

## **The Effects of Governments on Management and Organization**

Jone L. Pearce

Rebekah Dibble

Kenji Klein

The Paul Merage School of Business  
University of California, Irvine  
Irvine, CA 92697-3125  
USA

T: (+1) 949-824-6505

F: (+1) 949-725-2839

[jlpearce@uci.edu](mailto:jlpearce@uci.edu)

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## **The Effects of Governments on Management and Organization**

### **Abstract**

We review and integrate existing research from organization theory, strategy, organizational behavior, economics, sociology and political science on the effects of governments on organization and management, with a focus on how governing ideology and government capability influence independent organizations' forms, strategies, and their participants' behavior. When brought together these works suggest significant research opportunities in the fields of management and organization, as well as new perspectives on public policy challenges. Several avenues of potentially profitable empirical research include more attention to the influence of government on corporate strategies, more research on the strategies of pursuing corruption and government capture for competitive advantage, the role of government in fostering innovation and the growth of entrepreneurial organizations, and extra-organizational contextual effects on managerial and employee organizational behavior. Possible public policy implications are illustrated with an application to the role of organizations in national wealth generation and dispersion.

In recent decades there has been increasing attention to the effects of governments on other organizations and their management. Particularly in the sub-disciplines of international business, strategy and social issues in management, scholars are beginning to recognize the effects of governmental practices on a wide range of organizational phenomena. This recognition is reflected in part by two *Academy of Management Review* Special Topic Forums in 2005 and in 2007. Moreover, interest in how governments affect organizations and management also is growing among economists, sociologists, and others who study the societal effects of government policies and practices.

This burgeoning interest reflects increasing confidence that understanding governmental effects on management and organization is important, but it also highlights two problems. First, perhaps because the scope for governmental influence on organizations and management is so broad, this growing attention has resulted in a proliferation of differing conceptualizations of governments and a parallel profusion of government typologies in the sociological and economic literatures from which different management scholars often draw (see Martinussen, 1997; Tsai, 2002). While attention to government has helped expand the body of work on this important subject, this expansion has occurred at the expense of a coherent understanding of the specific mechanisms whereby governments impact organizations and their management. Thus, further progress in understanding governmental effects on organizations and management requires that we find the common themes that allow us to usefully integrate this diverse and growing literature.

The second problem is that the growing evidence of the powerful effects of governments on organizations and management has not made its way into mainstream intellectual work. Despite the recent attention to the role of governments in shaping organizations, too much of organization theory has developed in either a de-contextualized world in which organizational outcomes are solely the result of market, technical, or interpersonal considerations, or in an overwhelmingly contextualized

one in which institutional forces exert a powerful influence on organizational outcomes, but where many scholars have largely failed to differentiate the particular effects of governmental institutions from other institutions.

These two problems are not unrelated. Without an integrated view of the specific mechanisms by which governments affect organizations and management, organizational scholars are less able to recognize the role governments play in management strategies and managerial behavior, and they are less likely to incorporate governmental effects into organizational research. For example, without a clear understanding of the conditions that enable managers to capture government policy, it is easier for scholars to ignore the proactive attempts managers make to achieve such capture for their own competitive advantage. Similarly, without a framework for understanding how government capability indirectly affects interpersonal relationships within organizations, it is easy for scholars to overemphasize the impact that managers have on such factors as employee perceptions of fairness and justice.

Thus, assessing the literature on governments and providing a coherent view for how governments impact organizations is an important step in addressing this first challenge. Additionally, drawing attention to the variety of ways in which governments impact managerial and organizational behavior, while differentiating these governmental effects from more general institutional effects takes a step toward addressing the second challenge identified here. This paper attempts to address these two challenges by organizing extant work on governments around two dimensions that appear frequently in the literature and that seem to have the clearest effects on organizations. These dimensions are government ideology (i.e., the extent to which governments direct organizational objectives and provide direct support) and government capability.

