ORGANIZATIONAL TRANSFORMATION IN TRANSITIONAL 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 themselves from socialist to market economies thus face fundamental organizational restructuring. Many former state-owned firms in the transitional economies of Central and Eastern Europe failed, so far, at this task. Firms pursued primarily defensive downsizing, rather than forward-looking 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 transitional economies to restructure their organization. Both internal forces promoting or inhibiting the restructuring process, and external constraints arising in the transition context are taken into account. 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 themselves to competitive enterprises.

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Since political transition in Central and Eastern Europe (henceforth CEE) began, the effectiveness and performance of former state-owned enterprises (SOEs) has been considered one of the chief forces driving the development of these transitional economies (Frydman et al., 1998). Governments and international institutions, such as the 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 (Pucik, 1999; Stiglitz, 1999).

Policy makers focussed on privatization as means to induce restructuring. Yet the change of ownership and the creation of appropriate governance structures is only a part of the privatization process. 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 transitional economies (Carlin and Aghion, 1996; Whitley and Czaban, 1998; Wright et al., 1998). Privatization may have produced the necessary organizational restructuring in developed nations (Bishop et al., 1994; Megginson et al., 1994), but it often has not occurred as expected in transitional economies.

Recent research suggests several reasons for slow or inadequate transformation of privatized firms. First, many former SOEs in transitional 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 declined purchasing power (Linz and Krueger, 1998; Meyer, 1998a; Uhlenbruck, 1997, World Investment Report, 1995). Third, the legal and institutional framework and the factor markets to support organizational transformation is slow to develop (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 paper analyses how these firms learn to shape their resources to enable them to grow and develop advantage in increasingly competitive markets.

Surely there is evidence of substantial transformation and entrepreneurial activity in some privatized SOEs, and there are more optimistic evaluations of the economic development in CEE (e.g., Fischer and Sahay, 2000). Especially, firms acquired by foreign, strategic investors improve efficiency and performance based on the capital, technological resources, and management skills provided (Uhlenbruck and De Castro, 2000; World Investment Report, 1995). Moreover, a small number of 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 on the macro level while insufficiently considering organizational realities (Meyer, forthcoming; Newman, 2000; Zahra et al., 2000). The past ten years have shown the limits of top-down transformation, as evidenced by the inconclusive results of the governance of privatized firms in CEE (Bevan et al., 1999, Carlin 2000). More recent research has shown that fundamental organizational change and deep restructuring has to occur before former SOEs in CEE will be able to compete effectively in their home markets and abroad (Antal-Mokos, 1998; Frydman et al., 1998; Newman, 2000).

In view of this state-of the art, we take a bottom-up approach to enterprise transformation. We propose a theory-based model of the transformation of enterprises that focuses on the firm's resources and markets. 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 in their new context. In our theory development we focus on the processes observed across transition economies, which may be complemented with country-specific variables for resource-endowment or institutional constraints when applied to 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 (Barney, 1991; Fey and Denison, 1999; Spicer, et al., 2000). These perspectives allow us to focus not only on product but also on factor markets. Such foci are important because both markets 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 transitional 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 subsequently developed model. 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 in the literature on organizational transformation regarding the changes required for former state-owned enterprises to survive in the post-transition economy (Linz and Krueger, 1998: 13). Restructuring primarily through downsizing of output, employees, energy use, and assets was common during the past decade. Because of traditional overemployment at enterprises in socialist countries in combination with declining sales during the first years of transition, the initial focus of research was on restructuring the former SOEs primarily by reducing employment. Since then, performance has greatly varied across CEE. Business activity in some countries, notably Poland, has enetered a positive growth path after only two years, while elsewhere the output decline continued for up to ten years. [1]

Based on an analysis of privatization cases studies, Carlin and Aghion (1996) concluded that firms have neither the capital nor the skills necessary for deep restructuring. Even in Hungary, where initial conditions in 1990 allowed more entrepreneurial freedom than elsewhere in the region, privatized firms show little change in products and markets served nor have they implemented the radical organizational changes necessary (Whitley and Czaban, 1998). Also, Hungarian companies largely have not engaged in new product development or technology upgrades (Bonin and Abel, 1998). The World Bank (1996), summarizing the evidence, stated that most privatized firms in CEE rarely move beyond the early stages of transformation. Rather, former SOEs have implemented defensive downsizing in reaction to external change, but largely have not engaged in deeper strategic restructuring.

