

**ORGANIZATIONAL TRANSFORMATION IN TRANSITION ECONOMIES:
RESOURCE-BASED AND ORGANIZATIONAL LEARNING PERSPECTIVES**

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ABSTRACT

The capitalist and socialist societies of the 20th century assigned firms different roles within their economic systems. Enterprises transforming from socialist to market economies thus face fundamental organizational restructuring. Many former state-owned firms in the transition economies of Central and Eastern Europe have failed at this task. These firms have pursued primarily defensive downsizing, rather than strategic restructuring, as a result of both internal and external constraints on restructuring strategies.

Building on the organizational learning and resource-based theories, we analyze strategies available to management in privatized, former state-owned enterprises in transition economies to restructure their organization. Both internal forces promoting or inhibiting the restructuring process, and external constraints arising in the transition context are examined. A model and testable propositions are developed that explain post-privatization performance. Implications of our research point to the ways in which firms should manage and develop their resource base to transform to competitive enterprises.

Since political transition in Central and Eastern Europe (henceforth CEE) began, the effectiveness and performance of former state-owned enterprises (SOEs) have been considered the chief forces driving the development of these transition economies (Frydman et al., 1998). Governments and international institutions, such as the International Monetary Fund (IMF) (IMF et al., 1991), predicted that organizational transformation would be completed by the end of the 1990s. However, this expectation has been largely unrealized (Stiglitz, 1999).

Policy makers focused on privatization as means to induce restructuring. Yet the change of ownership and the creation of appropriate governance structures are only a part of the privatization process (Uhlenbruck and De Castro, 1998). Internal changes in the organization are essential. The needed post-privatization restructuring has proved far more complex than anticipated (Blasi et al., 1997) and has rarely been effective in former SOEs in transition economies (Carlin and Aghion, 1996; Whitley and Czaban, 1998; Wright et al., 1998).

Recent research suggests several reasons for slow or inadequate transformation of privatized firms in transition economies. First, many former SOEs in transition economies are burdened with mediocre assets and managers who lack the skill, resources, and experience to manage firms in competitive market environments (Filatotchev et al., 1996; Nellis, 1999; Peng and Heath, 1996). Second, many firms in CEE lost their traditional markets because of new competition, vanished international trade relations, and reduced purchasing power (Linz and Krueger, 1998; Meyer, 1998a; Uhlenbruck, 1997; World Investment Report, 1995). Third, the legal and institutional framework and the factor markets necessary to support organizational transformation have been slow to develop (Swaan, 1997; Spicer et al., 2000). Fourth, the magnitude of the required change may exceed many managers' and employees' cognitive abilities (Newman, 2000). In light of these adverse conditions, this work analyses how these firms learn to shape their resources to enable them to grow and develop advantage in increasingly competitive markets.

There is evidence of substantial transformation and entrepreneurial activity in some privatized SOEs, along with more optimistic evaluations of the economic development in CEE (e.g., Fischer and Sahay, 2000). Especially, firms acquired by foreign, strategic investors tend to improve efficiency and performance because of the capital, technological resources, and management skills provided (Uhlenbruck and De Castro, 2000; World Investment Report, 1995).

Moreover, some firms privatized domestically have restructured and improved performance without the support of foreign investors (Djankov and Pohl, 1998; Johnson and Loveman 1996; Krueger, 1995; Newmann and Nollen, 1998). Case studies have identified privatized firms that prospered despite significant competition from global competitors entering now unprotected markets. These firms recognized the strategic threat of foreign competitors and developed competitive advantages based on knowledge of local markets and lower costs. Some formerly communist business leaders also have proven to be entrepreneurial and quick to learn from the foreign competition (Djankov and Pohl, 1998; Lyles and Salk, 1996; Peng, 2000). Thus, strategic transformation and adaptation of privatized firms in CEE seems possible, but in the majority of firms it is occurring much slower than expected (Stiglitz, 1999; Wright et al., 1998).

There is considerable research grounded in economic and financial theories reflecting the emphasis of reform in these countries based on intervention at the macro level while insufficiently considering organizational realities (Meyer, 2001; Newman, 2000; Zahra et al., 2000). Researchers and policy advisors have been preoccupied with privatization and the creation of suitable incentive systems. Yet, the past ten years have shown the limits of top-down transformation, as privatization and new systems of governance have not generated the expected results (Estrin and Wright, 1998, Nellis, 1999; Carlin, 2000). Recent research has shown that fundamental organizational change and deep restructuring of organizational resources has to occur before former SOEs in CEE can compete effectively in their home markets and abroad (Antal-Mokos, 1998; Newman, 2000).

In view of this state-of the art, we propose a theoretical perspective that departs from the dominant agency theory explanation. Based on organizational learning theory and the resource-based view of the firm, we develop a model that identifies variables critical to the transformation of firms, its resources and markets. The theory development focuses on the processes observed across transition economies. These may be complemented with country-specific variables for resource-endowment or institutional constraints in specific countries.

Organizational learning and the resource-based view are particularly relevant as they account for the history of a firm and address the process of adaptation to a dynamic environment in which competitive advantage has become critical for firm performance (Fey and Denison, 1999; Makadok, 2001; Spicer et al., 2000). These perspectives allow a focus on product and

factor markets, important because both are underdeveloped in CEE. The acquisition and development of resources becomes more important as competitive markets develop (Hoskisson et al., 2000). This theoretical discourse provides the basis for future empirical testing and implications for the management of privatized firms in transition economies.

We begin by examining the current literature on organizational transformation in CEE. Thereafter, resource-based and organizational learning theories are introduced as the basis for the subsequent model development. Following, we suggest a number of propositions regarding the relationship between key variables and firm performance. Finally, we present implications for research and management.

