Stages of Organizational Transformation in Transition Economies: A Dynamic Capabilities Approach

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ABSTRACT How do organizations previously dominated by the state develop dynamic capabilities that would support their growth in a competitive market economy? We develop a theoretical framework of organizational transformation that explains the processes by which organizations learn and develop dynamic capabilities in transition economies. Specifically, the framework theorizes about the importance of, and inter-relationships between, leadership, organizational learning, dynamic capabilities, and performance over three stages of transformation. Propositions derived from this framework explain the pre-conditions enabling organizational learning, the linkages between types of learning and functions of dynamic capabilities, and the feedback from dynamic capabilities to organizational learning that allows firms in transition economies to regain their footing and build long-term competitive advantage. We focus on transition contexts, where these processes have been magnified and thus offer new insights into strategizing in radically altered environments.

INTRODUCTION

Enterprises in transition economies have faced unusually radical transformation processes, while lacking both the resources and capabilities to face competitive markets, and the internal routines and processes that would facilitate organizational change (Newman, 2000; Uhlenbruck et al., 2003). At the outset, firms were often constrained by their socialist institutional imprinting (Kriauciuunas and Kale, 2006). Their operational capabilities were also geared towards a now defunct economic system. This system had discouraged entrepreneurship, innovation and experimentation, such that the dynamic capabilities required for organizational change and adaptation in a volatile environment are largely absent. This setting thus provides a useful context to explore how organizations develop dynamic capabilities and bring about organizational change when radical external institutional changes render their organizational
capabilities largely irrelevant. In particular this setting raises questions about how organizations, facing radical external institutional change, develop the dynamic capabilities required to compete in a volatile market economy. How does this process interact with leadership and organizational learning, and how is it conditioned by and supportive to organizational performance?

In the present paper, we explore these questions and develop a theoretical framework that explains how changing leadership styles and processes of organizational learning lead to the development of different types of dynamic capabilities over subsequent stages of organizational change and adjustment to a new market economy. We synthesize and extend rather than elaborate existing theory on organizational transformation in transition economies which, to date, has been partial in applying transaction cost theory, institutional theory or the resource-based view (Estrin et al., 2009; Meyer and Peng, 2005; Wright et al., 2005). An important gap in the literature thus remains with respect to the interdependencies of different aspects and levels of organizational change processes. Theoretical frameworks have been proposed that integrate organizational learning and organizational change theory (Newman, 2000) or resource-based and organizational learning theories (Uhlenbruck et al., 2003). Related work investigates the links between governance, firm capabilities and restructuring (Filatotchev et al., 2003), or the relationships between top management team and organizational learning (Dixon et al., 2007). However, these frameworks are of a static nature and do not distinguish stages of transformation that an organization in a transition economy is likely to experience. In this respect, several studies have identified very distinct stages of economic transition (Peng, 2003; Peng and Zhou, 2005; Puffer et al., 2000). Our theorizing therefore synthesizes prior research and in doing so is able to develop a clearer elaboration of three stages of transformation that we analyse at four conceptual levels – leadership, organizational learning, dynamic capabilities, and performance. We demonstrate the interrelationships between these constructs at various stages of transition, thus presenting a more integrated understanding of the processes by which firms develop novel capabilities allowing them to thrive in a novel market economy context.

Firms in transition economies face particular challenges, because of the nature of their embeddedness in an economic and social system that is quickly becoming obsolete. Yet, gradually their challenges become more similar to those of firms facing environmental change in mature market economies. Moreover, the underlying processes are similar, which makes our framework also relevant to mature organizations in other contexts facing unanticipated radical change in their environment. As such, although we focus on the specific context of transition economies, we argue that our framework may, by extension, offer insights to scholars interested in radical organizational change and dynamic capabilities. Specifically we highlight micro-processes involved in the development of dynamic capabilities in volatile environments, including operational and higher order capabilities, and learning processes that are incremental versus those that involve new knowledge trajectories (Easterby-Smith et al., 2009). This broader contribution adds to existing work on the micro-foundations of capabilities and their evolution over time in line with changes in the environment (Ambrosini et al., 2009; Teece, 2007; Teece et al., 1997).
THEORETICAL PERSPECTIVES ON ORGANIZATIONAL TRANSFORMATION

Recent literature on organizational change in both transition and developed economies provides key concepts as a theoretical foundation for our research (Tables I and II). Dynamic capabilities are an appropriate perspective for developing a theory of organizational change in turbulent environments because they are focal to the organizational processes that enable growth and adaptation in changing environments (Eisenhardt and Martin, 2000; Teece et al., 1997). They are grounded in managerial capabilities and organizational learning: the former, because managers play crucial roles in developing organizational capabilities (Teece et al., 1997) and the latter, since organizational learning both leads to dynamic capabilities and is a dynamic capability (Zollo and Winter, 2002). In contrast, operational capabilities are defined as ‘zero-level’ capabilities, being the ‘how we earn a living now’ capabilities (Winter, 2003, p. 992).

The concepts of operational and dynamic capabilities are of pivotal interest to organization scholars as well as management practice (Eisenhardt and Martin, 2000; Helfat et al., 2007; Teece et al., 1997). Dynamic capabilities have been defined as ‘the firm’s ability to integrate, build, and reconfigure internal and external competencies to address rapidly changing environments’ (Teece et al., 1997, p. 516). They constitute the firm’s systematic methods for modifying operating routines and are created by organizational learning (Zollo and Winter, 2002). They enable both new resource creation via ‘reconfiguration, leverage, learning and integration’ (Bowman and Ambrosini, 2003, p. 293) and alteration of an existing resource base by creating, integrating, recombining and releasing resources (Eisenhardt and Martin, 2000).

