

The significance of Institution in Business Model Reconstruction – Two Approaches

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Abstract – The article presents two approaches of enterprises in the development of strategic actions in conditions of the so called institutional voids. According to type 1, which is typical for traditional enterprises, a change is regarded as a necessary compromise which is a threat to efficiency. When it comes to type 2, institutional voids are perceived as indicators for further development. Creative approach towards structural constraints of the setting translates into institutional innovation which may be the basis for strategic efficiency of enterprises which lack traditional sources of competitive advantage.

Key words – institutional voids, business model, innovation, replication

I. Introduction

The institutional context significantly helps to understand strategic choices regarding creating a business model of an enterprise. According to North, institutions shall be defined as “the rules of play”, or, in other words, as social constraints that shape the structure of social interactions [North, 1990, p. 3]. Institutions create formal rules (e.g. law, regulations, accepted behaviour) and informal constraints (customs, standards, accepted ways of behaviour) [North, 1990, p. 36, 46]. The characteristics of business activity models is specific for a particular set of institutional conditionings which vary radically both in time and depending on the sector [North, 1990, p. 110]. On the fundamental level of the analysis institutions are comprised of three “pillars”, i.e. prescriptive, regulative and cognitive [Scott, 2001]. The regulative pillar includes such institutions as legal rules and regulations which are expected to ensure governance and stability within the society [North, 1990; Williamson, 1975, 1991]. The cognitive pillar is connected with the area that belongs to social psychology [Berger and Luckmann, 1967; Kostowa and Zaheer, 1999] and a cognitive current of the institutional theory [Meyer and Rowan, 1977]. It refers to cognitive social structures which are taken for granted and which are adopted and used by social actors [Di Maggio and Powell, 1983]. The prescriptive pillar (which goes beyond formal standards or knowledge) is related to legitimation. Social standards, values and convictions that stand behind it set the boundaries of actions regarded as desirable and appropriate [Zimmerman and Zeitz, 2002]. It is a “level of cultural support for an organisation” indicated by the consistency of values represented by the organisation and setting [Meyer and Scott, 1983, p. 201]. The cognitive and prescriptive domains emerge mostly in the processes of education and socialisation, whereas the normative domain – by way of political social processes. The pillars do not have to be considered separately. In the

long period of stability, the state of complementary consistency between them is more likely to occur.

In response to the setting structure understood in this particular way organisations decide to apply strategic solutions which indicate their compromise, active joining or resistance. The aim of this article is to identify ways in which institutions influence possibilities of development of business activity of an enterprise which consists in business model replication or innovation. Enterprises investing on foreign emerging markets were selected for the empirical context of the considerations. On the one hand, lack of institutions appropriate for mature markets, that is, the so called, institutional voids, characterizes emerging markets [Khanna and Palepu, 2010; Khanna and Palepu, 1997; Khanna, Palepu and Sinha, 2005]. On the other hand, competitiveness of enterprises coming from “the peripheries” of the world economy increases which may suggest that their setting creates conditions suitable for the development of interesting strategic forms of organisation. As Scott put it, “it is difficult, or even impossible, to identify the influence of institutions on social structure and behaviours, if all our cases are set in the same or very similar ones” [Scott, 2001, p. 146].

II. Institutional voids in structural conditionings of the enterprise’s setting

The phenomenon of emerging markets forces us to pay greater attention to the issue of the setting infrastructure that supports the implementation of intentions of an international enterprise which, facing institutional voids, may constitute a strategic challenge. It is therefore traditionally accepted that the role of an institution is “to reduce uncertainty by setting stable (though not necessarily effective) structures, in human interactions (...) institutions influence the results of the whole economy by means of their effects in the costs of exchange and production” [North, 1990, p. 5, 6]. In this respect, poorly secured transactions, communication, and transparency of partners on emerging markets may create opportunities for opportunistic behaviours. They also increase uncertainty [Khanna, Palepu, 1997]. Khanna and Palepu mention lack of sources of information, or their unreliability, uncertainty in the sphere of regulation and inefficient legal system as main sources of institutional voids [Khanna, Palepu, 2010, p. 16].

Institutional voids are one of the criteria of categorising markets as emerging ones. The emerging market is the one where advanced institutions that support transactions between the buyer and seller on the sales, employment or capital markets are not present or function in an inefficient way. On the basis of this structural definition, emerging markets may be placed on the continuum between completely dysfunctional markets and the developed ones [Khanna, Palepu, 2010 p. 24–25]. Adaptation of Western practices by emerging countries is regarded as a necessary condition for growth if there is the inflow of direct foreign investments.