In this review we bring together the literature and discuss how government ideology and capability affect a broad range of organizational and managerial outcomes. In doing so, we draw

attention to areas where incorporating the effects of government can further expand our theorizing and research. We highlight the ways in which current theory often takes a manager-flattering view that management strategies and organizational design are principally the result of managerial responses to market and technological forces and we offer alternative explanations for these phenomena in the context of governmental effects. Additionally, we identify gaps in our current understanding of the nature of the relationship between characteristics of government and managerial and organizational outcomes, signaling areas where future research is needed.

Finally, we end our review with a discussion of how a fuller understanding of the effects of governments on organizations can have practical applications not only in the realm of management, but also on public policy. Heretofore, government policy is developed with little understanding of the organizations and managements through which they are expected to operate. Here we draw attention to what a better understanding of the effects of governments on organizations and management can contribute to government policies and practices geared toward the creation, growth, and dispersion of national wealth. In this way we hope to accomplish two objectives: making the growing body of research on governmental effects on organizations and management more cumulative and useful, and showing that a review that integrates research on organization and management with research from political science and economics can provide useful insights into important societal questions.

### **EFFECTS OF GOVERNMENTS ON WHAT?**

Governments are the bodies that develop and administer the laws, policies, and regulations for a nation or community. Some social science scholars use the term state, the territory organized under one government, synonymously with government. The study of what governments should and should not do is as old as writing itself: the earliest Sumerian and Chinese written documents were concerned with such issues. Today, entire social-science disciplines – political science and public

administration – address these questions, and there is practically no limit to what can be said about the organizational effects of governments. Because we wish to address organization and management scholars, we will confine ourselves to that theory and empirical research which addresses the effects of government policies and practices on the strategies, forms and actions of independent organizations and their management.

Independent organizations are formal organizations not under the direct strategic and operational authority of governments. These organizations are not administrative divisions of government; nor do they exist to achieve government-determined objectives. While no organization is completely independent of the government under which it operates, there are meaningful differences in the degree and nature of organizational dependence on government. If organizations are free to set their own strategic and operational goals, we consider them to be independent. Yet, even this distinction is not perfectly clear; government mandates often influence the goals of independent organizations. For example, governments can and do require that foreign firms in a certain industry have government-owned organizations as their joint-venture partners, or mandate that private schools provide social services such as free lunches. Such mandates make these organizations less free to set their own goals. However, because these organizations are less constrained than those organizations which are direct agents of governments or governmental policies, we consider them independent. Therefore, our focus is on organizations, whether for-profit or non-profit, that have been created for some purpose other than the administration and enforcement of government policy. These organizations may vary in the degree of governmental influence on their practices, but they all pursue some autonomously set primary objectives.

Finally, we will not address those cases in which organizations create specialized departments or structures in response to direct government command or requirement. For example, in the waning years of communism in Hungary the government required all organizations to have

strategic planning and personnel departments that reported to the organization's managing director, hoping these ostensibly modern organizational structures would revive unproductive companies (Pearce, 2001a). That managers will do what they are commanded to do by sovereign governments with monopolies on the use of force is obvious and outside the scope of this review.

Yet even with these cases eliminated, governments can directly and indirectly affect organizations in meaningful ways that are relevant to organization and management theorizing and research. Governments provide (or fail to provide) the laws and enforcement systems within which organizations and their managers must operate (Kaufman, Kraay & Zoido-Lobaton, 1999; Ring, Bigley, D'Anno & Khanna, 2005), and this function gives them tremendous power. Governmental actions set the rules under which resources are possessed and exchanged (Fligstein, 2001). They also supply (or fail to supply) much of the infrastructure and institutional framework that enable possession, transformation, and exchange of those resources. This is most visible at times of upheaval as people turn to governments to address crises like the global financial one unfolding at the time of this writing. Government's importance also may become more visible when foreign organizations accustomed to operating with the benefit of a more robust governmental institutional infrastructure choose to do business in locations where governments do not ensure these supports. Thus, governments play a key role in shaping the environments under which organizations must operate. Their actions create or moderate the uncertainties that organizations must manage, and therefore governments are able to shape organizations in powerful and important ways.