Dynamic capabilities are created by organizational learning (Eisenhardt and Martin, 2000; Mahoney, 1995; Pisano, 2000) in a process of co-evolution of past experience, knowledge articulation and knowledge codification processes (Zollo and Winter, 2002).

Table I. Constructs used in frameworks for organizational transformation

<table>
<thead>
<tr>
<th>Constructs</th>
<th>References</th>
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<tbody>
<tr>
<td>TMT/leadership</td>
<td>Barr et al. (1992); Clark and Soulsby (1995, 1999, 2007); Dixon and Day</td>
</tr>
<tr>
<td></td>
<td>(2007); Dixon et al. (2007); Filatotchev et al. (2003); Pettigrew et al. (1992);</td>
</tr>
<tr>
<td></td>
<td>Pettus et al. (2009); Uhlenbruck et al. (2003); Vera and Crossan (2004)</td>
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<tr>
<td></td>
<td>(2005); Peng et al. (2005); Pettigrew et al. (1992)</td>
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<tr>
<td>(Internal) administrative</td>
<td>Clark and Soulsby (1995, 1999); Dawson (2003); Dixon and Day (2007);</td>
</tr>
<tr>
<td>heritage</td>
<td>Newman (2000); Pettigrew et al. (1992)</td>
</tr>
<tr>
<td>Organizational learning</td>
<td>Dixon and Day (2007); Dixon et al. (2007); Newman (2000); Peng and Zhou</td>
</tr>
<tr>
<td></td>
<td>(2005); Uhlenbruck et al. (2003); Vera and Crossan (2004)</td>
</tr>
<tr>
<td>Dynamic capabilities</td>
<td>Pettus et al. (2009); Rindova and Kotha (2001)</td>
</tr>
<tr>
<td>Operational capabilities</td>
<td>Dixon et al. (2007); Filatotchev et al. (2003); Peng and Zhou (2005)</td>
</tr>
<tr>
<td>Resources</td>
<td>Barr et al. (1992); Filatotchev et al. (2003); Uhlenbruck et al. (2003)</td>
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However a further explanation of the processes underlying these functions is required, linking specific functions of dynamic capabilities with specific processes of organizational learning.

Our paper presents a more detailed understanding of the micro-foundations of dynamic capabilities and how these are linked to organizational learning. Helfat et al. (2007) distinguish two functions of dynamic capabilities as (1) the ‘deployment’ of resources in a firm and (2) the search, selection and creation of resources, both of which serve ‘to purposefully create, extend or modify’ (p. 4) the firm’s resource base. Teece

Table II. Studies of organizational transformation

<table>
<thead>
<tr>
<th>Authors</th>
<th>Framework</th>
<th>Context</th>
<th>Type</th>
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</thead>
<tbody>
<tr>
<td>Barr et al. (1992)</td>
<td>Cognitive change, strategic actions, and organizational renewal</td>
<td>Developed economies</td>
<td>Empirical</td>
</tr>
<tr>
<td>Clark and Soulsby (1995)</td>
<td>Social, economic, and institutional change, and transformation of former state enterprises</td>
<td>Transition economies</td>
<td>Empirical</td>
</tr>
<tr>
<td>Clark and Soulsby (1999)</td>
<td>Adoption of multi-divisional form in large enterprises</td>
<td>Transition economies</td>
<td>Empirical</td>
</tr>
<tr>
<td>Clark and Soulsby (2007)</td>
<td>Processual analysis of top management and organizational change</td>
<td>Transition economies</td>
<td>Empirical</td>
</tr>
<tr>
<td>Dixon and Day (2007)</td>
<td>TMT, administrative heritage, and absorptive capacity</td>
<td>Transition economies</td>
<td>Empirical</td>
</tr>
<tr>
<td>Dixon et al. (2007)</td>
<td>Organizational learning</td>
<td>Transition economies</td>
<td>Empirical</td>
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<tr>
<td>Filatotchev et al. (2003)</td>
<td>Corporate governance and learning capacity</td>
<td>Transition economies</td>
<td>Empirical</td>
</tr>
<tr>
<td>Peng et al. (2005)</td>
<td>What determines the scope of the firm: institutional relatedness</td>
<td>Transition and developed economies</td>
<td>Theoretical</td>
</tr>
<tr>
<td>Pettigrew et al. (1992)</td>
<td>Contexts for change</td>
<td>Public sector</td>
<td>Empirical</td>
</tr>
<tr>
<td>Pettus et al. (2009)</td>
<td>Sequential development of dynamic capabilities</td>
<td>Deregulated industries</td>
<td>Empirical</td>
</tr>
<tr>
<td>Rindova and Kotha (2001)</td>
<td>Relationship between continuous morphing and competitive advantage</td>
<td>Developed economies</td>
<td>Empirical</td>
</tr>
<tr>
<td>Uhlenbruck et al. (2003)</td>
<td>Resource development in privatized firms</td>
<td>Transition economies</td>
<td>Theoretical</td>
</tr>
<tr>
<td>Vera and Crossan (2004)</td>
<td>Strategic leadership and organizational learning</td>
<td>Developed economies</td>
<td>Theoretical</td>
</tr>
</tbody>
</table>
(2007) examines the micro-foundations of three disaggregated aspects of dynamic capabilities: sensing and seizing opportunities, and maintaining competitiveness through reconfiguration. We build on both studies, adopting Helfat et al.’s terminology, in developing our framework. The concept of dynamic capabilities has not yet been applied to firms in transition economies, as research has focused on operational capabilities (for instance, Hitt et al., 2000). Yet, as we shall demonstrate, even the operational capabilities, that are required for short-term survival, have to be generated by some form of dynamic capabilities.