The possibilities for adjustment in conditions of institutional voids were studied by, inter alia, Khanna et al. [2005], Khanna and Palepu [2010] who analysed

mostly the experiences of American, Western European and Japanese corporations. According to them, strategies need to be adjusted to the context of each country, however, it is necessary for the cost of additional coordination not to exceed the advantages which the change brings [Khanna, Palepu, 1997, Khanna, Palepu, 2010]. In this respect they suggested three possible strategies in the setting of emerging market, i.e. adaptation of the business model, change of context (setting) and abandonment of further development of business activity. The first strategy – adaptation of the business model – consists in its adjustment to limitations of sales market, supply market, or both. It is, however, necessary to retain key components of business activity. Too radical change could undermine global economies of scale or a global brand. The second strategy refers to international enterprises which are strong enough to influence the setting in which they operate. Product or service offer may result in a significant change on the local market. However, in some circumstances, business model modification may turn out to be unprofitable and/or uneconomical. Then, the third option, i.e. withdrawal from entering the market, is recommended. To sum up, as far as the traditional approach is concerned, the necessity for adjustment to institutional voids is regarded as a negative compromise which infringes the efficiency on the level of an enterprise. Acknowledgment of diversity of the emerging market setting takes place in case of shortage of the so called market power [Hymer, 1976]. Strong grounds of results constitute the necessary condition for the process of internationalisation to take place. Whereas, economic justification constitutes a sufficient condition.

What draws the attention while observing economic practice is the fact that even markets traditionally regarded as mature, periodically acquire traits of emerging markets. In such circumstances the ability to creatively handle new institutions may be of strategic importance. According to Oliver, enterprises are not doomed to passive adjustment to institutional setting but they can change it by developing strategic initiatives [Oliver, 1991]. The success of such initiative requires, however, access to specific local resources [Meyer, 2004]. This thesis may be the beginning of further exploration of ways to neutralise market limitations different from the traditional ones.

III. Method in the field research

The results presented in the article are a part of broader study on strategies of international enterprises in the conditions of emerging markets. Qualitative approach with the use of a descriptive study case were used for the preparation of the presented research project [Yin, 2009]. The group of research entities included deliberately selected enterprises operating on the international scale. All the enterprises belong to the same industry of manufacturers of parts for mining machinery. The selection of entities operating within one branch eliminates a possible influence of specific industrial institution on the results. Head offices and branches of

five small and mid-sized international enterprises were selected as research units. It is justified by the fact that such enterprises lack resources giving market power understood in a traditional way [Hymer, 1976]. The selection was supposed to ensure the best possible access to data. Chief executive officers of both enterprises and branches, as well as employees who had acquired knowledge regarded as significant from the perspective of the research problem constituted the elements of the research. In the course of conducting field research empirical data were collected with the use of structured personal interview and unstructured personal interview.

TABLE 1
BASIC CHARACTERISTICS OF COMPANIES IN THE RESEARCH SAMPLE

Company	Country of origin	Volume of turnover (FDI / company; in EUR mln)	Number of employees (FDI / the whole company)	Location of selected FDI (entry time)	Form of organisation of FDI
Company I	Poland	3/7	50/90	Colombia (2007)	Own branch / JV
Company II	Germany	23 / 45	50/300	China (2003/2008)	JV / Own branch
Company III	Italy	128/323	600/2800	Malaysia (1988)	Own branch
Company IV	Poland	4/70	23/120	Russia (2007-2009)	JV
Company V	Germany	11/63	25/160	China (2008)	JV

The sample included enterprises from both mature and emerging markets. The analysis was conducted by comparing cases from the sample with traditional patterns of adjusting business models by international enterprises in the conditions of emerging markets described in the previous paragraph (Khanna et al. 2005, Khanna and Palepu, 2010). Business model should be understood as the basis of economic results of an enterprise on a particular foreign market. The obtained results made it possible to divide cases in the research sample into two distinctively different groups. The cases in the first group adopted a traditional approach, whereas cases in the second group used more diverse strategies. For the transparency, the groups shall be hereinafter referred to as type 1 and type 2.

IV. Replication and innovation of MNC business model on the emerging market

There was one case of an enterprise in the research sample which corresponds with the traditional way of adjustment defined above as type 1. In the course of implementation of strategic intentions Company III used, to a large extent, market infrastructure typical of the Western model. Shortages in this respect were identified as obstacles. For example, facing lack of appropriate quality of suppliers, existing co-operators were invited to participation in investments and cooperation. Conditions

of investments were also negotiated with local authorities. The company's strong position enabled it to implement plans on the international market. Company III is one of the leading manufacturers with respect to the assortment it offers. The case of Company III corresponds to the strategy targeted at the change of setting.