This review integrates and extends theoretical and empirical works that have addressed how governments affect the form, managerial strategies, and function of independent organizations, as well as the affective and behavioral reactions of participants under differing governments. We review research which addresses, proposes, or tests the effects of governments on organizational size and structures, management strategies and practices, and participant organizational behavior,

identifying commonalities in definitions in order to integrate these works to provide a more useful foundation for our research. This rather large literature is listed in Tables 1 and 2.

Before describing how this literature has been organized and why, we note that although some scholars who focus on governments provide complex multi-dimensional models of governments, they rarely link individual dimensions to specific outcomes. Rather, they provide a list of governmental features and a list of proposed organizational, managerial or behavioral effects without specifying whether or not the dimensions might be additive, multiplicative or have potentially differential effects. For example, Brunetti, Kisunko and Weder (1997) identify eleven characteristics that, as a whole, can affect business operations, and the World Bank group lists 44 dimensions of governance which they later group into three categories (Voice and Accountability, Political Stability, and Government Effectiveness; see, Hellman, Jones, & Kaufmann, 2003 and Kaufmann & Kraay, 2000). As an empirical matter this is understandable, since so many governmental dimensions are highly collinear in practice. However, theory and research would better advance if we could articulate the distinct effects that different dimensions of government have on organizations; here we do that. Finally, the broad disciplinary scope and large size of the literatures discussed precludes a detailed analysis of each paper. These works range from arm-chairing speculations to rigorous scholarship and extensive theory testing. We identify the strongest contributions, but also include essays with provocative relevant ideas that other scholars might find useful, taking care to distinguish strong empirical research from other contributions.

We organize this research into three sections corresponding to two dimensions along which these diverse theorists propose that governments vary in their effects on organizations and management, and one public policy application. The first section discusses work that addresses how differences in government ideology (i.e., the extent of direct intervention in organizations' strategies) affects organizational strategies, forms, and practices. In the second section we identify

the effects that differences in governmental capability have on organizational forms and strategies, and on the interpersonal interactions and psychological states of organizational participants. To organize such vast literatures we chose two dimensions that seemed to best summarize the effects of government on organization and management. We believe they capture the broad, essential effects of government on organizations and management proposed by those who have addressed these questions and incorporate other sub-categories of governmental effects on organization and management. Reducing these ideas to two dimensions inherently oversimplifies these rich and nuanced literatures, but does help direct readers to that research most relevant to their own interests. The effects of government ideology and capability discussed here are summarized in the Figure. In the third section we apply this research to demonstrate how attention to governmental effects on organization and management can be used for public policy questions with an application of this research to understanding relative national wealth.

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### **GOVERNING IDEOLOGY EFFECTS ON ORGANIZATION AND MANAGEMENT**

One of the largest bodies of research on the effects of governments addresses how differing ideologies regarding direct intervention in organizations affect differing organizational forms and management practices (see Table 1). Governments are formed and operate with specific policy objectives, and these policy objectives can be vastly different from government to government. Organizational dependence vis-à-vis governments can give these government-defined priorities and agendas a powerful influence over the structures and strategies of organizations as well as the behavior of organizational participants. We group the research on how differing government goals or

ideologies affect management and organization into three streams: Institutional theory, the corporatist versus liberal-market debate, and privatization.

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### **Governments in the Institutional Field**

Much of the work addressing governments in organization theory has been undertaken by institutional theorists. Institutional scholars generally discuss governmental policies and forms as reflective of larger, more complex historical and institutional structures, which in turn become reflected in organizational forms and strategies (e.g., DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Zucker, 1987). For example, Jepperson (2002) proposes that business organizations reflect the differing societies and politics within which they operate, becoming isomorphic with dominant institutions such as government. Institutional scholars may describe how a governmental policy influences independent organizations and their strategies, but rarely seek to isolate governmental effects from the larger historical and cultural contexts in which independent organizations operate, referring to “the institutional environment” without seeking to specify which institution might have which particular effects. Recent work in international business scholarship also takes this broader institutional view. For example, Peng, Wang, & Jiang (2008) have suggested that there is an emerging institution-based view of international business strategy, which argues that national institutions affect firm strategy and outcomes as powerfully as do industry and resource effects.