Transformational change represents an organizational metamorphosis (Meyer, 1982) or a change in organizing templates (Greenwood and Hinings, 2006). It can be triggered by changes in the external environment (Meyer, 1982) or by a change in the top management team (TMT) (Virany et al., 1992). Both triggers are manifest in transition economies and we thus utilize both institutional theory and leadership theories. Institutional theory is important because the behaviour of firms cannot be separated from their institutional environment – they are embedded in the broader socio-political environment in which competition takes place (Granovetter, 1985; Peng et al., 2005; Spicer et al., 2000). The study of transformation in transition economies therefore needs to look beyond the internal processes of the organization. The degree of institutional embeddedness (Granovetter, 1985) in the old planned economy is likely to constrain organizational change since organizational capabilities fit an obsolete economic and social system. Leadership theories suggest that top managers are an important resource. Their knowledge determines the organization’s ability to leverage and exploit other resources and to adapt to changes in the environment (Barney, 1986; Mahoney, 1995; Penrose, 1959). This is especially true in transition economies, where firms face transformation challenges of magnitudes rarely seen elsewhere.

Organizational transformation is constrained by organizational history, inherited routines and managers’ bounded rationality. These represent the firm’s administrative heritage, that is the internal configuration of assets, capabilities, managerial responsibilities and influence that continues even after structural change (Bartlett and Ghoshal, 1989). In transition economies, these constraints are magnified, as not only are the historical resources of firms inefficient (Uhlenbruck et al., 2003), but also the inherited norms, values, and assumptions underlying economic activity are completely different to those of a market economy (Newman, 2000). This imprinting from the previous socialist institutional and economic system impacts firms’ awareness of the need to change operating capabilities that were fitted to a planned rather than a market economy (Kriauciunas and Kale, 2006). These historically grounded constraints have proven to be hard to overcome (Dixon and Day, 2007; Michailova and Husted, 2003; Vlachoutsicos and Lawrence, 1996).

An important element of the transformation process is organizational learning – the process of improving actions through better knowledge and understanding (Fiol and Lyles, 1985). In particular the concepts of exploitation and exploration (March, 1991) are relevant in transition economies because they help to explain how a firm (1) acquires knowledge that is required for survival in a market economy and (2) explores for new possibilities of competitive advantage in a challenging and unstable institutional environment. Three theoretical models of organizational transformation in transition
economies incorporate organizational learning: Uhlenbruck et al. (2003) combine the resource-based view and organizational learning; Newman (2000) integrates institutional, organizational learning, and organizational change theory; and our prior study (Dixon et al., 2007) links TMTs, learning, and capabilities. We advance this literature by elaborating the focal process of developing dynamic capabilities as part of a holistic theoretical framework to explain the link between different types of learning, dynamic capabilities and effects on performance.

**ORGANIZATIONAL TRANSFORMATION IN TRANSITION ECONOMIES**

Managerial processes vary at different stages of organizational transformation in transition contexts (Peng, 2003; Puffer et al., 2000). We distinguish three stages, which we analyse at four interlocking conceptual levels: leadership, organizational learning, dynamic capabilities, and performance (Figure 1). In Stage I, *Break with the Past*, the main challenge is to bring about awareness of the need to change, in order to dislodge operational capabilities that are no longer of use. In Stage II, *Exploitation and Deployment*, exploitation learning leads to the development of dynamic capabilities in the deployment mode that enable the organization to reconfigure, leverage, and integrate resources, and thus to develop the threshold operational capabilities for short-term survival in a market.

![Figure 1. Stages of organizational transformation in transition economies](image-url)
In Stage III, *Exploration and Innovation*, exploration learning generates dynamic capabilities in their search and innovation function that are important for the organization to acquire the strategic flexibility to adapt to changes in the environment, and thus to secure sustained competitive advantage in a market economy with an unstable institutional context. Feedback loops lead from the dynamic capabilities of search and innovation to exploitation and exploration learning, enabling the constant refreshing of strategic capability and thus ongoing survival and sustainable competitive advantage.

**Stage I: Break with the Past**

Organizations adapt their routines to their environment. When this environment undergoes radical change they may find themselves with a mismatch between their established capabilities and routines, and the new environment. Members of the organization are well adapted to the old routines which therefore tend to endure. Historical endowments are ‘sticky’ in the sense that in the short term firms are stuck with their existing resources and structures, and the resultant processes that drive firm operations (Teece et al., 1997). Their capabilities ‘fit’ an obsolete system. Organizational change is thus constrained by this ‘administrative heritage’ (Bartlett and Ghoshal, 1989) or what Kriauciunas and Kale (2006) describe specifically as ‘socialist organizational imprinting’ in the case of transition economies. Socialist imprinting refers to ‘the impact of the institutional and market environment characterizing the socialist economy at the time of the firm’s founding on its knowledge sets’ (Kriauciunas and Kale, 2006, p. 660). Therefore the first requirement for organizational transformation is to create an awareness in the organization of a need to change, such as to decouple members from their old routines. Whether an organization succeeds in this break with its past depends on its embeddedness in old institutions and the characteristics of the leadership team.

