



## Strategic Responses to Deregulation: An Institutional Theory Perspective

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## Strategic Responses to Deregulation: An Institutional Theory Perspective

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### Abstract

Firms adopt distinct strategic orientation in response to change in environment. Deregulation is a drastic change in firm's environment. This paper attempts to explain strategic orientation exhibited by firms in response to deregulation from an institutional theory perspective. Integrating propositions have been developed to examine congruence of institutional theory concepts of coercive and mimetic isomorphism with stylized strategic orientation. Unique methodology of corroborating propositions with empirical findings from past studies was adopted. While partial support was found for propositions, the inferences drawn provide alternative explanations for results of empirical studies and for expanding the boundaries and scope of institutional theory.

## Introduction

The debate on role of government in influencing policies that can significantly affect business organizations has resurfaced after 2008 financial crisis. In fact, contrary to popular belief, role of government in regulating and managing business has significantly increased after 9/11 incident (Ring, Bigley, D'Aunno, and Khanna, 2005). Strategy researchers have always been interested in studying environment-strategy co-alignment. This concept is rooted in strategy, and organization behaviour literature. Past studies on strategic response to change in environment have identified regulation as most dominant environment factor (Tan and Litschert, 1994). Similar empirical studies (Smith and Grim, 1987; Ramaswamy, Thomas, and Litschert 1994; Tan and Tan, 2005) have shown that firms exhibit certain pattern in their strategic orientation in response to environmental change from regulated to deregulated environment. Strategy theorists have explained these findings on distinct strategic response of firms in very general practical terms. However there is a need to link these findings with theories to gain deeper understanding of these phenomenons. An attempt is made in this paper to provide an alternative institutional explanation based on pioneering work done by Demaggio and Powell (1983). This approach is in tandem with emergent thinking in institutional theory field as evident in following statement made by Scott(1987).

*“Recently several theorists-including DiMaggio(1988) and Zucker(1987)- have momentarily suspended their efforts to expand the variety and scope of institutional arguments and/or devise new data sets and tests, in order to step back and take stock of the progress of this new perspective to date.”*

## Understanding institutional theory

Organizational structure and design are central issues for organization theorists. In early organization theory, up until the late 1970's, a contingency theory approach dominated thinking about organizational structure and design. Contingency theory proposed that organizational structure is contingent upon (dependent upon) the environments in which the organization acts, and on the specific characteristics of the organization and the production. This means that various organizations are assumed to have different structures because they are different in size and in technology, and because

they act in different markets. A basic assumption, however, is that the formal structure of organizations is chosen based on efficiency. Thus the chosen formal structure the most efficient way to organize as it optimizes co-ordination and control based on the contingencies set by the organizational environment. In other words, these theories assume co-ordination and control to be the most critical dimensions for measuring success of formal organizations. The contingency approaches thus focused on differences. Organizations looked different because they met different Environments and because they had different technical requirements. In the late 1970's and early 1980's, researchers were asking a strikingly different question. Rather than focus on differences, scholars noted that organizations display considerable similarities and in structures and processes regardless of time, place, and other contingencies. They asked. Why are organizations so similar? And why are organizational structures becoming increasingly complex? Companies do not only seek to be efficient and effective but also legitimate. The myths and rules of institutional environment influence design of formal organizational structures. In the process they become isomorphic with institutional environment. Scott (1987) provides brief review of sociological formulations of institution and institutionalization.

- (a) **Institutionalization as a process of instilling value:** Salznick (1957) argued that institutionalization infuse values much in excess of the technical requirements of the task at hand. He distinguished between technical and institutionalized organizations. Technical organizations are designed for achieving definite goals. Therefore they are expendable. In contrast, institutional organizations emerge from social interaction and adaptation. Thus they reflect group ideology. Institutionalization instills value and thereby imparts stability to the organization structure. He also emphasized the role played by effective leaders in defining and defending organization's institutional value.
- (b) **Institutionalization as a process of creating reality:** According to Berger (1967), social order based on shared social reality constrains human behaviour. *The process by which actions become repeated over time and are assigned similar meanings by self and others is defined as institutionalization.* Later this idea was extended to organizational forms. Zucker (1977) defined institutionalization rooted in

conformity as both a process and a property variable. Meyer and Rowen (1987) also defined institutionalization as process by which they acquire rule like status in social thought and action.

- (c) **Institutionalization systems as a class of elements:** society legitimizes institutional forms.

DeMaggio and Powell (1983) argue that ideally the design of organization should emerge from efficiency considerations, as firms have to compete in the market place. However, the design is also influenced by constraints that are imposed by the state and institutional environment. However, beyond a certain limit, further adaptation entails giving priority to legitimacy concerns over efficiency improvement opportunities. The mechanisms through which firms become clones of each other are as follows.