This rich body of work often treats governments as just one in a field of institutions affecting organizations. The scholars provide numerous examples and illustrations of governmental effects but tend to treat governments as an outcome of a more abstract causal set of institutional forces. Yet a careful reading of some of this work often indicates that differing government beliefs regarding the

appropriateness of government involvement in the economy is often responsible for differences in organizational behavior and strategy. So, for example, Hamilton and Biggart's (1988) ambitious historical and comparative empirical study contrasts the organizational forms and growth strategies of the automobile industries under the different institutional environments of South Korea, Japan and Taiwan. That is, South Korean government policy supported and directed the strategies of large family-owned business groups, while Taiwanese government policy allowed markets to develop undisturbed, leading to very different automobile industries in the two countries. Guillén (1994) provides a rich description of the historical developments that produced differing governmental ideologies toward independent organizations with resulting different management practices in Germany, the United Kingdom, Spain and the United States. When institutional scholars such as Hamilton, Biggart and Guillén do theorize about the effects of governments themselves they have produced valuable contributions.

### **The Corporatist vs. Liberal-market Debate**

One of the most prominent approaches to studying the effects of governmental ideology on organizations is to compare what have been called more corporatist governments to more liberal-market governments. Corporatist governments generally include those of developed economies such as those of continental Western Europe, but also include many of the post-Socialist countries of Eastern Europe as well as Asian economies such as Japan and China. The more corporatist a government the more it actively attempts to directly help the independent businesses operating in its jurisdictions to adapt to changing circumstances (see Keister & Zhang, this volume). For example, Griffiths and Zammuto (2005) documented the extensive strategic involvement of the corporatist Dutch government in assisting the firms in its meat industry to adapt. This is in contrast to ideologically more liberal-market governments, such as the United Kingdom and the United States, which expect independent organizations to make their own adaptations.

Within this literature there is evidence that technology and markets are less important strategic considerations under more corporatist governments than they are under liberal market governments. Kogut, Walker and Anand (2002) found little evidence for the technological determinism dominating corporate strategy research: diversification strategies in a sample of corporatist and liberal-market countries reflected differing governmental policies and practices, with the ties among the more corporatist French elite in government and independent organizations influencing the forms of diversification France's independent organizations took. Schröter (1997) argued that more corporatist governments produced more cooperative relationships between governments and independent organizations than what is observed under more liberal-market governments. Kristensen (1997) documented how relatively more government support for the professions under corporatist governments resulted in greater authority for the professions in the managerial strategies and operations of independent organizations. Thomas and Waring (1999) found that expected investment returns drove investment by firms in the more liberal-market U.S., but that in the more corporatist Germany and Japan, business investment strategies were driven primarily by the ability of the firm to fund the investment itself, not the investment's expected return.

Thus, the strategies of independent organizations will differ under relatively more corporatist or liberal-market governments. Because governments are a more critical dependency under active corporatist government, governments become a key determinant of the strategies of independent organizations there. Under liberal-market governments, on the other hand, the comparative lack of government involvement in managing the environment ensures relatively greater managerial attention to the critical uncertainties created by market and technological forces.

These scholars raise an important issue that has yet to be acknowledged by mainstream strategy theorizing. The United States is considered among the more liberal-market governments,

and historically strategy theory and research have been dominated by scholars based or trained there. Given this history, it is not surprising that governments have played such a minor role in most strategy theorizing and research originating in the United States. Because governmental actions are less strategically important to independent organizations under liberal-market governments than under corporatist ones, they are not prominent in theory or research developed there. Rather, technological factors and product or services markets are assumed by many to drive organizational strategies (Chandler, 1990; Rumelt, 1974; Teece, Rumelt, Dosi, and Winter, 1994). Yet liberal-market governments are far from the dominant form in the world, and so these U.S.-based theories tend to underplay the strategic importance of governments and their agents, and to overplay the importance of technology and product or service markets in more corporatist nations.

