internal organisational structures and market strategies (Maurice et al., 1986; 1990; Soskice, 1999).

The impact of the public training system on firm structures and behaviour is greatly enhanced when combined with certain features of the institutions governing labour markets and employment policies (Thelen, 2004). Particularly important in this respect are the relatively strength of sectoral and/or national employers and labour union groups and their coordination of bargaining over employment conditions. Where there are *strong employer and labour union federations with centralised bargaining*, firms tend to become accustomed to working together and with unions in relatively stable relationships that inhibit highly opportunistic behaviour, as in many continental European states (Jurgens, 2003; Thelen and Kume, 2003).

Many of these features of dominant institutions are interrelated (Amable, 2003; Schmidt, 2002; Whitley, 1994). For example, societies in which strong states play the dominant role in coordinating economic development and share risks with the private sector tend not to develop strong intermediary associations. Employers' associations and labour unions are, then, usually weak in such countries. Market segmentation, on the other hand, is often considerable since this is a major way in which state agencies coordinate development. These kinds of states also tend to be associated with bank credit based rather than capital market based financial systems for two reasons. First, because they are typical of late industrialising economies where capital is scarce and more readily mobilised through the banking system, and, second, because it is easier for the state to influence economic development through the financial system when it is dominated by banks rather than capital markets (Zysman, 1983).

Conversely, low levels of state risk sharing and economic coordination are often combined with capital market based financial systems in what might be termed *arms' length* or differentiated business environments. In these contexts, institutional arenas and elites are organised quite separately from each other according to their own particular logics. Social relationships tend to be regulated by formal rules and procedures that treat actors as discrete individuals pursuing their separate interests, as exemplified by classical contracting. Authority and trust relations are here governed by formal institutions that limit mutual obligations to contractually specified duties. Collaboration between employers, unions and other groups is difficult to establish in such societies because collective actors are typically adversarial in their relations with each other.

On the other hand, where strong intermediary associations have developed with state support, they tend to be involved in regulating market entry and exit. They are often engaged in negotiation with each other on a continuing basis with strongly institutionalised procedures limiting opportunistic behaviour. Such procedures depend on considerable trust between social partners and widespread beliefs in their joint dependence on cooperation for gaining group objectives. Commitment to relatively impersonal associations and an institutionalised ability to mobilise loyalties to collective goals beyond purely personal ones are important features of these kinds of societies. When combined with strong public training systems, as in many Continental European

countries, these institutional features are conducive to collaboration between economic actors and so can be termed *collaborative* forms of institutional environments.

Finally, cultures where trust in formal institutions is low and loyalties are focused on the immediate family rather than more impersonal collectivities limit the growth of intermediary associations and the development of exchange relationships governed by formal procedures. Capital markets are unlikely to be significant sources of investment funds in such societies and the largely personal nature of authority relationships will restrict the development of strong labour unions. Social relationships in these cultures tend to be highly personal and particularistic, and so can be described as *particularistic* business environments.

#### b) The Impact of Institutional Features on Firm Characteristics

Before continuing to outline the particular ways in which these nine features of dominant institutions can be expected to affect firm characteristics, it is important to bear in mind two points. First, the most direct connections between institutional features and characteristics of leading firms in a market economy often occur when institutions display particularly strong features at extremes of the dimensions being considered. Relatedly, the connections are often not reversible in the sense that the negative relationship may not hold to the same extent. Second, interdependences between single institutional features and firm characteristics are tendencies that, in practice, are modified by other aspects of dominant institutions and by a variety of historical contingencies.

The effects of particular political, financial, labour and cultural institutions on firms are often most marked when the strength of a particular feature is very high or low. For example, the link between a strong, developmentalist state and the prevalence of growth goals is not a linear, continuous one but rather is particularly significant - and dominates other factors - when the level of business dependence on the state is especially high, as in post-war Korea (Amsden, 1989; Fields, 1995; Whitley, 1992a; Woo, 1991). Similarly, the effect of weak institutions governing trust relations on inter-firm alliances and sector organisations is most evident when formal institutions are widely regarded as unreliable, as in many expatriate Chinese dominated economies (Redding, 1990; Silin, 1976).

Additionally, these direct connections between particular institutional features and firm characteristics often do not apply in reverse. Where, for instance, the state is relatively weak and/or does not pursue developmentalist policies, firms' strategies may or may not follow growth goals. Although, then, the strong, developmental French state in much of the post war period has, amongst other factors, encouraged large firms to pursue growth goals, the less *dirigiste* post-war federal German state has not led German companies to pursue profit maximisation priorities (Schmidt, 2002). This is because of other institutional features, such as the financial system and strong intermediary organisations, which encourage growth goals (Lane, 1992). Similarly, the existence of an effective legal system governing contractual trust does not necessarily lead to

extensive delegation of control to salaried managers by owners, although the lack of such formal institutions is likely to encourage strong owner control.