Nevertheless, 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, a formerly vertically integrated Hungarian truck manufacturer focused on those parts of its value chain were its technology was

[1] Even 10 years after transition began in CEE, GDP for most countries is still below that of 1989. Russia's 1999 GDP, for instance, is forecasted to be down 45% from 10 years ago (Transition Report, 1999).

the most current (Dawar and Frost, 1999). By 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 found that deep restructuring is quite possible in the absence of foreign investors and government support, and with the old management in place. Firms there had 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 firms, particularly in the food processing industry, improved cash flow by building their own distribution system. Overall, he concluded that many firms implemented sophisticated long-term strategies. Frydman et al. (1998) found for a sample of over 300 current and former SOEs that privatized firms improved performance because of their entrepreneurial adaptation of products to new market opportunities compared to firms that continued to be owned by the state.

While the largely economics driven research on privatization observes 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 transitional economies does not develop hypotheses regarding the relationship of specific transformational efforts and performance. A notable exception is the work by Peng and Heath (1996). They developed a model of firm growth in transitional economies relative to predictions made by Western research on growth as a strategic choice. The 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 transitional economy. Overall, we conclude that the literature 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 and make strategic choices. We follow this fundamental insight in strategic management, but build on the formally developed theories of organizational learning and the resource-based view of the firm to explain transformation of privatized firms in CEE. In particular, the resource-based view provides insights in the analysis of firm strengths and weaknesses as well as the development of firm resources and capabilities as a basis for taking advantage of market opportunities (Barney, 1986, 1991; Dierickx and Cool, 1989; Wernerfelt, 1984). The organizational learning theory (Fiol and Lyles, 1985; Huber, 1991; March and Levitt, 1999) provides insights how firms understand and evaluate their 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).

The organizational learning literature builds on insights in sociology and organizational theory and complements the resource-based view. Often, organizational learning is considered a requirement for effective development of firm resources (Mahoney, 1995; Penrose, 1959). An organization learns if its range of potential behaviors changes through its processing of information (Huber, 1991). 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 thus can be written 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). In fact, firms must have the appropriate absorptive capacity in order to select, acquire and integrate knowledge from other sources. Absorptive capacity is the firm's ability to recognize valuable new knowledge, integrate it into the firm and use it productively (Lane and Lubatkin, 1998). Prior related knowledge contributes to a firm's absorptive capacity. Thus, in order to learn appropriate knowledge, firms may have to 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 build the basis for firm performance, evolution, and sustainability (Conner, 1991; Peteraf, 1993). The growing popularity of the resource-based theory as an explanation for differences in performance across firms has led to increasing focus on the effects of resources on a firm's ability to generate rents. Of particular interest herein is the development of dynamic capabilities (Teece et al., 1997) that in turn allow firms to develop new resources and enable it to take advantage of new opportunities, i.e., there is path dependence between existing and new resources of the firm (Prahalad and Hamel, 1990).

To sum up, organizational learning and the resource-based view are interrelated because the former provides explanations for the firm's ability to recognize and develop needed resources and capabilities. The outcome of organizational learning is an enhancement of intangible resources and thus an increase in 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). Considering the inadequate condition of SOEs relative to the efficiency of Western firms, earlier research suggested gradual transformation of privatized firms building on old relationships between firms and institutions (Peng and Heath, 1996). 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 transitional economies are facing an environment characterized by major political and economic changes, an uncertain legal and institutional framework, and poorly developed factor and product markets. Because of the nature of newly privatized firms, they rarely have the power or ability to change their environments; thus being aware of and adapting to these conditions is critical in the model. 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 environment (Fahey and Narayanan, 1986; Porter, 1980).

Insert Figure 1 here

Firms in transitional economies plunged into the market economy with a bundle of resources brought together to serve the needs of the central-plan economy. Previously, resources were allocated in part through implementation of the central plan, and in part through unintended incentives created by the plan regime.[1] In 1989, the typical state-owned firm had excess

[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 descretion (e.g. Kornai 1968) which facilitated the development of managerial capabilities.

employment (due to lack of incentives to economize on labor costs), excess inventories (due to lack of accounting for capital costs), dated physical equipment, extensive social services, and an uncompetitive product portfolio, especially for consumer goods (due to lack of market pressures) (Kornai 1980). Firms were highly integrated both vertically (due to high transaction costs of inter-firm relations, which had to go through central ministries) and horizontally (due to the focus on economies-of-scale of socialist industrialization policy) (Meyer 1998b; Peng and Heath, 1996).