### **The Effects of Differing Privatization Ideologies**

From the beginning of the corporate organizational form (the East India Company) there have been debates about which organizations should or should not be wholly or partially government owned. Research on the impact of whole or various forms of partial government ownership on organizational strategies and the efficiency of management practices and employee organizational behavior is well developed. However, again, because government ownership has (almost uniquely) been weaker in the United States, theories of organization and management have not included this important literature.

For example, as formerly communist governments moved away from policies of hostility towards independent organizations, they allowed varying degrees of privatization of government-owned organizations in order to spur greater strategic and operational focus on success in product or service marketplaces. Scholars have studied the effects of the degree and form of government involvement on these organizations. Such partial privatization policies allowed more managerial autonomy than under communism, but many observers documented that strategic attention to

governmental policy preferences continued to dominate. Kornai (1989) reported that under reform communism, government-owned businesses responded more flexibly to changes in demand for their products or services and improved the technical quality of their products and processes. However, Child and Yuan (1996) found that government-owned organizations that were granted more formal autonomy retained significant dependence on governmental officials for their strategic objectives. This dependence was also evident under the Contract Responsibility System in China, an effort to integrate government and enterprise administration as part of the attempt to reform state-owned enterprises (Hassard & Sheehan, 1997). Although these scholars agree that reformed government-owned enterprises had more strategic autonomy than they had under strictly command government ideologies, they found that continued government ownership and involvement in these enterprises limited the responsiveness of these organizations to market forces. That is, the greater the government ownership of an organization, the more governmental policy preferences appear to take precedence over technological or market considerations in managerial strategies.

One of the more interesting themes from studies of privatization and relative organizational autonomy is how independent organizations proactively seek to decrease their dependence on governments in order to avoid government influence and how these efforts shape their strategies. For example, Keister (2004) describes how executives in the People's Republic of China sought to borrow from non-governmental sources, despite increased risk, even when they had sufficient internal capital to fund their expenditures. She found this was a tactic to reduce their dependence on government, because retained earnings were considered state property in these transition state-owned enterprises. The practices she observed may reflect a more universal desire of independent organizations to become as independent of government as economic conditions allow. After all, governments impose a host of costly mandates on dependent organizations, and the more active governments are in seeking to influence independent organizations, the more we would expect a

strategic focus on decreasing dependence. Conditions in the U.S. financial services sector at the time of this writing suggest that this desire to reduce dependence on government extends to liberal market economies as well. As the global financial crisis that began in 2007 threatened the survival of powerful financial institutions there, many turned to the U.S. government to obtain scarce capital. Yet, once it became clear to these firms that such capital came with strings attached, several firms made efforts to return the funds they had previously sought.

Thus, research on the degree and form of governmental ownership of organizations and control of management is relevant not only to communist countries. The privatization of government-owned organizations continues in different forms throughout Europe and Latin America (e.g., see Mudami, 2003). Further, government organizational ownership is far from a receding issue. Global financial turmoil has prompted governments throughout the world to take ownership of financial institutions, insuring that the effects of degree of governmental ownership on strategy and organizational practices will remain an important issue for management and organization theory.

### **Ideology and Management**

These bodies of scholarship on how different governing ideologies affect organization and management make important theoretical contributions by demonstrating the dependence of organizational forms and strategies on government ideologies. A government's stance with regards to organizational intervention has fundamental effects on organizational ownership, organizational design, and strategies. The more attention governments devote to the strategies and practices of their independent organizations, the more likely government priorities are to shape managerial strategies. As the worldwide financial crisis beginning in 2007 demonstrates, any government may decide that its society is better served by directing select strategies and practices of the organizations in their jurisdictions. The consequences of the present increase in governmental involvement in financial institutions and automobile companies in countries across the corporatist-liberal-market spectrum

provide a fertile field for research on contradictions between governing ideology and governmental actions. What is more, this research provides a particularly important caution to scholars living and working under more liberal-market governments who implicitly, if not explicitly, produce universal conclusions and recommendations. Griffiths and Zammuto (2005) contrasted the “firm-centric” bias of the strategic management literature with the “state-centric” focus of scholars of political economies. These scholars make a persuasive case that the strategic management literature cannot ignore the effects of national governments by assuming that independent organizations’ strategies are driven primarily by technological and product market changes (see also, Henisz & Delios, 2002). Future research might profitably begin to integrate the effects of government ideology into their theories of corporate strategies.