This point highlights the interdependence of these institutional features in structuring dominant firms. In any particular market economy, the prevalent type of firm will reflect the influence of all dominant institutions as they have developed in conjunction with each other during and after industrialisation. The linkages between institutions and firm characteristics discussed in the following pages are, then, tendencies which are most likely to occur when institutional features are particularly distinctive and other features reinforce, rather than conflict with, them (Deeg, 2005).

Bearing these points in mind, in table 3 I summarise the expected relationships between particular features of dominant institutions in a market economy and prevalent patterns of firm governance and capability development in those environments. As can be seen, direct connections are not always unequivocal since the impact of particular features usually depends on the nature of other institutions. A very rough attempt at distinguishing the degree of influence has been made by using a five-point scale of low, limited, some, considerable and high.

### **TABLE 3 ABOUT HERE**

Considering first the connections between institutional features and forms of owner control, direct owner control is strongly encouraged in societies where trust in formal institutions governing relationships is low and authority is predominantly paternalist in nature. Without strong mechanisms ensuring that owners can rely on managers to carry out their instructions and act in their interests, it is unlikely that they will readily delegate control over their property to salaried employees. Similarly, if authority in a society is more personal and direct than formal and procedural, owners will be expected to exercise direct control over employees.

A high level of business dependence on the state in dominant developmentalist states also encourages direct control because owners typically manage political risks directly with decision-makers and would find it difficult to implement agreements through third parties. Since state co-ordination and direction are often not transparent and public, remote owners would be disadvantaged if they left political negotiations to managers, and so they have to become directly involved.

Conversely, market based forms of owner control are only feasible when trust in formal procedures is high and authority predominantly procedural. They are less likely in credit based financial systems because these typically lead to considerable interdependence and lock-in between the owners/controllers of financial assets and managers of enterprises. They are, though, strongly linked to the existence of liquid capital markets in which assets can be easily traded and managed as items in a portfolio. The stronger the market for corporate control in such financial systems, the more difficult it will be for firms to coordinate policies and work together in business associations and employers'

groups since ownership and corporate strategies are liable to change rapidly. Highly capital market constrained governance relationships are unlikely, then, to occur in market economies with strong intermediary associations and coordinated employer-union bargaining practices.

Employee interests are unlikely to be significant influences on firms' strategies and actions when state dominance is high and trust in formal institutions is low. Major political risks focus attention on state interests and priorities so that other groups are subsidiary, except perhaps for a small cadre of senior managers. Equally, a culture in which trust in strangers is difficult to establish and maintain except on a personal basis is not likely to encourage reliance on employee skills and commitment to the organisation as distinct from the individual owner-manager. Firms in this situation will not be greatly influenced by the needs of employees as a whole in making decisions. Employers will additionally be discouraged from giving weight to the interests of the bulk of employees where there is a strong market for corporate control since the threat of hostile takeovers focuses managers' attention on financial rates of return in the relatively short term.

Conversely, effective public training systems, centralised bargaining and powerful employers and union federations, together with communitarian authority relationships encourage more concern with employee interests. Where unions have strong legal and/or labour market powers, they are obviously in a position to insist on worker interests being taken into account when strategies are being developed and implemented. Equally, a strong training system produces high-level skills that employers can rely upon since they are usually involved in developing them. Furthermore, where managerial authority rests largely – or even partly – on perceptions that employers and employees share a common destiny, and are jointly responsible for the future of the organisation as a whole, the significance of employee interests is likely to be considerable relative to economies where authority is more contractarian.

Business partner constraints on strategic decision-making are likewise inhibited by dominant states, capital market financial systems and low trust in formal institutions. High levels of business dependence on the state combined with considerable antagonism to intermediaries between the family, firms and the central state in dominant developmental states, ensure that firms concentrate on developing close links with state agencies and compete with each other for state support, within and across industries. In such economies, it is clearly difficult for them to develop substantial and stable linkages with each other. Strong markets for corporate control in capital market financial systems also inhibit alliances and networks since ownership can change quickly in such markets, as can strategic choices and elite managerial personnel. For similar reasons to those mentioned above, an inability to rely on formal institutions for ensuring trust between firms limits the extent and stability of inter-firm networks since alliances are based on personal connections and risks are difficult to share in such societies.