Managers were mostly highly qualified in technological skills, based on generally high standards of education in sciences and technical professions. Beyond this, they had to use their relationships with political authorities, notably the communist party and the central plan authorities, for the firm to achieve its plan targets and obtain resource allocations (Ledeneva, 1999). Moreover, the real 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 (Martin, 1999), which they continue to utilize (Peng, forthcoming), but lack experience in managing in a market environment (Lawrence and Vlachoutsicos, 1990; Pearce, 1991; Puffer et al., 1994; Fey and Björkman, 1999).

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 change 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. Because of shrinking product markets and hard budget constraints, privatized firms often have very small financial reserves (Wright et al., 1998).

The term resource acquisition comprises thus various forms of obtaining control of 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 of privatized firms in CEE also suggest that firms may divest significant parts of their business. Divesting assets may produce financial resources needed to acquire other resources. Even with adequate financial resources, firms also need to upgrade their existing capabilities with particular emphasis on the firm's 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 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). Privatized firms in CEE often need to make substantial changes throughout the organization in order to adapt to significant change in the environment. Thus, the problem of internal consistency becomes critical. For instance, if the firm modernizes technology, its traditional organizational systems—based on Fordist mass production (Sorge, 1993)—may be incapable of taking advantage of technology that is used to best effect only with very different, flexible work arrangements.

In addition, the invariably changing market conditions in transitional 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 pro-act 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 repeatedly changing environments and is a significant capability developed by firms that affects performance (Lee and Hitt, 2000). Sources of strategic flexibility are resource flexibility, i.e., the identification and acquisition of resources 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 flexibility 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 (5-year plans, no serious competition, stable distribution channels) and their internal organizational structures (e.g. rare technological innovations, long-term employment). Hence, 'strategic flexibility' was not a critical success factor. The notion of flexibility, and associated concepts such as continuous improvement and adjustment to volatile market forces was unfamiliar (e.g. Meyer and Møller 1998). We assert that, therefore, the change of organizational culture to achieve strategic flexibility has been one of the most difficult tasks, yet most critical in distinguishing the successful from the unsuccessful firms. The creation of strategic flexibility of the firm is critical to successful transformation, as is the creation of internal consistency between historical resources of the former SOE, newly developed or acquired resources, and organizational systems.

The following propositions build on this need for internal consistency and strategic flexibility and provide more detail on the relationships implied in the model. Divesting certain assets while acquiring others or internally enhancing organizational capabilities through knowledge acquisition and learning will strengthen the potential of the firm to develop strategies to take advantage of product market opportunities. Limited by their absorptive capacity and organization structure, firms can process information acquired from markets to learn about opportunities and identify the required resources (Huber, 1991). Likewise, firms identify which resources are available from factor markets and acquire those needed or develop them internally (Dierickx and Cool, 1989). Because of the inefficiency of factor markets in transitional economies, firms able to acquire needed resources have the opportunity to develop a competitive advantage (Barney, 1986). We look at this process of resource development beginning with the configuration of existing resources, and then at the upgrading and integration through organizational learning and top management leadership.

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 build 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). Because in the past these firms often provided outdated products, they are unlikely to possess all resources needed to produce products that can take advantage of these opportunities. Thus, the privatized firm 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 have traditionally provided a number of services unrelated to their main business functions. The central plan regime made firm-to-firm exchanges difficult as communication had to go via the plan authorities, or transaction had use informal (if not illegal) channels. In consequence, the transaction costs of inter-firm coordination were high and led to high degree of vertical integration. At the same time, the central plan aimed at optimizing economies of scale as they system did not acknowledge the beneficial effects of multiple firms competing with each other. Thus, the SOEs typically has a high degree of both horizontal and vertical integration, compared to firm in the same industry in the mature market economies (Berliner 1957, Kornai 1980).