ORGANIZATIONAL TRANSFORMATION IN CENTRAL AND EASTERN EUROPE

There is little agreement regarding the changes required for former state-owned enterprises to survive in the post-transition economy (Linz and Krueger, 1998, p. 13). Restructuring primarily through downsizing of output, employees, energy use, and assets has been common in the past. Because of traditional overemployment at enterprises in socialist countries along with declining sales during the early transition years, the initial research focus was restructuring former SOEs primarily by reducing employment.

Based on an analysis of privatization cases, Carlin and Aghion (1996) concluded that firms have neither the capital nor the skills necessary for deep restructuring. Even in Hungary, where initial conditions allowed more entrepreneurial freedom than elsewhere in CEE, privatized firms have made few changes in products and markets served nor have they implemented the radical organizational changes necessary to be competitive (Whitley and Czaban, 1998). Also, Hungarian companies have rarely engaged in new product development or technology upgrades (Bonin and Abel, 1998). The World Bank (1996) concluded that most privatized firms in CEE have not moved beyond the early stages of transformation. Rather, former SOEs have implemented defensive downsizing in reaction to external change.

Despite discouraging reports for many privatized firms in CEE, case studies from across CEE suggest that some privatized firms have engaged in strategic restructuring and thereby developed competitive advantage and sustained positive performance despite international competition.

These case studies suggest that CEE local firms may be able to compete effectively without support from foreign investors. For example, soft-drink maker Pikra competes successfully with Coke and Pepsi on price and concentrates efforts in the eastern region of Russia (McKay, 1999). The firm originally learned the business as a bottler for Pepsi, but now is an independent competitor. Similarly, Raba, formerly a vertically integrated Hungarian truck manufacturer focused on those parts of its value chain where its technology was the most current (Dawar and Frost, 1999). In doing so, it achieved success by manufacturing and selling tractor axles even in international markets.

Djankov and Pohl (1998) examined 21 case studies from Slovakia and inferred that deep restructuring is possible even in the absence of foreign investors and government support, and with the same management. These firms attracted capital by selling unused assets, selling shares to outside investors, and reinvesting the capital in new technology. Also, new skills were learned via foreign partnerships. Krueger (1995) interviewed managers in 34 former SOEs in Russia and found that several firms improved cash flow by building their own distribution system and also implemented sophisticated long-term strategies. Frydman et al. (1998) examined over 300 current and former SOEs and found that privatized firms improved performance through entrepreneurial adaptation of products to new market opportunities more than continuing SOEs.

While the economics dominated research on privatization explains firm restructuring as an outcome of changes in governance, it provides few implications for the management of privatized firms. In particular, prior literature on privatization in transition economies does not examine the relationship between specific transformational efforts and performance. A notable exception is the work by Peng and Heath (1996). They developed a model of firm growth in transition economies relative to predictions made by Western research on growth as a strategic choice. Their model proposes boundary blurring between firms and institutions as a network-based growth strategy. We draw on their work in developing our model, in particular their description of a stylized SOE in a transition economy. Overall, prior work is largely descriptive and lacks theoretical models and normative propositions.

A MODEL OF POST-PRIVATIZATION RESOURCE DEVELOPMENT

Theoretical Foundations

Examples of successful transformation indicate that privatized firms in CEE can make strategic choices. We build on this fundamental insight in strategic management using theories of organizational learning and the resource-based view of the firm to explain transformation of privatized firms. In particular, the resource-based view provides insights on firm resources and capabilities, and their development and deployment to take advantage of market opportunities (Barney, 1986, 1991; Dierickx and Cool, 1989; Makadok, 2001; Wernerfelt, 1984). Organizational learning theory (Fiol and Lyles, 1985; Huber, 1991; March and Levitt, 1999) provides insights on how firms understand and evaluate their environment as well as how they develop capabilities to cope with the environment.

While the industrial organization paradigm focuses on industry characteristics to explain differences in firm performance, the resource-based view emphasizes performance differences based on firm heterogeneity. Firms vary in their resources and in the capabilities derived from those resources. Resources that are valuable, unique and difficult to imitate can provide the basis for firms' competitive advantages (Amit and Schoemaker, 1993; Peteraf, 1993). In turn, these competitive advantages allow firms to earn above normal returns (Barney, 1991). Firms employ both tangible resources (e.g., buildings, financial resources) and intangible resources (e.g., human capital, reputation) to develop and implement competitive strategies. However, intangible resources are more likely to produce a competitive advantage because they are often rare and socially complex, making them difficult to imitate (Black and Boal, 1994; Rao, 1994).

Work on organizational learning complements the resource-based view. Often, organizational learning is considered a requirement for effective development of firm resources (Eisenhardt and Martin, 2000; Mahoney, 1995; Penrose, 1959). A key aspect of organizational learning is knowledge acquisition, which includes drawing on existing knowledge within the firm, gaining understanding from experience or observation, and environmental scanning. Knowledge can be classified into articulable and tacit (Lane and Lubatkin, 1998). Articulable knowledge can be codified and more easily transferred (Liebeskind, 1996). Tacit knowledge, however, is not articulable and therefore cannot be easily transferred (Kogut and Zander, 1993; Teece et al., 1997). Tacit knowledge is often embedded in uncoded routines and in the firm's

social context. In fact, it is partially embedded in individuals' skills and in their collaborative working relationships (Nelson and Winter, 1982; Szulanski, 1996).

However, the learning firm also interprets new information and distributes and stores knowledge within the firm (information processing). A necessary condition to interpret and utilize new information is prior related knowledge (Cohen and Levinthal, 1990). Prior related knowledge contributes to a firm's absorptive capacity, which is the firm's ability to recognize valuable new knowledge, integrate it into the firm and use it productively (Lane and Lubatkin, 1998). Firms must have the appropriate absorptive capacity in order to select, acquire and integrate knowledge from other sources. Thus, in order to learn and capitalize upon knowledge, firms must develop an adequate absorptive capacity (Cohen and Levinthal, 1990).