## **GOVERNMENTAL CAPABILITY EFFECTS ON ORGANIZATION AND MANAGEMENT**

Another large body of work on the effects of governments on organizations and management addresses what has variously been called modernization, government capability, or government strength (see Table 2). We address these phenomena here in our discussion of government capability. Concern about a government’s capability to assert its authority over its own territory has a long history in political theory, probably because it reflects one of the most fundamental challenges for governments. The less capable the governments the less able they are to control local officials, enforce property rights, and ensure the rule of law, with important implications for organizations functioning under the jurisdictions of these governments. As Wang (2006: 199) concluded, “the lack of market-supporting political and legal institutions is at least as important a problem [for Chinese non-state enterprises] as various informational problems.”

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We include studies of the effects of government instability with studies of government capability. With the radical transformations in governments following the transition from communism, many organizational and managerial scholars have taken the opportunity to learn more about how government instability affects organizations. Government instability can be chronic, in what are called “failed states,” or instability can come upon previously stable governments, for example, through revolution or other radical upheavals. While instability in governments has a profound effect on organizations, we believe that most of these effects are the result of instability’s effect on government capability, and therefore have chosen not to discuss instability as a separate dimension of governments’ impact on organizations. Unstable governments, such as those undergoing political revolution or dramatic transition in governmental form, usually lose whatever capabilities they may have had. What laws and regulations that may have existed become uncertain as dramatic governmental changes lead to a collapse of enforcement and rapid alterations in regulations, laws, and institutional structures, generating uncertainty and making it difficult for both government officials and independent organizations to function effectively. Such unstable governments can fairly be called incapable.

Government incapability is an important issue for management. With increased globalization, managers of organizations that were founded and developed in countries where capable governments are taken for granted now find themselves with significant parts of their operations in countries with governments of varying capabilities. It is clear that organizational scholars need to address more thoroughly the question of how operating under governments of varying degrees of capability affects organizations and management practices. Research on the effects of government capability is grouped into six discussions: bureaucratization, relationship-based strategies, dysfunctional organizational behaviors, organizational size, competitive orientation, and strategies of corruption and government capture.

## **Organizational Bureaucratization**

Here we build on Weber's idea that the more modern or bureaucratic administration is, the more capable it will be (Weber, 1947; c.f., Parsons, 1956; Meyer & Rowan, 1977), and on North's (1990) argument that governments provide critical institutional support that enables economic activity. Nearly a century ago, Weber explained why legal-rational or bureaucratic governments were more capable than traditional or charismatic ones (Weber, 1947 [1924]). Organizational scholars have long been aware that Weber's legal-rational, or bureaucratic, organizations produce superior performance to the traditional or neo-traditional organizations dominated by particularistic practices (Walder, 1986; North, 1990). As Weber saw it, the characteristics of bureaucracy (purposeful rules applied universally, limited spheres of authority, strict delineation between person and office, transparent recorded decisions, meritocracy, and loyalty to an impersonal order) provide the backbone for the effective exercise of authority and ensure that decisions and actions taken within an organization further the formal goals of that organization. This can be applied to governments as well, such that those organized along legal-rational bureaucratic lines are better able to further their stated goals and are more capable than those that are not.

Government capability through greater bureaucratization exerts a powerful influence over the organizations that operate within them. Many market-supporting institutions upon which organizations rely, such as unbiased means for resolving disputes and enforcement of contracts are not generally produced in the market and require government supply (North, 1991). Fligstein sees supply of these market supporting institutions as one of the core functions of modern state-building and argues that it is government provision of property rights, governance structures, and rules of exchange that "enable actors in markets to organize themselves, to compete and cooperate, and to exchange" (1996: 658). When governments lack the capability to reliably provide these resources, it hinders the ability of organizations to pursue their goals, and forces them to find compensating

mechanisms and adopt less efficient and productive substitutes for these services, with implications for organizational actions and actors.