Moreover, firms were not liable to pay for the capital costs of inventories, which led – among other distortions – to hoarding of physical assets and often building of slack in certain types of 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 harder budget constraints, may sell off these slack resources to attract needed resources from factor markets and/or upgrade existing resources (Djankov and Pohl, 1998). Selling selected assets generates funds that can be reinvested in resource acquisition and development to take advantage of market opportunities. Whitley and Czaban (1998) found in an analysis of 27 cases of business restructuring in Hungary that few firms sold off core units but most closed or sold auxiliary units. Lízal, Singer and Svejnar (2001) found that in Czechoslovakia in 1991, breaking up of large SOEs resulted in improved financial performance of the successor firms. Hence we propose:

Proposition 1 *The divestment if resources in form of sale or closure of business units by large conglomerate firm created under central planning results in improved internal consistency, strategic flexibility, and hence performance.*

A reduction of products and services offered allows privatized firms to focus on core competences rather than continuing to provide for their 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). Reduction of specialized assets also can add to strategic flexibility (Aaker & Mascarenhas, 1984). Streamlining the organization may also attract investors and thus financial resources. On the other hand, maintaining obsolete product lines and the associated employment should be least conducive to transformation.

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 transitional 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 we suggest divesting selectively excess resources and using the returns to improve the current resource bundle as an effective short-term strategy.

Proposition 1a *Resource divestment in form of assets outside the privatized SOE's core business, rather than general downsizing, facilitate the development of coherent core competences and will be positively related to internal consistency, strategic flexibility, and performance.*

All firms have specific resource endowments (Barney, 1991) but often need further resources in order 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 be able 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 underused resources increases strategic flexibility (Aaker and Mascarenhas, 1984). Competence can build on synergies created between existing and added resources. For firms in transitional 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 internal consistency and strategic flexibility, should be favored. For example, assuming a firm produces a marketable product, but has no adequate distribution network, distribution improvements—and associated sales growth—will increase utilization of the existing productive capacity. In a comparative study, Kogut and Zander (1999) find 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).

We expect that a gradual change of the privatized firm provides 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. Improved market access allows the firm to learn from customers (Kogut and Zander, 1999; Krueger, 1995) and thus more efficiently improve existing products. Better market access and expanded sales based on improved products may enhance the organization's capacity to learn and thus its ability to expand further. [1]

Former SOEs that historically were deeper 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 may face a largely disappearing market.

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

They may however control technologies with application in civilian markets. For them, new product development is a necessity to be able to serve any market at all and thus has to precede market penetration.

Hence, the acquisition of both managerial and technological resources has an important role in enterprise transformation. Yet we assert that, due to the new demands after the change of economic system, the acquisition of new managerial and marketing capabilities has been essential for privatized SOEs:

Proposition 2 *Privatized SOEs acquiring resources that complement the current resource bundle of the firm strengthen internal consistency and strategic flexibility, and improve performance.*

Proposition 3 *For privatized SOEs the acquisitoon of complementary managerial and marketing resources has been a necessary condition to achieve sustained higher internal consistency and performance.*

ORGANIZATIONAL LEARNING

The learning requirements for privatized SOEs in CEE are daunting. Before transition, they 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 for the firm to which it has to react in new and different ways, which requires learning.

There are three particular challenges to these learning processes that distinguish the situation of privatized firms in CEE from western firms. First, the disappearing traditional product "markets" makes the identification of new market opportunities (product demand) an immediate necessity. Second, factor markets, which are generally limited, provide particular challenges to identify the resources needed from external sources (Peng and Heath, 1996). Finally, the socialist experience has equipped firms with little prior knowledge that would allow them to adequately interpret the information acquired to make the optimal decisions on opportunities to pursue, and where to find needed resources (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 the firm to adapt better. Systematic knowledge acquisition has been linked to improved performance (Daft et al., 1988; Hambrick, 1982).

Before privatization, however, SOEs' primary sources of information on input and output decisions were state agencies and thus typical environmental information gathering 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). Invariably changing market conditions increase this need for knowledge acquisition even further. To improve their ability 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 to acquire knowledge are environmental scanning and learning from networks and alliances (Huber, 1991; March and Levitt, 1999). Networks are particularly important for firms in transitional economies, both domestically (Child and Marcozy, 1993; Peng and Heath, 1996; Stark, 1996) and to integrate into international production (Meyer 2000). However, networks between former SOEs may also undermine true transformation. "Webs of mutual support"

(Ericson, 1998, p. 104) maintain non-market interaction and barter trade, but not the learning of how to adapt to the market-based economy. Also, these networks provide significant opportunity for negotiating continuation of subsidies and protection, collusion, or other unethical transactions, which reduce firm efficiency and transformation of the organization's culture (Broadman, 1999; Hoskisson et al., 2000; Woodruff, 1999).