Resources in the form of managers and other employees, knowledge, firm capabilities (processes/routines of the firm), and firm-specific assets provide the basis for firm performance, evolution, and sustainability (Peteraf, 1993). Of particular interest herein is the development of dynamic capabilities (Teece et al., 1997; Eisenhardt and Martin, 2000) that allow firms to create new resources and enable it to take advantage of new opportunities. Learning is required for dynamic capabilities. Hence, there is path dependence between existing and new resources of the firm (Prahalad and Hamel, 1990).

To sum, organizational learning and the resource-based view are interrelated because the former provides the basis for the firm to recognize and develop needed resources and capabilities. Organizational learning enhances intangible resources that in turn increase the possible strategies the firm can employ (Hitt et al., 1999a; Huber, 1991).

Model Development

Building on organizational learning and resource-based theories, we propose a model of the transformation of privatized firms in CEE (see Figure 1). We argue that effective restructuring necessitates a coherent package of complementary changes that build on existing strengths of the firm and the ability of organizations to learn and develop. Firms in transition economies face an environment characterized by major political and economic changes, an uncertain legal and institutional framework, and poorly developed factor and product markets. Newly privatized firms rarely have the power or ability to change their environments; thus being aware of and

adapting to these conditions is critical. In the following we focus on market conditions because of their direct effect on firms and because they typically incorporate changes in the other arenas of firms' external environments (Fahey and Narayanan, 1986; Porter, 1980).

Insert Figure 1 here

Firms in transition economies entered the market economy with a bundle of resources brought together to serve the needs of a central-planned economy. Resources were allocated partly through implementation of the central plan, and partly through unintended incentives created by the plan regime.¹ The typical state-owned firm had excess employment (no incentives to economize on labor costs), excess inventories (lack of accounting for capital costs), dated physical equipment, extensive social services, and an uncompetitive product portfolio, especially for consumer goods (lack of market pressures) (Kornai, 1980). Firms were highly integrated both vertically (due to high transaction costs of inter-firm relations, coordinated through central ministries) and horizontally (due to the focus on economies-of-scale of socialist industrialization policy) (Meyer, 1998b; Peng and Heath, 1996).

Most managers had strong technical skills, based on generally high standards of education in sciences and technical professions. Beyond this, relationships with political authorities, notably the communist party and the central plan authorities, were used to help the firm to obtain resource allocations and achieve its plan targets (Ledeneva, 1999). Moreover, the existing socialism required firms to engage in informal, sometimes semi-legal, interactions with each other to overcome shortages. Managers thus developed considerable political networking skills, which continue to be valuable (Peng, 2001), but lack experience in managing in a market environment (Fey and Björkman, 2001; Lawrence and Vlachoutsicos, 1990; Pearce, 1991; Puffer et al., 1994).

This bundle of resources, while contributing to survival under socialism, is profoundly different from the requirements for effectiveness in a market economy. Firms thus have to reconfigure their resources dramatically and learn to operate successfully in the new context. Because the firm may not have appropriate resources to adapt to the changed context and take advantage of new opportunities, and because factor inputs, including management and capital,

are difficult to obtain, the firm has to expend significant effort in acquiring or developing new resources, including financial resources. With shrinking product markets and the end of soft budget constraints (Kornai, 1992), privatized firms in CEE often have very small financial reserves (Wright et al., 1998).

Resource acquisition includes various means of gaining access to resources in addition to purchasing resources or hiring human resources. The lack of funds may force a firm to find ways to utilize scarce resources, possibly without actual ownership, a strategy considered important for resource poor, entrepreneurial firms in developed markets as well (Timmons, 1994). Resource upgrades refer to general improvements of existing resources of the firm, through such means as employee training.

The high degree of vertical and horizontal integration and excessive physical resources in CEE privatized firms also suggest that firms may divest parts of their business. Divesting assets may produce financial resources needed to acquire other resources. Even with adequate financial resources, firms also must upgrade their existing capabilities with particular emphasis on their human capital.

Existing and new resources need to be integrated to achieve internal consistency between the firm's resources and strategy, and to allow the firm to flexibly react to changes in the environment and to take advantage of specific market opportunities (Hitt et al., 1999b; Milgrom and Roberts, 1995; Teece et al., 1997). Milgrom and Roberts (1990) argue that as firms establish modern manufacturing methods, strategic, organizational and marketing variables have to be adapted as well for the firm to be fully efficient (c.f., Parthasarthy and Sethi, 1993). For instance, if the former SOE modernizes technology, its traditional organizational systems may be incapable of taking advantage of technology that works best with very different, flexible work arrangements. Privatized firms in CEE often need to make substantial organizational changes in order to adapt to significant environmental change, thereby potentially reducing the coherence between multiple resources and systems within the organization (Siggelkow, 2001). That is, the internal consistency of firms is threatened by deep organizational transformation.

In addition, the continuously changing market conditions in transition economies (Newman and Nollen, 1998) require the development of strategic flexibility (Harrigan, 1985). Strategic flexibility has been defined as "an expedient capability to manage capricious settings" (Evans,

1991, p. 69) or as "the capability of the firm to proact or respond quickly to changing competitive conditions and thereby develop and/or maintain competitive advantage" (Hitt et al., 1998, p. 9). Strategic flexibility becomes necessary in dynamic environments and can substantially affect firm performance (Lee and Hitt, 2000). Sources of strategic flexibility include resource flexibility, i.e., the identification and acquisition of resources (e.g., through organizational learning) that increase the range of strategic options, and versatility in coordinating the use of resources (Sanchez, 1995). Ultimately, however, strategic flexibility rests in the mental agility of top management (Harrigan, 1985; Hitt et al., 1998; Lee and Hitt, 2000).