Conversely, where: a) the state encourages regulation of markets, either directly or indirectly, b) banks and other financial intermediaries are locked-in to

firms' destinies, and, c) employers collaborate with the unions in managing the training system and with each other in centralised bargaining systems, firms will be encouraged to develop links with each other that are relatively wide-ranging and stable. All of these institutional features restrict the freedom of economic actors to change direction and act as short-term opportunists in terms of their immediate interests. They thus reduce the risks associated with making commitments to business partners, whether suppliers, customers, competitors or employees, and enhance the likelihood of benefits accruing from them.

Turning now to consider how institutional features are related to the ways that firms develop different kinds of capabilities, both authority sharing and the provision of organisational careers are likely to be limited to those with whom owners have strong personal relationships in societies where there is low trust in formal institutions and authority is justified in paternalistic terms. Building organisational capabilities around the contribution of most employees on a long term basis will be difficult in large firms, and highly focused on individuals' skills – as distinct from collective ones – in small ones in such circumstances. Coordinating and learning capabilities are accordingly likely to be restricted to a relatively small group of elite managers in these kinds of particularistic business environments.

Similarly, in societies dominated by strong developmentalist states, most risks and opportunities for leading companies arise from state actions and support and so firms are more likely to invest time and effort in meeting state demands and negotiating with officials than in investing in developing employee skills and commitment. When combined with paternalist ideologies justifying elite authority over subordinates, authority sharing within companies tends to be rather limited, and careers in the larger firms restricted to those demonstrating high levels of loyalty. The development of organisational capabilities will tend to be restricted to the senior managerial hierarchy in these kinds of situations, with little involvement by most employees.

Strong markets for corporate control are also likely to restrict authority sharing and organisational careers for most employees because changes in ownership and control are relatively easy in such economies. Managerial hierarchies may develop effective coordinating capabilities when market conditions allow firms to make credible commitments of organisational careers for managers, but pressures for continued high levels of investor returns from fund managers will limit these. On the other hand, highly liquid capital markets facilitate the rapid reallocation of resources and can provide venture capitalists with easy exit opportunities. In turn, this enables them to invest in a number of start-up enterprises on a portfolio basis, as well as supporting organisational restructurings.

Conversely, strong intermediaries, segmentation of product markets and communitarian patterns of authority all encourage greater levels of authority sharing, both internally and externally, and enable firms to offer relatively long term careers to many of their skilled workers. In turn, these facilitate the development of strong employer-employee commitment to the development of



firm-specific coordinating and learning capabilities, although not all firms necessarily manage to do so successfully.

Such commitments are further encouraged by effective public training systems and extensive collaboration between firms that restrict poaching of skilled workers and opportunistic free riding on others' investments. The combination of national and local state economic coordination of economic development, strong business associations and centralised bargaining in the more coordinated economies of many continental European countries and Japan has encouraged widespread involvement in the enhancement of firm-specific capabilities and knowledge (Soskice, 1999), while often limiting the ability of firms to undertake rapid and radical reconfigurations of their resources.

These relationships between institutional features and firm characteristics suggest how different kinds of firms are likely to be come established as leading companies in differently organised market economies. The five ideal types identified earlier will be encouraged by some of these features and discouraged by others, as summarised in table 4. In particular, opportunistic firms are most likely to be dominant in economies with low trust in formal institutions, where the state is predatory rather than developmental, and authority is primarily justified in paternalistic terms. They are less likely to be prevalent in societies where the financial system is largely autonomous from the state and operates according to its own, relatively impersonal and formal, rules, and the labour system is likewise governed by strong, separate institutions and federations.

#### **TABLE 4 ABOUT HERE**

Specialised network firms, in contrast, rely on more stable and reliable institutions to coordinate their activities through market contracting, and usually become established in cultures where authority is justified in contractarian or communitarian terms. They additionally tend to be significant economic actors in economies with relatively flexible labour markets and effective training systems that ensure both a supply of highly skilled workers and a means of matching skills to jobs. Given their specialist nature, such firms additionally need to be able to call upon a variety of complementary services and knowledge, whether these are primarily publicly or privately provided. Intermediary organisations and institutions that restrict predatory pricing and other means of large firm dominance are additionally important in establishing such firms.

Isolated hierarchies also rely on effective formal institutions governing economic relationships and limited state domination of the economy. In addition, though, they flourish where capital markets are firmly established and there are few restrictions on market entry and exit, including mergers and takeovers. Authority tends to be justified in terms of contractual relationships and skill formation is primarily a matter of individual initiative rather than being systematically coordinated through intermediary organisations. In general, they dominate in societies characterised by arm's length institutional environments that provide few constraints on short-term economic opportunism and relatively few collective competition goods.

Centralised hierarchies, in contrast, are most likely to be dominant where the state plays a strong developmental role and authority is largely paternalistic. The financial system is usually subservient to developmental goals and enables families to retain control of large and fast growing firms through cheap credit, often guaranteed by the state. The public training system tends to be weak in societies dominated by these kinds of companies, as are employer and employee unions.