Studies of organizational change in *developed economies* indicate that a firm must manage not only its internal but also its external contexts (Pettigrew, 1987). Indeed a basic tenet of institutional theory is that a set of values, norms, and organizational templates exists outside of particular firms that influences the way a firm is managed (Meyer and Bowman, 1977). However, Newman (2000) maintains that this would not apply in *transition economies* where the institutional context itself is changing radically. The institutional context no longer provides organizing templates, models for action, and sources of legitimacy. In transition economies, markets are continuously changing, emerging, and disappearing while the rules of the game are not yet established. Thus, organizations are affected by fundamental and comprehensive changes in the formal and informal rules of the game (Peng, 2003). The radical change in the institutional context also means that many existing capabilities of firms become defunct in that they no longer secure survival.

Strategic choice is embedded in the institutional framework, which has a strong influence on a company’s ‘genetic coding’ (Peng, 2000). This explains why companies in transition economies differ radically from Western firms. For example, Whitley and Czaban (1998) maintain that in a setting where the state has no coherent set of policies and oscillates under different pressure groups, short-term ad hoc adjustments to immediate pressure may be more rational than undertaking relatively large-scale and highly
risky changes in pursuit of long-run strategic objectives. When the rules of the game are highly uncertain, organizations are not able to invest in new capabilities and skills and will therefore, by default, continue in their old ways (Peng and Heath, 1996). Entrenchment behaviour by incumbents may act as a barrier to the acquisition of required resources and contribute to the maintenance of core rigidities (Newman, 2000). Indeed, the better the incumbents’ capabilities fit with the pre-transition context, the more difficult it may be for them to transform (Peng, 2003). Firms thus differ in the extent to which they adapt to the environment (Meyer, 1982; Meyer et al., 1990). In transition economies, many of the large state owned enterprises have become corporate dinosaurs, entrenched in old behaviours and unable to make the first steps of adapting to a radically changed environment.

The rapid mass privatization that took place in Central and Eastern Europe destroyed the old system, but did not create the institutional foundations that would enable it to achieve the required transformation of capabilities post privatization (Spicer et al., 2000). Even after privatization, organizations often ‘stick’ to their institutional templates (Johnson, 2000). Their strategies thus depend on their institutional relatedness – ‘the degree of informal embeddedness or interconnectedness with dominant institutions’ (Peng et al., 2005, p. 623). Therefore we suggest that the firm’s awareness of the need to change is limited by its socialist institutional imprinting, i.e. the degree of institutional embeddedness of the firm in the old system of the planned economy:

**Proposition 1:** In organizations in a transition economy, socialist institutional imprinting has a negative effect on the awareness of the need to change.

Research in *developed economies* has shown that managerial cognition has an important influence on the ability of organizations to adapt (Tripsas and Gavetti, 2000). Managers have bounded rationality and therefore often develop a system of beliefs or *dominant logic* for the organization based on a shared history (Prahalad and Bettis, 1986). Managers may thus have difficulty adapting their mental models (Barr et al., 1992; Brown and Eisenhardt, 1998; Greenwood and Hinings, 2006; Teece et al., 1997).

In *transition economies* managerial cognition is bounded by the experience of working in a planned economy. Managers who were brought up in the old system would be incapable of conceiving how to adapt to the new one (Meyer and Møller, 1998; Newman, 2000). If top managers stay in power during the transition process, they are likely to have limited ability to change themselves or their organizations as they would tend to reinforce past routines.

In *developed economies* Wiersema and Bantel (1992) suggest that strategic change is a function of receptivity to change, willingness to take risk, diversity of information sources and perspectives, and innovative decision making. This enhances the firm’s ‘absorptive capacity’ (Cohen and Levinthal, 1990) – its ability to assimilate useful external innovations – because of the broader set of experiences available for interpreting and internalizing new knowledge (Hambrick and Mason, 1984; Wiersema and Bantel, 1992). Changes in the management team can result in the unlearning of old routines and an increased probability of strategic reorientation and discontinuous organizational change (Tushman and Rosenkopf, 1996; Virany et al., 1992).
Research in transition economies suggests that post-socialist enterprises are more likely to change and restructure with a younger, marketing-oriented, short-tenured, well-educated, and heterogeneous TMT (Clark and Soulsby, 2007). Studies have also shown that outsider managers with an entrepreneurial approach have a positive effect on organizational restructuring and absorptive capacity (Dixon et al., 2007; Filatotchev et al., 2003).

Heterogeneous, entrepreneurial TMTs, containing outsiders, are likely to have high absorptive capacity, and thus understand that different capabilities are required for the new economic conditions. They are thus more likely to create an awareness of the need to change within their organization, despite the stultifying effect of the socialist institutional imprinting. Hence:

*Proposition 2a*: In the initial stage of organizational transformation, a top management team that is heterogeneous, entrepreneurial, and contains outsiders has a positive effect on the organization’s awareness of the need to change.

Studies of management style in developed economies have focused on transformational and transactional leadership (Bass, 1985, 1998). The transformational style increases absorptive capacity (Garcia-Morales et al., 2007) and is thus considered most appropriate for radical organizational change (Vera and Crossan, 2004). This style involves changing the basic values, beliefs, and attitudes of subordinates and is described as charismatic, inspirational, intellectually stimulating, and individually considerate (Avolio et al., 1999).