**Coercive Isomorphism:** Compliance to government mandates, legal and professional bodies, cultural expectations force organizations to adopt a certain type of organizational forms and rituals. Subsidiaries that are part of large corporations also face similar coercive pressures.

**Mimetic Processes:** Diffusion of a certain type of organizational models happens through employee migration and consulting firms.

**Normative Pressures:** Employees with same educational background and experience tend to approach problems in a similar way. This leads to emergence of common rituals and processes. This also leads to organizational legitimacy.

*Rooted in this line of thinking, I have argued in this paper that institutional factors influence strategy that in turn influences structure. Thus structural isomorphism and strategy isomorphism concepts can be substituted for each other to study impact of institutional factors.*

## Strategic response to deregulation:

Strategy researchers have posited that firms having co-alignment between their environment and strategy demonstrate superior performance. From an environment perspective, regulated and deregulated environment are commonly perceived to represent two extreme forms of environment. While regulated environment is synonymous with government control, deregulated environment symbolizes control through market mechanism.

Emery and Trist (1965) describe four types of environments (1) placid, randomized; (2) placid, clustered; (3) disturbed, reactive; and (4) turbulent. According to this typology, in a disturbed-reactive (regulated) environment, large number of organizations shares the same market and there is no information asymmetry. Thus organizations differ not on strategies but on operational details. In comparison to predictable environment under regulation, a deregulated environment (turbulent field) show great deal of uncertainty.

In an environment where managers can exercise their discretion freely, strategy is an important determinant of performance (Schendel and Patton). Extending this logic, importance of strategy is limited in environment which restricts management decision making prerogatives (Tan and Litschert, 1994). Similarly, Mahon and Murray (1981) assuming an all pervasive static aspect of environment, asserted that under conditions of deregulation, strategy has a limited role to play. This happens due to 'regulatory lag', and regulatory body's attempts to maintain uniformity- in terms of procedures, rated etc-across players. Firms adopting competitive postures have to seek prior approval of regulatory agency. This information being public, rival firms can fine tune their strategies to meet impending competition. Since law mandates the relationship between players, and termination is not possible, whatever strategy firms adopt are programmed, and negotiated. This causes organization atrophy with regards to its capability to formulate competitive strategies. Moreover, managing relationship with regulatory agency takes precedence over technical aspects of strategy viz. product/market expansion, service, price, innovation etc. *This explanation of environment-strategy gives preemptory role to the environment factors in strategy making process.*

## **Typologies of strategic orientation and strategic response**

In strategic management literature, strategies have been defined as pattern of firm behaviour (Mintzberg, 1973). Mahon and Murray (1980) hypothesized that in regulated situations, strategies are negotiated and programmed. Though managers should pay due attention to technical aspects (price, product/market etc) of strategy aspects, more importance should be paid to the organization's relationship with the regulatory body, especially where the role of regulatory body acts as buffer. Further, the importance of relationship aspect of strategy doesn't get diminished in even situations where regulatory bodies act as change agent. In nutshell, they emphasized the management of process (relationship) and not product (technical part). Tan and Litschert (1994) studied environment-strategy relationship for Chinese electronics industry. The study was significant because of its unique settings that of an economy in transition, very similar to regulation/deregulation process. Prior research milieu was of competitive market economies, where transition was from government control to regulation and then to deregulation.

## **Convergence between institutional theory (isomorphism) and strategic response to environmental change (deregulation process)**

Based on typology of Emery and Trist (1965) and the concept of isomorphism by DeMaggio and Powell(1987) I propose following propositions. In a regulated environment, broad economic policies related to price, regulatory body determines entry/exit. Further, any competitive policy initiatives by participants require prior approval of regulatory body. The state (regulatory body) influences strategy-making process. The organizational change is a direct response to state mandate. When deregulation happens, uncertainty increases in environment due to clamoring for resources, and entry of new entrants. Participants redefine their goals leading at times to goal ambiguity.

***Proposition 1: Organizations will exhibit coercive isomorphism under regulated conditions and mimetic isomorphism under deregulated conditions.***

In a competitive economy, though behaviour of organizations is moderated by regulatory agency, its control on organizational policies is not absolute. In contrast, decision making for organizations operating in centrally controlled economies is tightly monitored by administrative ministries. Since regulatory bodies are not autonomous, political interference stymies managers' decision making.

***Proposition 2: The degree of coercive isomorphism will be higher in centrally controlled economies.***

From argument given for proposition 1, it can be derived that there will be some sort of sequential isomorphism exhibited by firms in sectors being deregulated.