Collaborative hierarchies, on the other hand, develop in much more coordinated institutional environments that combine communitarian patterns of authority with strong intermediary organisations, effective training systems and coordinated bargaining between powerful employer and labour groups. The financial system is less separate from the rest of the economy than in arm's length institutional systems, and capital markets are typically not supportive of hostile takeovers.

While these connections between institutions and dominant firm types have often been most apparent within nation states, especially in the post Second World War period dominated by the Bretton Woods system for managing international capital flows and exchange rates, they are by no means necessarily national in nature (Whitley, 2005). Rather, the national specificity of institutional regimes and dominant firms is an empirical matter and the homogeneity of the national institutional environments faced by firms varies between countries and over time. For example, many aspects of corporate governance, including the rights of shareholders, in the USA vary between states and changed over the course of the 19th and 20th centuries (see, e.g., O'Sullivan, 2000; Roy, 1997). Other institutions affecting labour markets and property rights can also differ between regions in ways that affect inter-firm relations and growth strategies, as Saxenian (1994) has emphasised in her contrast of Route 128 firms in Massachusetts and Silicon Valley. Additionally, institutional regimes vary in the extent to which they standardise many characteristics of leading companies. Arm's length regimes, for example, typically leave the organisation of employment relationships much more to the discretion of individual firms than do more corporatist ones (Soskice, 1999; Whitley, 2005).

### **The Effects of Increasing Internationalisation on Firm Characteristics**

Such varying homogeneity and complementarity of the dominant institutions governing economic activities in different countries mean that the governance and capabilities of leading companies can vary between regions and sectors, as well as changing over time. The growing internationalisation of many firms in the postwar period has additionally increased the heterogeneity of institutional environments that they have to deal with, and can weaken the influence of domestic institutions. By locating major facilities in quite differently organised market economies, some firms may be able to develop distinctive kinds of transnational competitive competences that are not tied to particular institutional environments (Bartlett and Ghoshal, 1989; Ghoshal and Westney, 1993). It is worthwhile, then, considering how the expansion of foreign direct investment

(FDI) since the 1950s can be expected to affect the key characteristics of different kinds of firms operating in different institutional contexts, and in particular whether it has enabled them to become significantly different kinds of companies.

It is first important to note that any effects of internationalisation on firm governance and capabilities are only likely to be significant when companies commit major resources and managerial attention to foreign locations, and are willing to adjust their domestically developed routines as a result of adapting to different environments. In general terms, multinational companies (MNCs) are most likely to become distinctive kinds of organisation when they locate major proportions of key assets and activities in quite different kinds of institutional regimes, allow foreign subsidiaries to adapt to local conventions, and "learn" from these novel developments by adapting and integrating them with routines and procedures used elsewhere in the organisation, especially in their domestic operations. It is through the organisational integration of different ways of doing things in different kinds of business environments that makes MNCs potentially significant different kinds of strategic economic actors.

However, MNCs vary in the extent to which they allow their foreign subsidiaries to adapt to local conventions and innovate in their procedures, products and services. Some, like Ford in England in the 1920s and 1930s, insist on their overseas units following domestic policies and practices (Tolliday, 2000), while others permit more diverse responses to different markets and patterns of economic organisation, and a few actively encourage subsidiaries to experiment with new approaches, as perhaps is the case with some German MNCs in the Americas and central Europe in recent years (Lane, 2001; Meardi and Toth, 2006). MNCs that simply export their domestic practices to foreign locations are unlikely to develop new knowledge and skills as a result of operating internationally, and therefore are more national companies with foreign operations (Yu, 1992) than transnational enterprises, whereas those that allow foreign units to innovate could do so. Such innovation is more likely to happen when subsidiaries are forced to adapt to quite different environments that have strongly established patterns of business behaviour reproduced through powerful and complementary institutions, as in postwar Japan.

Local innovations may not, though, lead to MNCs developing new kinds of transnational organisational capabilities if the parent company does not use them to change procedures and practices elsewhere. For such firms to become distinctive kinds of economic actors as a result of operating across national borders, they have to "learn from abroad" in the sense of incorporating novel ideas, skills and technologies from innovating subsidiaries in other parts of the organisation. If they simply allow such units to continue to adapt to their particular situation without integrating any new approaches into the rest of the company, MNCs will not develop distinctively new kinds of collective competences.

It follows from this characterisation of MNCs that only some of them are likely to develop distinctive kinds of transnational organisational capabilities (Whitley, 1998; 2001). Firm specific organisational capabilities take time to build and

usually involve relatively “low powered” incentives to encourage employees to work together to deal with technical and organisational problems and to contribute to the improvement of organisational knowledge. For a MNC to learn systematically from its operations in quite different environments in such a way that it generates novel transnational competences, it has to encourage its employees and business partners in those environments to become committed to developing and enhancing its cross national capabilities.