Companies II and V (similarly to Company III) would replicate their business models (i.e. transferred solutions generated on other markets). On the contrary to Company III, these cases did not have at their disposal huge resources or a dominant position in the world industry. They should, therefore, in accordance with the pattern presented in the previous paragraph, adapt their business

model. Company II was willing to modify its methods of action by, for example, cooperating with institutions of higher education in order to acquire suitable technical staff. Implementation of project changes to the company's products that were adjusted to local solutions is another example. The company became the leader on the foreign market. Company V did not introduce any real changes in its business model. It was justified by the concern that the basis of value the customer was provided with might worsen. Company V did not achieve its strategic goals on the foreign market. Therefore the strategy of avoiding adjustment which was chosen by the company turned out to be inefficient.

TABLE 2

APPROACH TOWARDS INSTITUTIONAL VOIDS TYPE 2 – CASES OF STRATEGIC SUCCESS

Institutions of pillars of the setting	Business model innovation – Company I	Business model replication – Company II
Regulative	<ul style="list-style-type: none"> – Low standard of the mining law as a field of collaboration with business partners, trade organisation and representatives of state administration – Participation in consultations concerning creating the mining law – Carrying out current business activity inside the company to a largest possible extent 	<ul style="list-style-type: none"> – Application of legal protection of patents, but together with additional technical solutions – Regulations of the mining industry as an element that could lead to adaptation of products – Carrying out current operational business activity in the form of outsourcing
Cognitive	<ul style="list-style-type: none"> – Lack of qualified labour force was the reason for creating original labour teams – Participation as an expert in the governmental educational programme – Sharing knowledge openly with a wide group of interested party – Consolidating applied technical standards (e.g. by introducing new devices and tools which were not previously used in the local branch) – Employee trainings; learning a foreign language was as important as technical knowledge – In case of unforeseen difficulties designing technical solutions with the use of locally available equipment – Attempts to fill the senior managerial positions with local managers (which also had consequences that belong to the normative domain) 	<ul style="list-style-type: none"> – “Controlled” collaboration with state R&D units and collaboration with technical universities – Internships for students which increase chances for getting employees of suitable technical qualifications – Adaptation of one's own technical solutions to local requirements (trade and technical ones) – Securing one's own interests by means of introduced technical solutions
Normative	<ul style="list-style-type: none"> – Mutual interest to secure execution of the contracts – Demonstration of intention of long-term engagement on the market – Gaining trust of prospective clients by means of open presentation of implemented projects – Increasing social standards for employees from the local market 	<ul style="list-style-type: none"> – Building the image of an innovative company of high standard as a response to the conviction about discrimination against foreign investors – Introduction of local elements to the image of the company's branch – Building strong relations with clients – Limited placement of the most important elements of business activity on the foreign market out of concern of being copied

Companies I and IV are examples of companies which while entering the foreign market implemented innovations of the business model. Both of them decided to take up a new business activity. Company I regarded institutional voids as valuable knowledge about directions of development. One of the priorities of development of business activity, which, for example, prejudged the choice of FDI form in the form of company's own branch, was the conviction that it was necessary to gain trust of local partners. Another example concerns securing the contract against opportunistic behaviour of an enemy. Facing lack of possibilities to assert claims by means of legal proceedings, both partners were co-dependent in the obtained results (mutual success or mutual failure). Lack of traditional marketing channels was compensated by, inter alia, participation as an expert in governmental training projects¹. These programmes would gain interest of the press and prospective partners and clients. Generally speaking, lack of market infrastructure in the sphere of formal institutions would be successfully replaced with institutions of an informal character. Company I reached a significant position on the foreign market and became one of the biggest investors that came from Poland on the selected foreign market. Company IV entered the foreign market in order to launch one of its products in the new branch. Due to lack of knowledge of the market a JV with a local partner was created. The partner was supposed to be responsible for organisation of activities on site. However, it turned out that their scope and nature were too big for Company IV. The company eventually decided to withdraw from the market.

Table 2 presents the examples that show creative ways of dealing with limitations of the setting identified in case of enterprises regarded as a strategic success. The data were assigned to particular setting pillars: regulative, cognitive and normative.

Summing up, there were enterprises in the research sample which constitute examples of different approaches towards institutional voids. Company III is an example of an approach towards impediments to the development of business activity on the emerging market which was defined above as type 1. In this case replication consists in neutralisation of influence of the largest possible number of institutions on the organisations, which would require the change of action method. The conviction that a similar strategy requires suitable market power seems to be justified. Such an approach failed in case of Companies IV and V that were smaller than Company III. As the examples of Companies I and II show, lack of accumulated capital may be compensated by creative approach towards institution. It should be noticed that although two cases were considered a strategic success, the companies handled the obvious complexity of the setting in different ways. The issue has been further discussed in the next paragraph.