***Proposition 3: When environment change from regulated to deregulated, isomorphism will change from Coercive to Mimetic.***

Since deregulation is associated with increased uncertainty, reduction of barriers, and increased autonomy. Firms hitherto unexposed to such environment will mimic strategies of firms having already worked in such environments i.e. MNCs or in absence of them of early adopters of innovative practices. Also because of domination of western management practices, consultants diffuse structures and policies of MNCs. Thus presence of MNCs would make them focal point of imitation.

***Proposition 4: The presence of a successful multinational(s) already exposed to environmental change would accelerate the mimetic process.***



## Findings of Empirical studies examining strategic response to deregulation:

Past studies on strategic response to regulation/deregulation

Mahon and Murray(1981)	Conceptual. Regulation	General	Strategies don't matter due to regulatory lag. Technical and relationship strategies.
Ramaswamy, Thomas, and Litschert (1994)	Empirical. Regulation in competitive setting	U.S Airlines	Strategies matter. Defender more successful than prospector. Credit to top managers
Smith and Grim(1987)	Empirical. Deregulation in competitive setting	U.S. railroads	Focused strategies desirable in deregulated setting. Results contrary to hypothesis. Contingency & innovation
Tan and Litschert (1994) and Tan and Tan (2005)	Empirical. Deregulation in controlled economies.	Chinese electronics	Defensive even after 10 yrs. Regulation most uncertain. Focused after stabilization.

Ramaswamy, Thomas, and Litschert (1994) analyzed influence of government regulation on organizational strategies and performance for Airlines industry. The period of study was six years. The results demonstrated that managers affect firm performance. Since, this was sort of follow-up study on the original work of Snow and Hrebiniak(1980), it captured the longitudinal time frame aspect of strategy under a stabilized environment. Using Miles and Snow(1978) typology, and cluster analysis, they found empirical support for importance of managers role in strategy and its positive impact on performance. Between firms pursuing efficiency oriented defender strategy and firms with Prospector strategies, the former seem to have superior performance. In a way, the results corroborated the argument of Mahon and Murray (1981) who advocated adoption

of relationship strategy for regulated firms. The results indicated that in regulated environment, firms that pursue efficiency oriented strategies through capable managers far outperformed firms that pursued externally oriented prospector strategy.

Smith and Grim (1987) studied impact of change in regulation on 27 railroad firms. Experts categorized the strategies of these 27 firms using Porter's (1980) and Miles and Snow's (1978) typology they broadly categorized strategies as focused and unfocused strategies. In a focused strategy a specific strategic dimension is emphasized over others. In contrast, an unfocused strategy is defined as one in which no particular strategic dimension is emphasized.

Broad Categorization	Porter's Typology	Miles and Snow Typology
Focused	Low Cost	Defender
	Differentiation	Prospector
	Focus	Analyzer
Unfocused	Stuck in the middle	Reactor

Drawing support from management literature (Andrews, 1972; Porter, 1980, 1985; Thompson, 1967), they argued that in a competitive environment (read deregulated) a focused strategy yields better results as it aligns organizational resources with external environment. Similarly, Mahon and Murray (1981) argued that in a deregulated environment, firms would follow a focused strategy. They used cluster methodology and found that though majority of firms changed their strategies after deregulation, only few followed focused strategies. In fact majority of firms changed their strategies to contingency. The explanation offered was that perhaps regulation over a prolonged period impedes formation of focused strategies. With regards to appropriate strategies to enhanced performance for such strategic change, support was found for change from unfocused follower strategy to an innovation strategy. However, the most prominent finding was that during transition phase, firms adopt wait and watch policy to gauge the direction and extent of change.

The setting of of Tan and Litschert(1994) strategy-environment study was a centrally planned economy that was transitioning to a market driven economy. As a controlled economy is synonymous with a highly regulated economy, this study provided very useful insights into strategic response of firms to change from regulated (controlled) to a deregulated (market determined) environment. The country chosen was people republic of china and the sector chosen was electronics industry. The theoretical base was embedded in work of Mahon and Murray(1981), Smith and Grim(1987), Snow and Hrebiniak (1980) , Lenz(1980). The results showed that managers were wary of regulatory environment. In fact it was reported to be complex and unpredictable. It discouraged risky and future oriented decisions. However, the 2005 study showed that firms strategies had coevolved with environment even though the Chinese managers still lacked entrepreneurial orientation.

### **Discussion: Analysis of results from an Institutional theory perspective.**

**Proposition 1:** The regulatory agency influence both corporate action as well as public opinion (Mahon and Murray,1981) The regulatory agency exercise control by restricting price, and exit/entry. Because competitive postures do not yield any rewards, focused competitive strategies are not useful for firms operating in a regulated environment. Empirical results have corroborated their conclusions. Smith and Grim (1987) found very few firms adopting focused strategies during periods of regulation. Even findings of study carried by Ramaswamy, Thomas, and Litschert (1994) support adoption of strategies in compliance with state dictates, albeit in a different manner. According to their findings firms which adopted defensive strategies fared better than one adopting prospector strategy. This reinforces explanation of complete dominance of regulatory body on inter-firms policies. The firms with prospector strategies had to performe infringe on/trespass jurisdiction of regulatory body creating situations of conflict leading to abrogation of such initiatives. Whereas firms with defender strategies continued to improve performance as the intra-firm policies fell beyond purview of regulatory body, and coercive isomorphism was not applicable there. Thus coercive isomorphism fully explains strategic behaviour of firms operating in regulated environment.