Developing such transnational commitment involves authority sharing with employees in different locations and some provision of organisational careers for those that contribute most to the development of MNC capabilities and knowledge. Since the willingness of owners and managers to share authority and offer organisational careers is strongly influenced by dominant institutions in each society, this means that MNCs with major facilities in different kinds of institutional regimes are likely to develop varying forms of authority sharing and careers in different locations. As a result, the kinds of collective capabilities they develop in different national subsidiaries can differ greatly, and may well conflict in their basic principles, as highlighted by Kristensen and Zeitlin (2001; 2005) in their study of APV.

The extent of transnational authority sharing and careers will also be affected by the nature and strength of the international institutions governing business behaviour and property rights across national boundaries. However, while transnational governance organisations have become more significant in recent years, few are powerful enough to override the wishes of major nation states, such as the USA, and most have less ability to determine their own policies, select senior personnel and sanction deviance than do national regulatory authorities (Braithwaite and Drahos 2000; Nicol and Bensedrine, 2003; Lehmkuhl, 2003). Furthermore, most of these have been concerned to establish common rules of the competitive game for cross border trade and investment, and so internationalise markets for most products and services (Braithwaite and Drahos, 2000; Majone, 2005).

Driven by the interests of outside investors, investment banks and multinational companies seeking large, liquid and transparent capital markets, this focus on transparent and formalised regulatory procedures exemplifies central features of outsider dominated financial markets and arm’s length capitalism (Laurence, 2001; Lutz, 2004; Tylecote and Conesa, 1999). Few, if any, international institutions encourage investment in cross-national employer-employee commitment on a long term basis. Constraints on both employer and employee opportunism are typically lower across national borders than within most OECD countries, and hence the extent and longevity of employee commitments to MNC corporate goals and success are likely to be less than those to national employers, especially amongst middle managers and professionals.

Pressures from international institutions, then, are unlikely to lead many MNCs to engage in the sorts of extensive authority sharing with, and long-term career commitments to, foreign employees that firms in collaborative market economies often develop with their domestic staff. As British employees of Japanese banks found out in the 1990s, the norm of long-term employment for

male Japanese staff did not apply to them (Sakai, 2000; Whitley et al., 2003). In general, then, the lack of strong international institutions encouraging long term loyalties between business partners suggests that the degree and scope of cross national authority sharing and organisational careers within MNCs will not be particularly high, and usually less than occurs in their home organisations.

There remain, however, considerable variations in patterns of authority sharing and career commitments across national borders. These result mostly from domestic and host economy institutional differences, as the large literature on Japanese and US MNCs illustrates (see, e.g., Beechler and Bird, 1999; Dunning, 1993; Ferner et al., 2006; Kogut and Parkinson, 1993; Tolliday, 2000). In particular, the circumstances in which companies became established and developed distinctive competences are likely to have substantial influence on when and how they internationalise their operations and manage foreign subsidiaries. As Kogut (1993: 137) has suggested: "Even as the firm internationalises, it remains imprinted by its early developmental history and domestic environment", especially how it learns and innovates (cf. Doremus et al., 1998).

We can explore how firms from different institutional regimes are likely to encourage varying degrees of employee commitment in foreign subsidiaries, and so their probable development of distinctive firm specific international organisational capabilities, by comparing the probable patterns of international authority sharing and careers of firms from the three ideal types of business regime distinguished above: particularistic, arm's length and collaborative. These expectations are summarised in table 4.

#### **TABLE 4 ABOUT HERE**

Beginning with firms based in particularistic institutional regimes, since owners in these kinds of market economies remain reluctant to share authority with employees in their domestic location because of unreliable formal institutions and an unpredictable political environment, they seem unlikely to trust foreign employees a great deal, and so delegate much discretion to them. The combination of a low trust home economy with weak transnational institutions is unlikely to encourage much authority sharing with foreign managers and staff.

Equally, the common restriction of long-term career opportunities to relatives and others with whom family-like relationships have been developed in these frameworks suggests that few firms will offer organisational careers to foreign employees. As a result, hardly any subsidiary staff are likely to become so committed to the parent company that they will invest their energies in improving firm specific knowledge and skills on a medium to long-term basis. This means that enterprises from such environments are unlikely to develop strong international organisational capabilities, as distinct from those based on predominantly individual relationships and qualities. In particular, systematic cross-national organisational learning seems likely to be rather restricted, and coordinating capabilities limited to those tied to personal relationships.