In transition economies, Elenkov’s (2002) analysis of leadership in 350 companies in Russia, established that transformational leadership predicted organizational performance above and beyond the impact of transactional leadership. Russian organizations are characterized by a command-and-control approach which is manifested in authoritarianism, obedience to authority, the use of coercive power, and an emphasis on rank and status (Kets de Vries, 2001). Russian top managers have typically been highly directive, strong leaders, with centralized decision making and a rigid hierarchy (McCarthy et al., 2005). Our earlier work (Dixon et al., 2007) established that a top-down management style was the most appropriate for breaking with administrative heritage. We extend this study by introducing the concepts of transformational and transactional leadership to allow sharper theorizing. Thus we consider that in the early stages of organizational transformation a transformational management style may be more effective in changing the basic values, beliefs, and attitudes of managers within the organization and thus increasing its awareness of the need to change:

*Proposition 2b*: In the initial stage of organizational transformation, a transformational leadership style has a more positive effect on the organization’s awareness of the need to change than a transactional leadership style.

Organizational learning is vital for securing survival in a new institutional environment. But it is inhibited by the tendency of managers to interpret information based on prior knowledge or frames of reference (Cohen and Levinthal, 1990). Learning requires
an organization to reconstruct and adapt its knowledge base (comprising skills, structures, and values), and to creatively destroy outmoded practices and attitudes (Pettigrew and Whipp, 1991).

The organizational learning of companies in transition economies is limited by their experience in a different economic system. Their prior knowledge, accumulated in the planned economy, is not relevant to survival and success in a market economy, therefore organizational transformation is inhibited by both the lack of related knowledge and a large learning gap (Hitt et al., 2000; Newman, 2000). Notably, the cognitive ability of managers and employees to envisage major change and to identify and implement radically different routines is limited. Organizations, constrained by socialist institutional imprinting, have inherited capabilities, practices, and attitudes inappropriate for a market economy. Managers brought up in a planned economy will have learned the behaviours necessary for success in that environment. Therefore organizational learning can only take place if the organization becomes aware of the need to change and is therefore open to new ways of thinking and new business practices. This puts it in a position to exploit the knowledge that exists, for example in the West, about how to survive in a market economy.

**Proposition 3**: In the initial stage of organizational transformation, an increase in the organization’s awareness of the need to change has a positive effect on exploitation learning.

The initial stage of organizational transformation in transition economies differs most from what might be expected to happen in developed economies, precisely because of the extent of the institutional imprinting and the ‘stickiness’ of the administrative heritage. These concepts might, however, have relevance for Western organizations that are, for instance, constrained by historic paradigms in their technology, by their business models, or their methods of assessing the environment (e.g. risk management practices; Haldane, 2009).

**Stage II: Exploitation and Deployment**

In the second stage of transformation, organizations engage in exploitation, learning to enable the deployment function of dynamic capabilities that facilitates the reconfiguration of resources. This process may be enhanced by a contingent approach to leadership, adopting a transformational style for parts of the organization where learning is slowest, but moving to a transactional style to empower parts of the organization that are more advanced in their understanding of the requirements for survival under market conditions.

In the literature on developed economies two types of organizational change are described: continuous, or first order change, which is incremental and convergent; and discontinuous, or second order change, which is transformational (Meyer et al., 1990). These two modes of change can be linked to two leadership styles: transactional and transformational.
Transactional leaders set goals and develop agreements about what is expected from the organization, whereas transformational leadership is inspirational and helps the organization to reframe the future (Bass, 1985, 1998). The transactional leadership style serves to increase the robustness of the existing organization, whereas transformational leadership seeks to change it. Thus, Vera and Crossan (2004) suggest a contingent view of leadership. In times of change, when a firm’s institutionalized learning has to be altered, transformational leadership is required. In times of stability, transactional leadership is appropriate for the process of refreshing, reinforcing, and refining current learning.

In the transition economy context, our previous study (Dixon et al., 2007) suggested that different stages of organizational learning are associated with different leadership styles: initially an authoritative top-down approach to facilitate exploitation learning; followed by a more democratic approach empowering the organization and encouraging exploration learning. Our deeper theorizing suggests that both leadership styles can coexist, addressing the contingent needs of organizations undergoing change. Thus, at the intermediate stage of organizational transformation, transformational management is still evident in the parts of the organization that have been slower to break with the administrative heritage and therefore slower to unlearn and change, for example regional subsidiaries. However, transactional leadership becomes appropriate for parts of the organization that have already started to understand what is required for short-term survival, for example head office.

We suggest that a contingent approach, applying the appropriate management style for the given situation, is most likely to advance organizational learning in the intermediate stage of transformation. On the one hand a transformational approach continues to increase the awareness of the need for change and the absorptive capacity of the organization via the break with the socialist administrative heritage and unlearning of old routines. On the other hand, a transactional approach, empowering those parts of the organization, that learn and adapt faster than others, is important for accelerating exploitation learning.

**Proposition 4**: In the intermediate stage of organizational transformation, a contingent leadership style has a more positive effect on organizational learning than either a transformational or a transactional style alone.