Conclusions and reflections

Cases of enterprises which were included in the research sample show different approach towards the institution of emerging market. The obtained results indicate the possibility to implement initiatives, or the whole business models, in the conditions of institutional voids should be analysed with regard to institutional morphology of the market. The author's own research took into consideration the division of institutions into regulative, normative and cognitive ones. It is also important that each pillar of the setting differs in the level of formalisation and transparency, i.e. the possibility, for entities "from the outside" in particular to become directly familiarised with them.

Traditional approach – type 1, which is most broadly discussed in the literature on the subject, was developed on the basis of experiences of mature markets. In this case, enterprises on foreign markets that are new to them are willing to pay the greatest attention to the regulative domain which is characterised by a relatively highest level of formal codification. However, omitting two other domains in the complex setting may lead to loss of chances. In case of smaller enterprises it may even result in the strategic failure. The case of Company III is an example of type 1 approach. The company in the conducted business activity regarded institutional voids entirely as barriers. In this respect, the Company to a largest extent sought indicators of development of its business activity on the foreign market in the regulative pillar. Company III within the framework of its capabilities in this area attempted to influence the setting with the use of a negotiation advantage. The idea for filling limitations in the cognitive pillar was to transfer developed relations and solutions from the home market. Practically, the normative domain was not an area of strategic interest.

In cases of more creative approach towards institutional voids, the attention was paid to all pillars of the setting. In data analysis which took into consideration three domains of institutions in cases which illustrated type 2 approach made it possible to identify two different patterns. Company II which replicated its business model on the foreign market regarded institutional voids as threats. They were, however, a motivation to search for non-standard solutions. It may be stated that the field for development of new ideas was indicated by limitations which revealed the comparison of functions of mature market and emerging market institutions. In this respect, the traditional institution model was a "cognitive filter" for managers. Firstly, the possibilities of the use of institutions in the regulative pillar and in a relatively transparent scope of the cognitive pillar were analysed. The identified limitations were overcome by means searching for solutions, which were to a larger extent concealed from the foreign investor, in historically and culturally determined aspects. On this basis the adaptation of business model was performed. Another model was

identified in case of Company I which facing obvious complexity of the setting constituted the illustration of the most open approach towards institution. Company I regarded institutional voids as chances that indicated directions on its development path. What distinguished this case was the fact that it treated social legitimation of carried out activities as a priority. In this case all the pillars of the institution would be combined in the most creative way. For example, participation as an expert in the governmental training programme promoted, apart from education itself, technical solutions applied by Company I, increased social legitimation of actions as a foreign investor, and at the same time served as advertisement. The fact that trainings took place in the course of project implementation also motivated the investor to greater cooperation and engagement. The activity was not profit-oriented but it facilitated making new relations which, in turn, resulted in further chances for Company I. Generally speaking, lack of market infrastructure in the sphere of formal institutions was successfully replaced with informal institutions. Figure 1 summarizes the role of institution according to type 2 approach towards structural conditionings of the market in the development of activities of an enterprise.

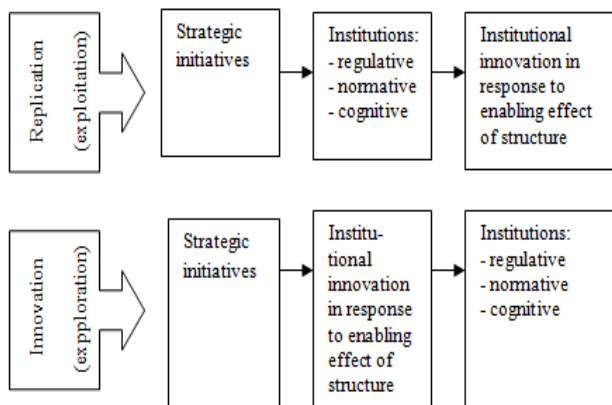


Fig. 1 Significance of institutions in replication and innovation – type 2

The presented examples suggest that enterprises which can combine their own strategies with institutional setting have a chance to improve their results. Finally, it is worth highlighting that transformation and changes of institutions may cause previous adjustment to become a burden in new circumstances. Dynamic setting requires continuous attention within the scope of the rules of play, which influence the assessment of the strategic decisions made. The companies which achieved success have a tendency to apply existing models of action since there is no pressure to take the risk of new ways of resources configuration. There is, therefore, a tendency for passive duplication of patterns to take place in the situation in which the success in “the game” itself changes “the game”. In this situation, tenacity in application of the old game transforms success into

failure. In the light of the above, development in the conditions of emerging markets, competences which correspond to type 2 approach, and in contemporary competitive conditions, serves as a valuable lesson also for entrepreneurs who apply traditional strategies of building competitive advantage.

Footnotes

¹Servicio Nacional de Aprendizaje – SENA, institution subject to the Ministry of Labour and Social Insurance. Its aim is to invest in social and technical development of human resources in Colombia. <http://www.sena.edu.co>

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