In contrast, owners of firms from market economies dominated by arm's length institutional regimes that share authority with, and develop organisational careers for, senior managers and some professional staff domestically could be expected to delegate rather more discretion to those in charge of foreign subsidiaries where formal institutions are considered reliable. They may also involve foreign managers and professional staff in cross national problem solving teams when their specialist expertise is highly valued. This is especially likely when dealing with complex problems that require knowledge of different business environments, as in many professional service companies such as those discussed by Morgan and Quack (2005).

Authority sharing with foreign professionals will here depend on the knowledge that managers of these MNCs have of their expertise and the reputation of national skill formation systems. Given the importance of technical knowledge and specialist skills in dealing with complex and uncertain tasks, domestic managers of MNCs are unlikely to share much authority with foreigners unless they are convinced that they are highly skilled and able to contribute to current problems. This will greatly facilitated by skills being standardised through professional associations that operate in similar ways in different countries, and so is more straightforward between arms' length economies that have flexible labour markets and similar institutional arrangements for developing high-level expertise.

In general, though, any such authority sharing by firms from arm's length economies is unlikely to extend much beyond professional staff and managers, given similar limitations at home and the lack of strong international institutions that might restrain employer and employee opportunism. While their subsidiaries located in economies with strong collaborative institutions may develop greater levels of authority sharing with skilled workers, this seems likely to be limited to local operations given the arms' length nature of the parent MNC's domestic business environment.

Similarly, few firms from these kinds of institutional frameworks are likely to make long-term career commitments to foreign employees, especially at the international level. Since commitments in general are short term in such economies, most employers will not feel able to offer cross-national organisational careers to more than a few senior foreign managers, nor would such offerings be viewed as highly credible. Again, where host economy institutions encourage high levels of employer-employee commitment and firms have to offer organisational careers to skilled staff in order to attract the most capable, MNCs may well enter into long term employer-employee commitments at the local level, as do many foreign firms in Japan, but such commitments are unlikely to be extended internationally.

Overall, then, we would not expect long-term commitment to building and improving cross-national problem solving capabilities and skills, as opposed to extending domestic ones, to be high in most foreign subsidiaries of MNCs from arm's length economies. Loyalty to the parent company and investment in the enhancement of its knowledge and capabilities will be no more extensive than

in its domestic operations, and so continuing organisational learning at the international level probably restricted to senior managerial levels.

Coordination capabilities across national boundaries may be quite strong in such companies where they have established integrated transnational managerial hierarchies and are able to provide credible organisational careers for their senior managers, as in, perhaps, some of the largest oil companies. However, their transnational learning capabilities are likely to be restricted to project teams and similarly short term collaborations, together with those developed through managerial transfers. As in more nationally specific companies, reconfigurational capabilities may be greater than in collaborative firms, but will be limited by strongly entrenched managerial routines and rules governing coordination practices.

Conversely, MNCs based in more collaborative home economies are embedded in a number of relatively long-term obligations with particular business partners, including skilled employees. However, few of the institutions leading to such commitments transcend national boundaries and so foreign employees are not as locked into the fate of MNCs from these kinds of societies as are many domestic ones. This means that both employer and employee opportunism is likely to be less constrained across borders than within such economies. As a result, long-term employee willingness to invest in enhancing the capabilities of the MNC will probably be lower in foreign subsidiaries than in the domestic organisation.

Furthermore, where such firms consider that their core capabilities are substantially derived from these long-term commitments and are highly specific to their home business environment, they will be reluctant to invest much in authority sharing with foreign staff. The more MNCs see their distinctive competences as being generated by their domestic organisation and its particular pattern of employment relations, the less they are likely to involve foreign staff from quite different environments in substantial international problem solving activities. This seems to be the case for many Japanese MNCs (see, e.g., Kopp, 1999; Pucik, 1999).

However, some companies from collaborative institutional frameworks have become more willing to delegate considerable discretion to foreign managers and professionals in some subsidiaries, and to involve them extensively in international problem solving teams as they seek to acquire new kinds of capabilities that their domestic business system appears unable to provide. In situations where the lock ins encouraged by home economy institutions are seen to be inhibiting radical innovation and limiting growth, such MNCs may deliberately use foreign subsidiaries to try novel practices with the different kinds of approaches and skills developed in societies with contrasting institutional frameworks, such as Japanese investments in UK and US biotechnology facilities (Kneller, 2003; Lam, 2003). Some German companies seem to have tried to do this in the 1990s, although such plans have not always been realised in practice, particularly in the car industry (Fleury and Salerno, 1998; Jurgens, 1998; Lane, 2001).