Organizational learning in both its exploitation and exploration functions is a foundation for developing dynamic capabilities, and thus indirectly for securing the survival of the organization in a market economy. In transition economies, exploitation learning is required to develop the operational capabilities required for survival in a market economy, but missing in a centrally planned economy, for instance marketing, finance and HR capabilities, corporate governance, information sharing, and the fostering of innovation (Filatotchev et al., 2003; Hitt et al., 2000; Peng, 2000; Puffer, 1994). Exploitation learning involves selecting, implementing, and adapting systems and capabilities that are already available in organizations operating in the Western market economies. By learning about, and then deploying, the new capabilities (via the deployment function of dynamic capabilities), the organization is better adapted to a market economy and its
chances of survival are enhanced. Exploitation learning supports the development of new routines – the dynamic deployment and/or redeployment of resources – which helps to transform the organization. Thus these dynamic capabilities are higher order capabilities that manipulate resources and capabilities that directly engender rent (Zott, 2003). These dynamic capabilities are specifically involved with redesigning routines around new capabilities. The dynamic capability routines co-evolve with exploitation learning, utilizing knowledge that already exists in developed economies to deploy, adapt, and reconfigure its processes and operations in order to create new operational capabilities that are taken for granted the West. Exploitation learning thus contributes to the deployment function of dynamic capabilities. Yet by its nature it cannot generate fundamentally new capabilities because the knowledge being exploited, although new for the organization in a transition context, already exists elsewhere. It is therefore developing the threshold capabilities for short-term survival.

Proposition 5: In the intermediate stage of organizational transformation, the greater the level of exploitation learning, the greater the deployment function of dynamic capabilities.

Proposition 6: In the intermediate stage of organizational transformation, an increase in the deployment function of dynamic capabilities will increase the likelihood of short-term organizational survival.

This stage of organizational transformation is likely to differ between transition and developed economies due to the radical nature, the extent and the significance of the change required to reach threshold levels for survival in a transition context. Western companies, even those most resistant to change and constrained by their history, would be unlikely to need such a comprehensive overhaul of operational capabilities.

Stage III: Exploration and Innovation

In the advanced stage of organizational transformation the organization moves beyond mere survival to securing sustainable competitive advantage. March (1991) maintains that organizations need both exploitation and exploration to succeed. However, researchers dispute whether it is possible to simultaneously engage in both types of learning (Gupta et al., 2006), since exploration and exploitation compete for scarce organizational resources (March, 1991). Benner and Tushman (2003) and He and Wong (2004) suggest the possibility of an ambidextrous organization, balancing continuous and discontinuous change and the two types of learning. Burgelman (2002), on the other hand, concludes from his longitudinal study of the Intel corporation that exploitation and exploration learning were temporally differentiated in a process of punctuated equilibrium. We argue that in transition economies the latter case is more likely since even exploitation of threshold operational capabilities requires radical transformation necessitating the focus of the organization on the urgent task of survival.

Survival requires what Winter (2003) called zero-level capabilities, being the ‘how we earn a living now’ capabilities (p. 992). They represent the organization’s ability to
produce a desired output (tangible or intangible), which he distinguishes from dynamic capabilities that are the higher-order capabilities to manipulate operational capabilities. These ‘substantive capabilities’ (Zahra et al., 2006) facilitate organizational efficiency and effectiveness.

However, operational capabilities of the type in common use by companies in a market economy are not in themselves sufficient to secure sustainable competitive advantage. For this, the organization needs to search for and create new business models that add value in the specific context of the transition economy (London and Hart, 2004; Prahalad, 2004). Firms that are still in crisis due to failure to adapt to a market economy do not have spare capacity for search and innovation – they are likely to focus on adaptation and acquisition of existing best practice. However, once firms have secured the basic operational capabilities for survival, after the intermediate stage in our model, they are then likely to have greater potential to search, take risks, experiment, and innovate – key characteristics of exploration (March, 1991). Thus we subscribe to Burgelman’s (2002) punctuated equilibrium model.

**Proposition 7:** In the advanced stage of organizational transformation, the stronger the capabilities for short-term survival the stronger the likelihood of exploration learning.

In *developed economies*, Heller and Yukl (1969) classify leadership styles on a continuum from no subordinate influence to complete subordinate influence in relation to specific situations. More recently, the balance has swung towards greater subordinate influence and empowerment. Empowerment has been described as both a relational dynamic and a motivational construct (Conger and Kanungo, 1988). As a relational dynamic it is the process by which a leader shares power with subordinates and as a motivational construct it implies an enabling, rather than just a delegation (Conger and Kanungo, 1988). Recent empirical research (Mom et al., 2007) indicates that top-down knowledge flows of managers positively relate to exploitation activities, whereas bottom-up and horizontal knowledge flows of managers positively relate to these managers’ exploration activities.

Given the complexity and unpredictability of change in the institutional environment, we maintain that in the advanced stage of organizational transformation the TMT can no longer be the main interface of the organization with the environment or the sole arbiter of creativity and innovation. Transactional leadership within an empowered organization with delegated authority and motivation to act, encouraging bottom-up and horizontal knowledge flows, is more likely to foster exploration learning at that stage.

**Proposition 8:** In the advanced stage of organizational transformation, a transactional leadership style has a more positive effect on exploration learning than a transformational leadership style.

Exploration refers to learning gained through processes of concerted variation, planned experimentation, and play (Baum et al., 2000), and involves learning along an entirely new trajectory (Gupta et al., 2006). This may be necessitated by changes in the environment that require a continuous rethinking of current strategic actions, organization structure, communications systems, corporate culture, asset deployment, and
investment strategies. This requires flexibility and the ability to balance stable and fluid states of the organization (Hitt et al., 1998). Hence exploration learning is necessary to ensure the strategic flexibility to act in a volatile environment (Hitt et al., 1998; Teece et al., 1997).