Still, alliances can be a significant tool for organizational learning if clear and targeted goals are established. This includes alliances with suppliers to overcome problems of factor markets, with customers to learn about opportunities, marketing needs, and innovation (Lyles and Salk, 1996). Strategic alliances provide interactive learning opportunities from the experiences of the partner (Hitt et al., 2000; March and Levitt, 1999). They help firms develop new capabilities, even tacit components, and build their resource endowments (Lane and Lubatkin, 1998). In particular, privatized firms from CEE are likely to learn the most from foreign partners, in particular if those firms come from a developed country. Such an international alliance permits organizational learning that has a high probability of producing a competitive advantage because it allows the transfer of tacit knowledge. Alliances allow a firm 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).

Proposition 4: Active knowledge acquisition strategies are particularly important for the performance of former SOEs in industries with foreign competitors.

Klaus – do we need P4? Is it really developed out of the theoretical arguments?

Proposition 5: Active knowledge acquisition strategies (for the product as well as the factor markets) will be positively related to strategic flexibility and firm performance.

Proposition 6a: Alliances can be a particularly effective knowledge acquisition strategy in achieving specific learning outcomes.

Generally, there are several options for firms to acquire tacit knowledge in addition to alliances, for instance via mergers with other firms or via hiring of employees with this knowledge as part of their human capital (Bresman et al., 1999; Hitt et al., 2001). However, firms in CEE face limited factor and capital markets compared to firms in developed countries. Thus, the needed human capital may not be available for hire and firms may not have the financial resources to make the appropriate acquisition of organizations with the required knowledge.

Proposition 6b: Establishing alliances as an acquisition strategy for tacit knowledge is more important for firms from transitional economies than for firms from developed countries.

Klaus – somehow this is breaking the overall structure of the paper. if we want to push this direction, we ought to think about the other propositions in a similar direction

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, for instance via a trial and error approach (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). Observational learning is also often more efficient than experimental learning because it reduces the number of errors typical in experimentation (Bandura, 1977). Nevertheless, observational learning often fails in turbulent environments—

such as transitional economies—because they require adaptation of newly gained know how to new conditions which requires full comprehension (Huber, 1991; Van de Ven and Polley, 1992). Alliance partners may protect some know how from other alliance participants (Zahra et al., 2000), reducing the comprehensiveness of observational learning. Likewise, causal ambiguity reduces effective observation (Lippman and Rumelt, 1982). Tacit knowledge is difficult if at all possible to obtain via observation. Thus privatized firms cannot rely on imitation alone, but must also invest in experimental learning aimed at internal innovation (Kim, 1997; Zahra et al., 2000). Experimentation may be needed to develop new behaviors that are in concordance with existing cultural values, resources, and routines (Kogut and Zander, 1996; Kogut, 1996).

Proposition 7 *Privatized SOEs in CEE actively engaged in both observational and experimental learning will 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, or other means of data gathering (Huber, 1991). That is, an organization has to distribute information within the organization and interpret it, i.e. give it meaning (Daft and Weick, 1984). Organizations, similar to individuals, 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.

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 governing their ability to augment and create knowledge (Nonaka and Takeuchi, 1995). A firm's absorptive capacity is a function of characteristics of the organization itself, notably its organizational structure and combinative capabilities (Van den Bosch et al., 1999). These factors also affect strategic flexibility (Das, 1995). Research on Hungarian firms has shown that firms there improved their capacity to learn if organizational flexibility was promoted (Lyles and Salk, 1996). Organizations improved their ability to process acquired knowledge if collaboration and exchange of information within the organization was encouraged, employees were given greater latitude in altering activity patterns, and processes were adapted to perceived changing needs and conditions.