Before 1989, firms in CEE enjoyed relative stability in their external environment through five-year plans, severely limited competition, and consistent distribution channels and in their internal organizational structure because of rare technological innovations, long-term employment, etc. Hence, strategic flexibility was not critical for success. The notion of flexibility and associated concepts, such as continuous improvement and adjustment to volatile market forces, were unfamiliar (e.g., Obloj and Thomas, 1996; Meyer and Møller, 1998). We assert that, therefore, the change of organizational resources to achieve strategic flexibility has been one of the most difficult, yet most critical tasks in distinguishing the successful from the unsuccessful firms in the CEE. Supporting this assertion is recent empirical research in Russia which found that firms' flexibility traits were the most useful dimensions of organizational culture for predicting overall firm performance (Fey and Denison, 1999). The creation of strategic flexibility is critical to successful firm transformation, as is the creation of internal consistency between the historical resources of the former SOE, newly developed or acquired resources, and organizational systems.

RESOURCE RECONFIGURATION

For the socialist SOE, the central plan and bureaucratic control basically dictated procurement, distribution relationships, and the product line (Ericson, 1991; Kornai, 1992; Lawrence and Vlachoutsicos, 1990; Peng and Heath, 1996). After privatization and economic reform, these firms have had to search markets for information on which products are in demand and decide which products (demand) they are best able to fulfill (Swaan, 1997). The best opportunities are those for which the firm has or can develop the resources to create value for the

customer that is superior to the competition (Barney, 1991). Obviously, to produce and market products, firms must have the appropriate resources (Wernerfelt, 1984). They are unlikely to possess all resources needed to produce products that can take advantage of new market opportunities. Thus, the privatized firms must reconfigure their resources by divesting inappropriate ones, acquiring complementary ones, upgrading existing ones, and integrating all of them (Figure 1). This section focuses on divestment and acquisition of resources by privatized SOEs.

SOEs in CEE traditionally provided a number of services unrelated to their main business functions. The central plan regime made firm-to-firm exchanges difficult as communication occurred only through the plan authorities, or transactions were through informal (if not illegal) channels. Consequently, transaction costs of inter-firm coordination were high and led to increased vertical integration. Simultaneously, the central plan emphasized optimizing economies of scale and did not acknowledge beneficial effects of multiple firms competing with each other. Thus, SOEs typically had a high degree of both horizontal and vertical integration, compared to firms in the same industry in mature market economies (Berliner 1957, Kornai 1980). A high degree of integration inhibits strategic flexibility.

Moreover, firms were not liable to pay for the capital costs of inventories, which led to hoarding of physical assets and slack in resources that are less valuable for competing in open markets (Kornai, 1980; Meyer, 1998b; Peng and Heath, 1996). Privatized firms in competitive markets, now subject to greater budget constraints, may sell off the slack resources to obtain needed resources from factor markets and/or upgrade existing resources, thus mustering some strategic flexibility (Djankov and Pohl, 1998). Selling these assets generates funds for reinvestment in other resources to take advantage of market opportunities. Whitley and Czaban (1998) found that few restructuring Hungarian firms sold off core units but most closed or sold auxiliary units. Lízal, Singer and Svejnar (2001) found that the break up of large SOEs in Czechoslovakia resulted in improved financial performance of the successor firms. Hence we propose:

Proposition 1 The divestment of resources through the sale or closure of business units by diversified and vertically integrated firms created under central planning

results in improved internal consistency, strategic flexibility, and higher performance.

A reduction of products and services offered allows privatized firms to focus on core competences rather than continuing to provide for a larger community as previously required by state agencies (Frydman et al., 1998). Thus, strategic reduction of the product portfolio and vertical integration, through spin-offs or closure, allows for deeper organizational transformation than general, operational downsizing (Ericson, 1998; Ernst et al., 1996). Cutting product lines may enhance internal consistency because fewer product strategies and associated resources need to be aligned. Reduction of specialized assets also can add to strategic flexibility (Aaker & Mascarenhas, 1984). In addition, streamlining the organization may attract investors and thus financial resources. For firms in developed markets, an alternative route to asset divestment may be the utilization of excess capacity by expanding production (Penrose, 1959). However, in transition economies, shrinking markets, limited market access, and/or new competitors with often higher-quality products at lower prices significantly reduce the privatized firm's ability to sell its full range of products at efficient capacity utilization rates. Thus, divesting excess resources selectively and using the returns to improve the current resource bundle is an effective strategy.

Proposition 2 Resource divestment outside the privatized SOE's core business, rather than general downsizing, facilitates the development of coherent core competences and produces internal consistency, strategic flexibility, and higher performance.

All firms have specific resource endowments (Barney, 1991), but often need further resources to be competitive (Hitt et al., 1999b). The need for more resources is particularly acute in newly privatized firms from CEE. Newly privatized firms from CEE generally have critical needs for financial capital and for technical and managerial capabilities. The newly privatized firms from CEE find it difficult to compete in product technologies with firms from developed market countries. Often, they do not have the capabilities to effectively develop and offer new

and sophisticated products in sufficient quantity and quality to be competitive with firms from other countries. Therefore, these firms must be particularly resourceful to compete with foreign entrants (Peng, 2000).

An efficient way for firms to leverage their resources is to invest in complementary assets (Barney, 1988; Hamel and Prahalad, 1994; Hitt et al., 1999b). Investment in new resources increases strategic flexibility (Aaker and Mascarenhas, 1984). For firms in transition economies this may include investments in marketing assets to improve market access, in production facilities, training, etc. to improve the price/quality relationship of products, or in new product development.