Specific functions of dynamic capabilities result from exploration learning, for instance the ‘innovative’ factor (Wang and Ahmed, 2007), the search, select, and create function (Helfat et al., 2007), and the sensing and shaping of opportunities and threats and seizing opportunities (Teece, 2007). Easterby-Smith and Prieto (2007) also explicitly identified both exploitation and exploration learning as antecedents to dynamic capabilities, exploration involving moving outside the boundaries of current practice.

In transition economies, organizations need to engage in exploration learning, because the challenges of the environment may require new business models for that specific context (London and Hart, 2004; Prahalad, 2004). Market conditions are continuously changing in a transition economy and the institutional environment is unstable (Newman, 2000; Uhlenbruck et al., 2003). In other words, merely importing and exploiting Western business techniques may not suffice to secure sustainable competitive advantage. Firms learn through experimentation and internal development of new routines and capabilities adapted to the specific context, rather than the imposition of imported routines from others (Kogut and Zander, 1996).

We therefore suggest that exploration learning enables the search and innovation function of dynamic capabilities – this is the function that goes beyond manipulating and deploying capabilities already in existence (albeit in the West). Like the deployment function described above, it is a higher order capability that does not merely use exploration learning in seeking new directions for development, but also manages that exploration and implements its outcomes, such that routines are established to utilize the new ideas and knowledge. This is essential in the final stage of organizational transformation to enable the strategic flexibility to adapt to an unpredictable and volatile environment. Key concepts in differentiating between the constructs of exploration learning and the search and innovation function of dynamic capabilities are (a) that the learning involves routines around ‘how to’ do something differently, whereas (b) dynamic capabilities involve both enabling routines for exploration learning to take place and implementation routines for ‘what’ the organization actually does with the new knowledge. However, without exploration learning there would be nothing to implement, therefore:

**Proposition 9**: In the advanced stage of organizational transformation, the greater the exploration learning the greater the search and innovation function of dynamic capabilities.

Teece (2007) has disaggregated dynamic capabilities into ‘the capacity (1) to sense and shape opportunities and threats, (2) to seize opportunities and (3) to maintain competitiveness through enhancing, combining, protecting, and, when necessary, reconfiguring the business enterprise’s intangible and tangible assets’ (p. 1319). These categories broadly correspond to Helfat et al.’s (2007) functions of search, select, and creation (1 and 2), and deployment (3). Categories (1) and (2) correspond to what Ng (2007) calls ‘strong form’ dynamic capabilities. These involve the discovery of new resources and uses.
that may be a source of competitive advantage (Newbert, 2008). They enable organizations to develop the strategic flexibility that is necessary for long term competitive advantage in an uncertain and changing environment. Strategic flexibility thus provides a link between the capabilities of the firm, and what is going on in the environment (Kraatz and Zajac, 2001), and helps companies to respond to crises in their competitive environment (Grewal and Tansuhaj, 2001; Hitt et al., 1998).

Being aware of, and adapting to the environment, is critical for newly privatized firms in transition economies. Strategic flexibility is particularly important for firms facing significant political and economic changes, an uncertain institutional environment, and poorly developed markets (Uhlenbruck et al., 2003). Firms, according to Newbert (2008), continuously have to adapt or proactively develop strategic responses to external change in their efforts to secure sustainable competitive advantage (defined by Barney (1991) as the implementation of a value creating strategy not simultaneously being implemented by competitors and which cannot easily be imitated). The dynamic capabilities of search and innovation underpin strategic flexibility and thus may contribute to sustainable competitive advantage. Although the latter is by no means guaranteed, due to the risky nature of search and innovation (Helfat et al., 2007), nevertheless we suggest that these dynamic capabilities of search and innovation are necessary, even if not sufficient, for sustainable competitive advantage, thus:

**Proposition 10:** In the advanced stage of organizational transformation, an increase in the search and innovation function of dynamic capabilities increases the likelihood of sustainable competitive advantage.

This final stage of organizational transformation is likely to show less distinct differences between transition and developed economies, though the transition context tends to show more volatility in the competitive and institutional environment. An example of Western firms facing challenges that loosely resemble those of firms in transition economies is given by Pettus et al. (2009). They explore organizational change following industry deregulation and, like our framework, focus on the dynamic capabilities of managerial capabilities, organizational learning and strategic flexibility. The problems associated with industry deregulation are similar to those encountered in transition economies – both have to cope with an administrative heritage that is inappropriate for a competitive market environment. Our framework of organizational transformation complements Pettus et al.‘s sequential analysis of dynamic capabilities. Both frameworks emphasize the importance of a TMT with new mental models, and different types of learning.

Teece (2007), in explicating dynamic capabilities, refers to ‘entrepreneurial managerial capitalism’ (p. 1346), which incorporates the recognition of problems and trends, the direction of resources, and the reshaping of organizational structures to take advantage of opportunities. Similarly we maintain that the dynamic capabilities of search and innovation are the drivers of entrepreneurial routines that constantly refresh the organizational learning processes. In other words, for ongoing survival and long-term sustainable advantage there is a feedback loop from the search and innovation function of dynamic capabilities to exploitation and exploration learning. This leads to the constant
refreshing of operational capabilities and maintains the strategic flexibility of the organization, thereby avoiding the development of core rigidities, organizational inertia, and an administrative heritage that no longer fits the requirements for survival and success.