But contrary results are seen with respect to strategic orientation during deregulated period. While study of Smith and Grim points to adoption of contingency strategies, study by Tan and Litschert (1994) show that firms didn't changed their strategic orientation and continued with defensive strategies even after deregulation. Institutional theory suggests prevalence of mimetic isomorphism during periods of increased uncertainty. Thus empirical findings do not support second part of the first proposition. The anomaly can be explained by considering deregulation as a staged process. In the first phase i.e under complete regulation state dictates and determines behaviour of firms. The competition is deemphasized and state ensures survival of firm. This promotes a collective mutually beneficial behaviour of co-existence and cooperation among limited players. The competitive arena is refereed by the state. However this sets in a process of organizational atrophy with regards to decision making capabilities. Further during second phase of deregulation i.e in near future after deregulation is announced, players remain wary of government intention, and continue to look towards state for direction. This may be termed as *coercive isomorphism lag*. However as uncertainty keeps on increasing due to abolition of controls, and entry of new entrants, firms start scouting for prototypes of successful firms. During this process active aid of institutional mechanisms are taken to search for solution. Sometimes regulatory agency itself acts as a change agent. However in the third phase, as deregulated environment stabilizes and state slowly withdraws from competitive arena, and there is certainty of environment, firms start scrambling for resources. This leads to resource partitioning and differentiation strategies to ensure survival. Because of urgency with firms seek growth opportunities (active competition to increase market share); they adopt successful prototypes by mimicking them. These firms may be either those which are early adopters of innovation and working in same settings or these can also be firm working abroad in same sector. This rise of institutionalism is to monitor mutualism and ensure community survival. As suggested by institutional theory such isomorphism diffuses through consultants. The explanation finds support from findings of study done by Tan and Tan (2005). In a longitudinal study they found out that firms adopted focused strategies after deregulation had stabilized.

**Proposition 2:** Study done by Tan and Litschert(1994) undertaken for Chinese electronics industry showed that firms continued to exhibit defensive strategic orientation even after 10 years of deregulation. Managers found regulatory segment as least predictable, most complex, and most influential. Environment was perceived to be discouraging risky decisions aimed at future. Further even after a decade of economic reform, Chinese managers still lacked entrepreneurial orientation. This can be attributed to the fact that the state interference through its administrative ministries in day to day affairs of firms is very high in centrally controlled economies. This causes persistence of coercive isomorphism even after decontrol of sectors. Further, the social institutional factors, much stronger in economies with socialist orientation contribute to persistence of coercive isomorphism.

**Proposition 3:** As argued above, empirical findings suggest that firms operating in changing environment from regulated to deregulated do not show expected commensurate change in isomorphism from coercive to mimetic due to interspersed by a phase marked by coercive lag. This happens as firms are unsure of directions deregulation process would take place and partly due to organizational decision making atrophy.

**Proposition 4:** Lifting of regulatory controls on entry may see entry of some new players. In a globalized economy, it is possible that large MNCs seeking new emerging markets may enter the fray. It is presumed that because of their wider exposure of working in different settings these companies have perfected their decision making systems. Further, consultants play a major role in diffusion of mimetic isomorphism

## Contribution

- Provides alternative explanation through institutional theory to phenomenon which involves state and thus broadens scope of strategy.
- Adds to understanding that regulation-deregulation is a continuum.
- Policy interventions can be designed better to reduce lags.
- Isomorphism is not purely sequential. Interspersing processes are there.

## Limitations

Institutional theory is based on premise that the adoption of isomorphic structures could be just for ceremonial purpose. Efficiency enhancement may be a secondary objective. Towards that argument, it is difficult to identify strategies which are adopted merely for ceremonial purposes. Nevertheless, an attempt can be made to identify components of strategy where performance may be relatively weak criteria for adoption. Further, out of the three, I have selected to examine only Coercive, and Mimetic isomorphic changes in strategic orientation in response to deregulation process. The third type of isomorphism, which is normative isomorphism was excluded from this study mainly as an intuitive decision and not based on any empirical or theoretical study. The first two types of isomorphism i.e. Coercive and mimetic were found to more appropriate to this study. Nevertheless this can be a promising area for further stud to expand the boundaries of Institutional theory.

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