While the resource-based view makes no direct suggestion on which of these possible areas a firm should focus, investments in resources that facilitate a more efficient utilization of existing resources, thus advancing strategic flexibility, should be favored. For example, assuming a firm produces a marketable product, but does not have an adequate distribution network, distribution improvements—and associated sales growth—will increase utilization of the existing productive capacity. In a comparative study, Kogut and Zander (2000) found that socialism does not necessarily reduce technical capabilities of firms, but their separation from the customer severely impedes their ability to adapt to market needs. Investments in marketing may thus be critical for the performance of the privatized firm (Hooley et al., 1996).

Measured changes in the privatized firm provide the opportunity for learning and subsequent adaptation. Rigidities of organizational routines (Nelson and Winter, 1982) may limit the firm's ability to develop new capabilities in business activities that differ significantly from existing activities. However, improved market access allows the firm to learn from customers (Kogut and Zander, 2000; Krueger, 1995) and thereby improve existing products. Expanded sales from improved products in turn can enhance the organization's capacity to learn and thus its ability to expand further. ²

Former SOEs that historically were deeply embedded in the socialist central planning system face stronger impediments to development (Newman, 2000; Spicer et al., 2000). For example, firms that were primary providers of military equipment have to cope with a largely disappearing market. They may however control technologies with application in civilian markets. For them, new product development is a necessity to have markets and thus precedes market penetration.

Hence, the acquisition of both managerial and technological resources is important in enterprise transformation. Yet, due to the new demands of managing in a newly competitive market, the acquisition of new managerial and marketing capabilities is essential for privatized SOEs.

Proposition 3 Privatized SOEs strengthen their strategic flexibility and improve performance by acquiring resources that complement the current resource bundle of the firm. In particular, the acquisition of complementary managerial and marketing resources is a necessary condition to achieve sustained higher strategic flexibility and performance.

ORGANIZATIONAL LEARNING

The learning requirements for privatized SOEs in CEE are daunting. Before transition, organizations existed as production units within the central plan and now become economic agents as buyers and sellers in a market environment (Meyer, 1998b). To be able to adapt to the new market conditions, firms have to recognize the changes and understand the impact these changes are likely to have on the firm (Andrews, 1980; Keats and Hitt, 1988). The environmental changes result in new conditions to which the firm has to react in new and different ways, thereby requiring learning.

There are three particular challenges to learning that distinguish privatized firms in CEE from western firms. First, the disappearing traditional product "markets" make the identification of new market opportunities (product demand) critical. Second, factor markets are generally limited, and thus make it difficult to identify external sources for the resources needed (Peng and Heath, 1996). Finally, the socialist experience provided little prior knowledge that allows firms to adequately identify the optimal opportunities to pursue, and where to obtain needed resources to exploit these opportunities (Swaan, 1997). That is, insufficient absorptive capacity may hinder critical learning processes at the firm (Cohen and Levinthal, 1990; Fiol, 1996).

Knowledge Acquisition Strategy

The economic and social instability in CEE produces ambiguity and uncertainty regarding the rules of exchange. Thus, rules are largely emergent (North, 1990; Pedersen and Thomsen, 1997). The ambiguity and uncertainty make the environment difficult to analyze. Yet, firms can enhance their knowledge about new situations by actively and systematically searching for information (Fiol and Lyles, 1985; Huber, 1991). Knowledge about markets allows firms to adapt more effectively to their environments. It increases a firm's strategic flexibility because such knowledge alerts the firm of emerging opportunities in product markets and is necessary for efficient "picking" of resources from factor markets (Makadok, 2001) to take advantage of these opportunities. In support of this argument, systematic knowledge acquisition has been linked to improved performance (Daft et al., 1988; Hambrick, 1982).

Before privatization, however, SOEs' primary sources of information were state agencies, thus, typical environmental scanning processes are largely absent. Only recently have former SOEs begun to actively pursue knowledge about their market environments (Djankov and Pohl, 1998; May et al., 2000). And, changing market conditions increase the need for knowledge acquisition. To take advantage of market opportunities, privatized firms must be aware of the current status and trends in transforming product and factor markets.

Key tools for acquiring knowledge are environmental scanning and participating in networks and alliances (Huber, 1991; March and Levitt, 1999). Networks are particularly important for firms in transition economies (Child and Markoczy, 1993; Peng and Heath, 1996; Stark, 1996) but they also may inhibit change. 'Old-boy' networks between former SOEs may undermine effective transformation if they reinforce non-market interaction and barter trade (Ericson, 1998). Also, such networks provide significant opportunity for negotiating continuing subsidies and protection, collusion, or other unethical transactions, all of which reduce firm efficiency and transformation of the organization's culture (Hoskisson et al., 2000; Woodruff, 1999).

Alternatively, new or reorganized network relationships may be avenues for firm growth (Peng and Heath 1996), and can facilitate learning how to operate in a market-based economy. Especially producers of intermediate goods have to integrate into international production systems and build long-term relationships with major multinational customers (Meyer, 2000).

Alliances can facilitate organizational learning, particularly if clear and targeted goals are established. This includes alliances with suppliers (e.g., to overcome problems of factor markets) and with customers (to learn about opportunities, marketing needs, and innovation) (Lyles and Salk, 1996). Strategic alliances provide interactive opportunities to learn from the experiences of the partner (Hitt et al., 2000; March and Levitt, 1999). Privatized firms from CEE are likely to learn the most from foreign partners, especially if those firms come from a developed country. Alliances allow a firm to build its resource endowment and to get close enough to partners to understand even tacit components of their capabilities (Lane and Lubatkin, 1998). In addition, firms may also learn via observation from and imitation of successful foreign competitors (Dacin et al., 1997). This learning, particularly of tacit knowledge, may contribute to a competitive advantage or at least competitive parity for CEE firms.