**Proposition 11**: Dynamic capabilities of search and innovation have a positive impact on both exploitation and exploration learning.

A challenge to dynamic capabilities theory is the apparent inconsistency between organizational renewal and the routine nature of organizational capabilities (Schreyögg and Kliesch-Eberl, 2007). Our framework shows how dynamic capabilities theory can indeed embrace both change and routines, and how constant refreshing of this strategic capability through organizational learning is vital for organizational success in radically changing environments. Our framework thus provides both a theory of organizational transformation and a theory of potential sustained competitive advantage in conditions of environmental change.

**CONCLUSIONS AND RECOMMENDATIONS FOR FURTHER RESEARCH**

Our three-stage integrative framework of organizational transformation provides a basis to analyse complex organizational transformation processes in contexts of radical environmental change. It extends earlier theoretical frameworks on transition economies, notably Newman (2000) and Uhlenbruck et al. (2003). In explicating the framework we have added to dynamic capabilities theory by explaining the linkages, at different stages of the transformation process, first between exploitation learning and the deployment function of dynamic capabilities, and second between exploration learning and the search and innovation function of dynamic capabilities. Furthermore we have engaged in deeper theorizing to elucidate the micro-foundations of types of organizational learning and dynamic capabilities. In so doing we have contributed to the ongoing work to open up the ‘black box’ of organizational capabilities and add clarity to the concept of dynamic capabilities (for instance, Ambrosini and Bowman, 2009; Ambrosini et al., 2009; Easterby-Smith et al., 2009; Teece, 2007; Wang and Ahmed, 2007). The extent and speed of organizational transformation in transition economies has enabled us to separate out more clearly the two functions of dynamic capabilities – deployment, and search and innovation, which perhaps would not have been quite so obvious in less radical change contexts.

We further propose that different management styles are required over the process of organizational transformation. At the initial stage, the focal process is building awareness of the need to change, which is most positively associated with a transformational leadership style. In the intermediate stage, the most important processes are exploitation learning and the deployment function of dynamic capabilities. These are associated with a contingent approach (transformational or transactional leadership). In the final stage the organization moves towards exploration learning, which is associated most positively with a transactional leadership style, and supports the search and innovation function of dynamic capabilities. Finally we propose feedback loops from the dynamic capabilities of search and innovation to exploitation and exploration learning, that serve to continually

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refresh the strategic capability of the organization, enabling continuing survival and potential sustainable competitive advantage.

In summary, we have met the four major criteria for theory building, developed by Weber (2003). First we have articulated constructs that were the focus of prior theories in a different way. In particular we have elucidated concepts of dynamic capabilities (deployment, and search and innovation) in the context of organizational learning and change. We have also isolated the variables in the transformation process at four conceptual levels, namely leadership, organizational learning, dynamic capabilities, and performance. Second we have articulated the relationships between constructs not previously linked in one theoretical framework: specifically we linked exploitation learning with the deployment function of dynamic capabilities leading to the development of operational capabilities and short-term survival; and exploration learning with the search and innovation function of dynamic capabilities leading to strategic flexibility and sustainable competitive advantage. Third we have articulated the boundary conditions of the theory in the context of a transition economy with radical institutional change. Finally we articulated the event space of the theory, the set of changes of state of the constructs for which the theory is expected to hold. This relates both specifically to the process of organizational transformation in a transition economy, but also more broadly to any firms adapting their strategy to radical shifts in their environment.

The conceptualization of the process of organizational transformation in transition economies has facilitated theorizing at four levels: leadership, organizational learning, dynamic capabilities, and performance. The extent, difficulty and speed of the changes in this context provide a clearer focus for theory development – the radical nature of the changes serves to exaggerate their features, as if with a magnifying glass, permitting a clearer view of the change processes. On the one hand, Western-derived constructs of organizational learning and dynamic capabilities helped us to explain organizational processes in transition contexts. On the other hand, this study helps to enhance these theories and offers insights that may provide new ways to think about the processes of organizational transformation in Western companies, particularly well-established ones, anchored in their administrative heritage, yet facing radical external change in the fundamental logic how business is done their industry. This suggests that our model may provide a starting point for theorizing on firms’ strategic shifts triggered by the global crisis unfolding in 2009 (Rumelt, 2009; Sull, 2009; Williamson and Zeng, 2009).

Despite the above contributions this framework has a number of limitations. For example, in attempting to clarify the key processes involved in organizational transformation over time it portrays organizational transformation as a simple linear process. In fact there are many areas where constructs overlap and interact with each other, for instance organizational learning and dynamic capabilities, dynamic capabilities, and strategic flexibility. The three stages of organizational transformation are also likely to overlap. Furthermore, although the importance of context is emphasized at the front end of the framework, for reasons of parsimony we did not attempt to show the constant interactions between organization and context over time.

The theoretical framework would benefit from empirical testing in companies undergoing radical organizational transformation both in transition and developed economies. This research could take the form of qualitative case studies, as well as a large-scale
survey. Most of the constructs in the framework could be operationalized on the basis of previous studies, however, some thought would need to be given to the operationalization of the different types of dynamic capabilities. Furthermore, the complexity of the framework may require that a quantitative study be broken up into the three stages of the model.

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