These points suggest that, while developing coordinating capabilities through managerial hierarchies may be quite feasible in these kinds of firms, ensuring systematic organisational learning will be more difficult, especially if it involves radical changes to domestic operations. Equally, while establishing major facilities abroad may increase organisational flexibility, and enable firms to develop novel kinds of routines and ways of working in their foreign subsidiaries, their domestic institutional environment will restrict their reconfigurational capabilities, at least in the short to medium term.

This analysis of the organisational capabilities of MNCs in the light of differences in their home economy institutional frameworks suggests a number of conclusions about their development of transnational competences. First, while many companies with major facilities in different countries may develop distinctive collective capabilities at the national and regional levels, by no means all of them do so internationally. Because of the relative weakness of international institutions governing employer and employee opportunism, belief in the superiority of domestically developed competences and variable nature of institutional frameworks across market economies, many companies are often reluctant to share authority with many foreign managers and professionals or to offer them long term organisational commitments. This means that their organisational capabilities as MNCs are little different from those of their domestic organisation, together perhaps with those generated separately by some subsidiaries. The coordination of economic activities in different countries does not, then, necessarily produce distinctive cross national collective capabilities, and so MNCs as such do not constitute a distinctive kind of company from the point of view of the competence based view of the firm.

Second, the variety of organisational capabilities in MNCs reflects the varied nature of institutional regimes across market economies, and the resultant differences in kinds of firms that develop in them. Arm's length institutional frameworks may, for example, encourage firms to develop the ability to manage varied kinds of businesses through managerial procedures and routines that do not involve the bulk of the workforce. This in turn leads MNCs from such backgrounds to extend these control and planning systems to operations in different countries, limiting any authority sharing and career commitments to senior managers. The kinds of international organisational capabilities that they develop are therefore likely to be quite similar to domestic ones.

Similarly, MNCs from collaborative institutional regimes that have developed strong organisational learning capabilities through considerable authority sharing with, and career commitments to, many domestic employees are likely to restrict such commitments to foreign staff because the institutions that constrained opportunism in the home economy are often missing in their societies. This is particularly probable when long-term careers in the domestic organisation are both highly firm specific and general across specialisms.

Additionally, the impact of host economy institutions governing skill formation and labour markets can affect the development of cross-national capabilities by varying in their standardisation and certification of practical expertise, as well as in their control over employer and employee opportunism. In general, the more



fluid are external labour markets in an economy, and the more standardised are skills through educational and/or professional development and certification, the more difficult it becomes to develop long term employee commitment at both national and international levels. While such institutional arrangements do facilitate employers' ability to hire and fire staff with varied kinds of skills, and so rapidly transform their knowledge and expertise base, they limit employees' willingness to invest in developing firm specific capabilities on a continuing basis.

This suggests, third, that cross-national problem solving and learning should be easier when skill boundaries, knowledge bases and organisational structures in different countries overlap. When they do, careers in both internal and external labour markets are likely to reward comparable kinds of technically specialised contributions, and externally certified skills are sufficiently standardised across labour markets to provide common languages for joint problem solving. Even when commitments to developing employer-specific knowledge and skills differ considerably between national subsidiaries, continuing communication and gaining the cooperation of specialists across border on a long term basis will be greatly facilitated by organisational career structures that reward expertise-based performance, as distinct from broader contributions to general organisational success. However, such specialist careers can, of course, inhibit cross-functional collaboration.

These kinds of expertise-based career structures are in turn encouraged by similar kinds of public skill formation and evaluation systems that generate social identities and loyalties around certified skills. For MNCs to develop distinctive cross-national learning capabilities that enable different kinds of knowledge production and problem solving to be transferred between subsidiaries - as opposed to the codified results of such activities - careers and commitments have to overlap across organisational subunits.

Overall, the more varied are subsidiaries' environments and their organisation of careers, especially the kinds of contributions and skills that they reward, the more difficult it is likely to be for MNCs to develop distinctive international learning capabilities, particularly for developing new knowledge that is not readily codified. Establishing a common cross national career structure for some middle managers and professionals will contribute to the generation of these kinds of capabilities, but this requires the MNC to be able to offer credible commitments over business cycles and national differences.

Fourth, the few MNCs that do develop strong coordinating and learning capabilities across borders through long term international employer-employee commitments are unlikely to be able to reconfigure their skills and competences radically to deal with rapidly changing circumstances. This is because of their dependence on current employees' skills and their establishment of transnational integrating routines. Building and maintaining long-term firm specific organisational capabilities at the international level usually involves considerable investments in cross national procedures, routines and competences. These are unlikely to encourage rapid and radical transformation

of key skills and technologies that would enable firms to move effectively into quite novel industries with discontinuous technological trajectories and markets.