Generally, there are several means for firms to acquire tacit knowledge in addition to alliances, for instance via mergers with other firms or by hiring employees with this knowledge (human capital) (Bresman et al., 1999; Hitt et al., 2001). However, firms in CEE encounter factor and capital markets more limited than in developed countries. Thus, the needed human capital may not be available in CEE and firms may not have the financial resources to acquire organizations with the required knowledge. This makes alliances a critical, and maybe the primary, strategy for acquiring tacit knowledge for firms in transition economies.

Proposition 4 Active knowledge acquisition strategies (for product and factor markets) are positively related to strategic flexibility and firm performance.

Proposition 5a Alliances can be a particularly effective knowledge acquisition strategy in achieving specific learning outcomes.

Proposition 5b Establishing alliances as a strategy for acquiring tacit knowledge is more important for firms in transition economies than for firms from developed countries.

Organizational learning theorists distinguish between observational and experimental learning. The former refers to "vicarious" learning, i.e. the second-hand acquisition of new behaviors or knowledge structures as a consequence of observing others (Bandura, 1977; Weiss,

1990). The latter describes first-hand knowledge acquisition from direct experience (Huber, 1991; Weiss, 1990). Knowledge acquisition from alliance partners or environmental scanning leads to observational learning, encouraging imitation (Huber, 1991). Imitative processes may be of particular importance in early stages of transformation and improve the former SOE's ability to appropriate returns from its existing resources (Zahra et al., 2000). Also, observational learning is often more efficient than experimental learning because it reduces errors typical in experimentation (Bandura, 1977). Nevertheless, observational learning often fails in turbulent environments such as transition economies, because they require adaptation of newly gained know how to new conditions requiring complete understanding (Huber, 1991; Van de Ven and Polley, 1992). Firms may protect some know how from their alliance partners (Zahra et al., 2000), reducing the ability to achieve complete understanding from observational learning. Likewise, causal ambiguity reduces the effectiveness of observation (Lippman and Rumelt, 1982). Tacit knowledge is difficult and often impossible to obtain via observation. Thus, privatized firms cannot rely on imitation alone, but must also invest in experimental learning to produce internal innovation (Kim, 1997; Zahra et al., 2000). Experimentation can be useful to develop new behaviors that are in accordance with existing cultural values, resources, and routines (Kogut and Zander, 1996; Kogut, 1996). Thus, for the most complete learning, firms must use both observational and experimental forms.

Proposition 6 Privatized SOEs in CEE actively engaged in both observational and experimental learning perform better than those engaged in only one of these forms of learning.

Capacity for Learning

The learning process has to engage the whole organization. For the firm to utilize acquired knowledge and identify its market opportunities, it needs to process the information gained from alliance partners, from scanning, and other means of data gathering (Huber, 1991). That is, an organization has to diffuse information within the organization and interpret it, i.e. give it meaning (Daft and Weick, 1984). Organizations, however, interpret information based on prior knowledge or frame of reference (Cohen and Levinthal, 1990). Herein is a particular challenge for privatized firms in CEE because their frame of reference is a fairly stable planned economy

rather than turbulent markets. Furthermore, their prior knowledge is not similar in form or content to that which is required to compete in open markets.

The capacity of organizations to absorb knowledge and to process information depends not only on individual managerial learning. Rather, organizations form a context for individuals thereby governing their ability to augment and create knowledge (Nonaka and Takeuchi, 1995). A firm's absorptive capacity is a function of the organization's characteristics, notably its structure and combinative capabilities (Van den Bosch et al., 1999). For example, firms with effective horizontal coordination mechanisms embedded in their structure are more likely to learn and diffuse knowledge. These factors also affect internal consistency and strategic flexibility (Das and Elango, 1995). Research on Hungarian firms has shown that they improved their capacity to learn if organizational flexibility was promoted (Lyles and Salk, 1996). That is, organizations improved their ability to process acquired knowledge when collaboration and exchange of information within the organization was encouraged, employees were given greater latitude to alter activity patterns, and processes were adapted to changing needs and conditions.

Proposition 7 Privatized SOEs' capacity to process acquired knowledge is positively related to internal consistency, strategic flexibility, and firm performance. A firm's capacity to process acquired knowledge increases with the flexibility of its organizational structure.

MANAGERS AS A RESOURCE

Managers with experience only in former SOEs operating in planned economies are unlikely to be effective managing a market-oriented organization in transition. Inadequate managerial skills limit the development of resources in privatized SOEs in CEE (Zahra et al., 2000). Effective management is salient for firms to develop new resources and increase their strategic flexibility (Hitt et al., 1998; Penrose, 1959; Teece et al., 1997). Integration of new and old resources to exploit market opportunities requires general management skills, but general management skills in CEE firms are limited (Pearce, 1991; Puffer et al., 1994).

Managers in transition economies have to upgrade their knowledge and capabilities far more than provided by conventional management training. While training programs can help managers

build their explicit knowledge, they do little to develop the tacit knowledge needed by managers (Hitt et al., 2001). Consequently, Child (1993) and Villinger (1996) distinguish three levels of managerial learning necessary in CEE organisations. At the *technical* level, new and specific techniques have to be acquired such as methods for quality measurement, scientific and engineering techniques or the construction of samples for market research (largely explicit knowledge). At the *systemic* level, new systems and procedures have to be adopted, which requires integrative learning emphasising coordination, relationships and linkages (combination of explicit and tacit knowledge). At the *strategic* level, senior managers have to change their cognitive framework for doing business and completing management tasks. They need to reassess their criteria for business success and factors contributing to it, which requires a deep understanding of the technological and managerial processes to engage in innovation, select and adapt technology, and make strategic decisions (some explicit but largely tacit knowledge).