Proposition 8 *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

The effectiveness of managers with experience only in former SOEs operating in planned economies now managing a market-oriented organization in transition is questionable. Inadequate managerial skills limit the dynamic development of resources in privatized SOEs in CEE (Zahra et al., 2000). Effective management is salient for the capability of firms to develop new resources and increase strategic flexibility (Hitt et al., 1998; Penrose, 1959; Teece et al., 1997). Integration of new and old resources to take advantage of market opportunities requires general management skills. However, while the technical skills of managers in CEE are considered quite high, general management skills are limited (Pearce, 1991; Puffer et al., 1994).

Managers in transition economies have to upgrade their qualifications far more than provided by conventional management training. While training programs can help managers build their explicit knowledge, they can do little to develop the tacit knowledge needed by managers (Hitt et al., 1999b). 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 an integrative type of learning emphasising co-ordination, relationships and links (combination of explicit and tacit knowledge). At the *strategic* level, senior managers have to change their cognitive framework for doing business and conducting the tasks of management. They need to reassess their criteria of business success and factors contributing to that success, which requires an understanding of the technological and managerial processes in such depth that they can engage in innovation, select and adapt technology, and take strategic decisions (some explicit but largely tacit knowledge).

The interests herein are in the integrated capabilities of the management resources. We thus focus on top management teams in applying organizational learning theory. Management teams can be regarded 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 make use of its other resources (Mahoney, 1995; Penrose, 1959).

Research has identified that management teams are more able and willing to change the strategic orientation of a firm in a turbulent environment if managerial teams are more heterogeneous, where 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 experience and background may allow the firm to unlearn previous behaviors that are no longer functional and attempt different approaches to help the firm adapt to new conditions. Managers that have longer tenure with the firm and are familiar with its culture may be better able to preserve traditional firm strengths because they are aware of them and their roots. New practices have to be build on existing attitudes and value systems, preserving selectively what is valuable, and using experimentation to discover new best practices suitable for transition economies (Kogut, 1996; Spicer et al., 2000). Managers with a different background, however, can introduce new approaches, recognize different relationships between the firm and its environment, and may generally be more open to change (Finkelstein and Hambrick, 1996).

Team heterogeneity may come at a cost, however. Research indicates that heterogeneity of the top management team increases coordination costs and other group process losses, such as slowed decision making (Pfeffer, 1983). Instable environments, i.e. environments with discontinuous change (Tushman and Romanelli, 1985), enlarge the information-processing demands on the top management teams (Daft et al., 1988). Heterogeneous management teams are better able to handle this because they can absorb and recall more information, and consider problems and solutions from a wider range of perspectives (Finkelstein and Hambrick, 1996). Thus we expect that top management team heterogeneity compensates for its disadvantages given the instable conditions in transitional economies because it increases strategic flexibility of the firm (Lee and Hitt, 2001).

A second requirement for propensity to change is that the members of the management team interact and are collectively involved in decision making (Thomas and McDaniel, 1990), though team heterogeneity may impede interaction (Finkelstein and Hambrick, 1996; Murray, 1989). Sharing of varied experiences and prior learning between top managers can be a considerable source of knowledge creation in organizations (Lyles and Schwenk, 1992; Prahalad and Bettis, 1986). Furthermore, the involvement of the top management team in strategic decision making increases its pace, allowing the firm to keep up with change (Eisenhardt, 1989). Eisenhardt (1989) also finds that fast decision making is linked with strong performance.

Considering the need for change at privatized firms in transitional economies and the daunting managerial tasks, the above findings provide insights to the management of former SOEs. A heterogeneous, interactive management team is likely to have higher absorptive capacity because of the broader sets of experience on which it can draw to recognize, interpret, and internalize new knowledge. In view of the need and challenges in managerial learning addressed above, heterogeneous top management teams should provide stronger capabilities to develop, integrate and apply new knowledge and resources in new conditions while preserving traditional resources and values.

Proposition 9a *Management effectiveness is enhanced by the heterogeneity of the top management team, leading to deeper transformation of the privatized firm.*

Proposition 9b *Heterogeneity of the top management team may be less than optimal under some conditions for firms in developed economies. Because of high uncertainty and instability of transitional economies, top management team heterogeneity enhances management effectiveness in privatized firms in Central and Eastern Europe in general.*

Proposition 10 *Given heterogeneity of the top management team, management effectiveness is enhanced by the degree of participation and interaction within the management team, leading to deeper transformation of the privatized firm.*

IMPLICATIONS FOR FUTURE RESEARCH

Privatized firms in the transitional economies of CEE have initially adapted to new conditions mainly by downsizing. However, strategic restructuring, i.e., identifying new markets, developing new products or processes, etc., is a rare occurrence, except where SOEs are acquired by foreign investors (Ernst et al. 1996). The importance of the development of these organizations to the transformation of CEE economies, however, requires that these firms improve their efficiency and effectiveness. Fortunately, there is evidence that some firms have succeeded in this process despite adverse conditions.