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**TABLE 1****Ideal Types of Firms and their organisational capabilities****Type of Firm**

<b>Characteristics</b>	<b>Opportunistic</b>	<b>Specialised network</b>	<b>Isolated hierarchy</b>	<b>Centralised hierarchy</b>	<b>Collaborative hierarchy</b>
<b>Owner control type</b>	Direct	Direct/ Market	Market	Direct	Committed
<b>Employee constraint</b>	Low	Considerable	Limited to managers	Limited to top managers	Considerable
<b>Business partner constraint</b>	Low	Some in industrial districts	Limited	Limited	Considerable
<b>Degree of authority sharing</b>	Low	Considerable	Some	Limited	Considerable
<b>Scope of authority sharing</b>	Low	Considerable	Limited to managers	Limited	Considerable
<b>Longevity and scope of organisational careers</b>	Low	Low	Some for managers	Limited	Considerable
<b>Strength of co-ordinating capabilities</b>	Restricted to personal control	Restricted to specialised firms and limited in scope	Considerable	Considerable	High
<b>Strength of organisational learning capabilities</b>	Limited	Limited to teams	Limited to managers	Limited to top managers	Considerable
<b>Strength of reconfigurational capabilities</b>	High for entrepreneurs	Limited in industrial districts, high in professional networks	Considerable	Considerable	Limited

**TABLE 2**

**Institutional Features Affecting Firm Characteristics**

**Norms Governing Trust and Authority Relationships**

- a) Trust in formal institutions
- b) Paternalist/Contractarian/Communitarian justifications of authority

**State Structures and Policies**

- c) Dominance and directive role of the state
- d) State encouragement of intermediary organisations in developing and implementing economic policies
- e) State segmentation of markets

**Financial System**

- f) Size, liquidity and significance of capital markets and ease of mounting hostile takeovers

**Labour System**

- g) Effectiveness of public skill formation system
- h) Strength of employer and labour federations and their role in coordinating bargaining

**TABLE 3**

**Expected Connections between Institutional Features and Characteristics of Leading Firms**

**Characteristics of Leading Firms**

<b>Features of Dominant Institutions</b>	Prevalent Owner Control Type	Employee Constraint	Business Partner Constraint	Authority Sharing	Organisational Careers	Coordination Capabilities	Learning Capabilities	Reconfigurational Capabilities
Low Trust in Formal Institutions	Direct	Low	Low	Low	Low	Limited	Limited	Some
Paternalist Authority	Direct	Low	Limited	Limited	Limited	Some	Some	Varies
Communitarian Authority	Direct or Committed	Considerable	Varies	Considerable	Varies	High	High	Limited in short term
Dominant Development State	Direct	Limited	Low	Low	Limited	Varies	Limited	High
Strong State Encouragement of Intermediaries and Economic Co-ordination	Direct or Committed	Some	High	Considerable	Some	High	High	Limited in short term
Segmented Markets	Direct or Committed	Varies	Considerable	Some	Some	High	Considerable	Limited



Liquid Capital Markets and Strong Market for Corporate Control	Market	Limited	Low	Limited	Low	Varies	Limited	High
Effective Public Skill Formation System	Varies	Considerable	Varies	Some	Varies	Some	Some	Varies
Strong Employer and Labour Federations and centralised bargaining	Direct or Committed	High	Considerable	Considerable	Some	Some	Some	Limited

**TABLE 4**

**Institutional Features Associated with Different Ideal Types of Firms**

Institutional Features	Types of Firms				
	Opportunistic	Specialised network	Isolated hierarchy	Centralised hierarchy	Collaborative hierarchy
Low trust in Formal institutions	+	-	-	varies	-
Paternalist Authority	+	-	-	+	-
Communitarian Authority	-	some in industrial districts, low in professional networks	-	-	+
Dominant Developmental State	-	-	-	+	-
Encouragement of Intermediaries	-	+	-	-	+
Segmented markets	-	varies	-	varies	+
Strong market for Corporate control	-	varies	+	-	-
Effective public skill Formation system	-	+	-	-	+
Strong employer and Union Federations and Centralized bargaining	-	some in industrial districts, low elsewhere	-	-	+

**TABLE 5**

**International Authority Sharing and Careers in MNCs from Different  
Institutional Regimes**

Home Economy Institutional Regime

<b>International Authority Sharing and Organisational Careers</b>	<b>Particular- istic</b>	<b>Arm's Length</b>	<b>Collaborative</b>
Extent of Cross- border Authority Sharing	Low	Varies, but rarely extended beyond managers and experts with codified skills	Limited usually, but may be considerable when seeking specialist knowledge
Longevity and Scope of Cross- national Organisational Careers	Low	Varies, but long term career opportunities rarely extended beyond managers in most MNCs	Low