The integrated capabilities of management resources are of interest. We thus focus on top management teams as organizational resources because of their collective, and often complementary, skills and capabilities (Castanias and Helfat, 1991). The knowledge embedded in the management team determines the firm's ability to leverage and exploit its other resources (Mahoney, 1995; Penrose, 1959).

Research has shown that management teams are more able and willing to change the strategic orientation of a firm in a turbulent environment when those teams are more heterogeneous. Heterogeneity refers to different educational background, age, industry experience, tenure, etc. of the top management team members (Lant et al., 1992; Wiersema and Bantel, 1992). Different experiences and backgrounds help the firm to unlearn previous behaviors no longer functional and attempt different approaches to facilitate the firm's adaptation to new conditions. Managers with longer tenure in the firm and who know its culture are better able to understand and preserve traditional firm strengths. New practices have to build on existing value systems, preserving selectively the most valuable parts. However, experimentation is necessary to discover new best practices for transition economies (Kogut, 1996; Spicer et al., 2000). New managers with a background different from current management can introduce new approaches, recognize different relationships between the firm and its environment, and are more likely to be open to change (Finkelstein and Hambrick, 1996).

Team heterogeneity has costs, however. Research indicates that top management team heterogeneity increases coordination costs and creates other process difficulties, such as slowed decision making (Pfeffer, 1983). Unstable environments enlarge the information-processing demands on top management teams (Daft et al., 1988). Heterogeneous management teams are better able to handle these demands because they can absorb more information, and consider problems and solutions from multiple perspectives (Finkelstein and Hambrick, 1996). Thus, top management team heterogeneity compensates for its disadvantages in transition economies because it increases strategic flexibility of the firm (Lee and Hitt, 2001).

A second requirement for change is for the collective involvement of the management team members in decision making (Thomas and McDaniel, 1990), though team heterogeneity may impede interaction (Finkelstein and Hambrick, 1996; Murray, 1989). Sharing varied experiences and prior learning between top managers can be an important source of knowledge creation in organizations (Lyles and Schwenk, 1992; Prahalad and Bettis, 1986). Top management interaction also supports coordination of decisions, leading to improved consistency of organizational actions. Furthermore, the involvement of the top management team in strategic decision making allows the firm to better keep pace with change and fast decision making is linked with high performance (Eisenhardt, 1989).

Considering the need for change at privatized firms in transition economies and the daunting managerial tasks, the research conclusions reported above provide insights to the management of former SOEs. A heterogeneous, interactive management team likely has higher absorptive capacity because of the broader set of experiences on which it can draw to recognize, interpret, and internalize new knowledge. Heterogeneous top management teams should provide stronger capabilities to develop, integrate and apply new knowledge and resources while simultaneously preserving traditional resources and values.

Proposition 8 Management effectiveness is enhanced by the heterogeneity of the top management team, leading to greater transformation of the privatized firm and improved strategic flexibility and performance.

Proposition 9 *Given heterogeneity of the top management team, management effectiveness is enhanced by the degree of participation and interaction within the management team.*

IMPLICATIONS FOR FUTURE RESEARCH

The resource-based view and organizational learning theories provide an alternative perspective on enterprise restructuring in CEE. In applying these theories, we derive different implications for management than prior research on organizational transformation in CEE that has largely based on governance theories. While these are important, the present work develops a model explaining how firms in transition economies might learn and adapt their traditional resources to the new conditions. The propositions derived from the theoretical integration describe organizational transformation within specific internal and external constraints of privatized SOEs in CEE. The framework presented provides new insights on the transformational processes in transition economies through a window into the strategic management of CEE firms and helps in understanding why some firms have been able to develop into successful competitors despite their conditions. Also, this perspective identifies specific problems in the transformation of former SOEs, such as a limited absorptive capacity, and presents potential remedies.

One purpose of this work is to encourage further theoretical and empirical research. The propositions provided may be extended, for instance, to structures and systems of privatized firms as part of organizational transformation. Organizational structure is an important determinant of firms' learning capacity (Lyles and Salk, 1996) and must be adapted to optimize the returns to investments in new resources and capabilities. Further, research on human resource management could focus on organizational process issues regarding gatekeepers who facilitate CEE firms' internalization of new knowledge (Kogut and Zander, 1992).

Future research should identify the most effective composition of the top management team. For instance, acquirers of former SOEs sometimes have selected the general manager from within the new subsidiary because of his/her relationship to the employees, or replaced him/her with an executive from the acquirer to facilitate better communication with headquarters (McDonald, 1993). Research is needed to understand which approach is the most effective over

time. Moreover, future research should compare theoretically and empirically the transformation processes in CEE and China where changes in the business environment have been more gradual.

Empirical testing of the proposed model provides a further challenge. While sufficient measures have been developed to examine the constructs addressed herein, they typically have not been used in transition economies (for exceptions see e.g., Lyles and Salk, 1996; Luo and Peng, 1999). The environment in transition economies may require use of alternative variables. For instance, a traditional outcome variable in the strategic management literature is organizational growth (Ansoff, 1957; Peng and Heath, 1996; Penrose, 1959). However, privatized firms in CEE often have to become smaller before growth is possible. Also, survival may be more important than growth, particularly considering the overall decline of the transition economies in CEE. Moreover, initially divestment may be more important than efforts to grow the firm. Therefore, the appropriate outcome variable is the firm's financial performance to indicate optimal use of resources (Peteraf, 1993). Research, such as that by Frydman et al. (1998, 1999) has shown how financial performance of CEE firms can be measured reliably.