Klaus – this paragraph could be left out?!

Prior research on organizational transformation in CEE has largely focused on analyzing human resource or governance issues of former SOEs in CEE. While these are of critical importance, the present work draws on two influential management theories to develop a model how these firms might learn to adapt their traditional resources to the new conditions. Organizational learning theory and the resource-based view are integrated to develop a model and testable propositions for organizational transformation that focuses on specific firm-internal and external constraints of privatized SOEs in CEE. This perspective allows making specific problems in the transformation of former SOEs explicit, such as a limited absorptive capacity, and thus implies potential remedies.

This research is hoped to encourage further theoretical and empirical work. The propositions that we provided may be extended, for instance with respect to structures and systems of privatized firms in CEE as part of organizational transformation. As previous research has shown, organizational structure is an important determinant of firms' learning capacity (Lyles and Salk, 1996). Organizational structure also has to be adapted to achieve internal consistency of the organization in order to optimize the returns to investments in new resources and capabilities. Further, research on human resource management might focus on organizational process issues regarding gatekeepers who facilitate firms in CEE to more efficiently internalize new knowledge (Kogut and Zander, 1992). Future research may also identify which particular characteristics are essential in the composition of the top management team. For instance, acquirers of former SOEs have sometimes 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). Moreover, future research ought to compare both theoretically and empirically the transformation processes in CEE, triggered by rapid reform in the early 1990s, and in China where changes in the business environment began much more gradually.

Empirical testing of the proposed model provides a further challenge. While sufficient measures have been developed to measure the constructs addressed herein, they typically have not been applied in transitional economies (for exception see Lyles and Salk, 1996; Luo and Peng, 1999). This environment may suggest 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 transitional economies in CEE. Moreover, the model developed implies that divestment may be as important or even more so than efforts to grow the firm. We, therefore, suggest as the appropriate outcome variable for the model the firm's financial performance, such as profitability and productivity. Such measures indicate optimal use of resources (Peteraf, 1993). Research, such as that by Frydman et al. (1998, 1999) has shown ways how financial performance of firms in CEE can be measured reliably.

While there are numerous examples for improved competitiveness and performance of privatized SOEs in transitional economies, there is also evidence for conditions that impede transformation (Newman, 2000; Spicer et al, 2000). For instance, Peng (2000) suggests that larger privatized firms are particularly challenged in restructuring. Such conditions may plausibly moderate the relationships suggested herein. Moreover, external conditions can affect firms independent of their internal structure and capabilities. External shock, such as the 1998 financial crisis in Russia, may bankrupt a firm even with seemingly appropriate internal design and high strategic flexibility towards change in market conditions.

CONCLUSION

The recent recognition that the transformation of privatized firms in CEE to competitive organizations is progressing much slower than expected has served as a catalyst to shift research from issues of governance to managerial issues. In particular, weak institutional systems, turbulent product markets, and underdeveloped factor markets have been recognized as firm-external barriers to organizational change. Internally, many firms are hindered by outdated product lines, inadequate assets, and management with little experience in competitive market environments. Based on current management theory, the present study provides recommendations how managers of privatized firms may address some of these problems. In particular, we propose that firms improve their learning ability by actively searching for information in product and factor markets rather then relying on "grapevine" information provided by established networks (May et al., 2000). Also, there may be a need to adapt organizational structure and processes to allow for more efficient information processing. This should help firms in identifying market opportunities and needed inputs to improve the resources of the firm. Nevertheless, these firms have built resource stocks in form of assets, know-how and organizational processes. Rather than disregarding these, there may be potential for further development of these resources (Spicer et al., 2000). Managers need to spend significant efforts on integrating resources so that firms achieve the internal consistency and strategic flexibility to be able to take advantage of recognized opportunities. The proposed model provides the challenge to empirical research to identify the generality of important theories under extraordinary conditions.

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