While there are examples of improved competitiveness and performance of privatized SOEs in transition economies, there are also conditions that impede transformation (Newman, 2000; Spicer et al, 2000). For instance, Peng (2000) suggests that larger privatized firms face special challenges in restructuring. Moreover, external conditions can have additional effects on firms separate from those on internal structure and capabilities. External shocks, such as the 1998 financial crisis in Russia, may bankrupt a firm even with an appropriate internal design and high strategic flexibility.

CONCLUSION

The recent recognition that the transformation of privatized firms in CEE to become more competitive is progressing much slower than expected has served as a catalyst to shift research from governance to managerial issues. Slow progress of transformation is due largely to ineffective resource development and deployment and organizational learning. This is in part due to the incremental nature of these processes. Yet we assert that resource-related processes are

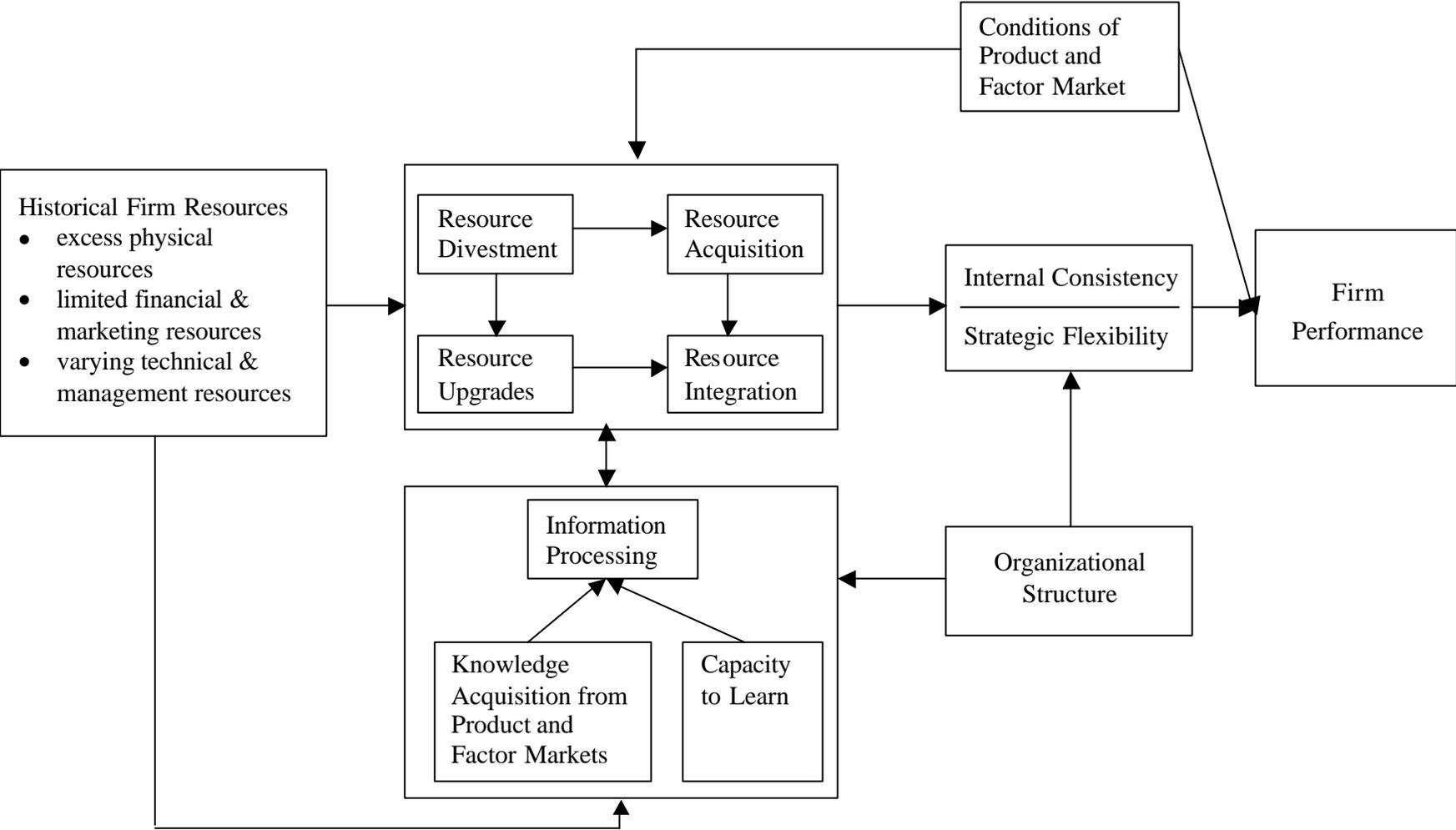
insufficiently understood. Better management of these processes can greatly enhance the transformation and eventual performance of former socialist firms.

Based on current management theory, we provide more specific recommendations on how managers of privatized firms may better manage their resources. In particular, firms may improve their learning ability by actively searching for information in product and factor markets rather than relying on questionable information provided by traditional networks (May et al., 2000). Also, firms need to adapt organizational structure and processes to allow for more efficient information processing. Such changes should help firms to identify market opportunities and resources needed to exploit those opportunities. Nevertheless, these firms have built resource stocks in tangible assets, know-how and organizational processes. But, there may be potential for further development of these resources (Spicer et al., 2000). Managers need to invest significant effort to integrate resources to achieve the internal consistency and strategic flexibility necessary to take advantage of recognized opportunities. The proposed model provides the opportunity for empirical research to identify the generality of important theories under extraordinary conditions.

¹ The real existing socialism differed to a degree in the ways the central plan regime was implemented. In particular Hungarian firms had more managerial discretion (e.g. Kornai, 1968), which facilitated the development of managerial capabilities.

² The above argument matches Ansoff's (1957) suggestion that firms grow first via market penetration and later via new product development.

Figure 1: A Model of Resource Development of Privatized Firms in Transition Economies



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