The predictability produced by capable, bureaucratic governments shapes the organizations operating in their jurisdictions. It has long been known that unpredictability is costly to organizations (Thompson, 1967). If managers cannot make reasonable predictions about the future, they are reluctant to invest and cannot take advantage of more efficient methods and emerging opportunities. For these reasons, there has been substantial research on how unpredictability, uncertainty, or radical change in product markets and technologies affect organizations (e.g., Forbes, 2007; Lawrence & Lorsch, 1967; Milliken, 1987; Song & Montoya-Weiss, 2001). Yet governments, too, can be an important source of unpredictability for independent organizations. Capable governments reduce this unpredictability by creating government systems that insure that government officials behave according to predictable and universalistic rules. As early organizational scholars have noted, bureaucratic independent organizations have developed in parallel with bureaucratic governments (Weber, 1947; Parsons, 1956; Meyer & Rowan, 1977). Those concerned with institutions have emphasized that organizations become isomorphic with their surrounding institutions (DiMaggio & Powell, 1983; Meyer & Rowan, 1977), proposing that organizations gain legitimacy by adopting the rational bureaucratic norms of important institutions such as governments. Beyond institutional forces, there are other mechanisms that drive rationalization of organizations under more bureaucratic governments. When governmental rules are transparent, impersonal, and universally and consistently applied, organizations can create consistent rules of their own for interacting with their governments. On the other hand, when governments are not bureaucratic, it is difficult to implement and sustain meritocracy and rational organization (Evans & Rauch, 1999).

Pearce, Branyiczki, and Bigley (2000) found that under the less capable governments of transition Lithuania, Czechoslovakia and Hungary, local organizations were built on personal

connections and particularistic favors and so were not legal-rational. Managers' dependence on personal relationships meant they were not free to act impersonally based on employee meritocratic performance, but personal relationships drove decision making. Further, there is evidence that large bureaucratic multinational enterprises, which have developed under more capable governments, systematically avoid investing in countries lacking well-functioning, universalistic regulatory systems. Xu, Pan & Beamish (2004), for example, found that multinational enterprises were less likely to expand in countries without impartial arbitration, efficient means of settling disputes through the legal system rather than through physical force, and effective monitoring of legal contracts. Lenway and Murtha (1994) proposed that large multinational enterprises have difficulty developing the local particularistic relationships that less capable governments require, and so are disadvantaged relative to local competitors. Thus, bureaucratic independent organizations appear to be less common under incapable governments.

### **Relationship-based Strategies**

When governments are not capable, managerial attention must be spent dealing with powerful sources of uncertainty, and there is growing research supporting the idea that this is done by developing what are called relationship-based strategies. Those studying management under incapable governments have found that managers seek to produce the predictability they need by building it through personal relationships of mutual obligation with the powerful. Redding (1990) was among the first to describe why independent organizations needed to rely on relationships when doing business under incapable governments. North (1990) argued that the role of institutions is to establish stable structures for interaction, and that lacking these structures, exchange is limited to personal exchange. Peng (2003) extended these ideas to argue that increased unpredictability in government intensifies dependence on relationship-based strategies, in which executives rely on inter-firm and governmental ties to achieve organizational goals, as opposed to capability-based

strategies, in which executives attempt to respond effectively to technological opportunities and market demands. Under incapable governments firms seek to borrow, buy from and sell to those with whom they have on-going personal relationships (see also, Peng & Heath, 1996). In support of Peng's theorizing, Luo and Chung (2005) found that the personal ties that were characteristic of organizations in family-owned business groups helped these organizations to out-perform other organizations during times of government incapacity during transition (see also, Hitt, Bierman, Uhlenbruck, & Shimizu, 2006; Li & Zhang, 2007). This need to rely on personal relationships also appears to affect mode of entry decisions made by foreign firms seeking to enter markets under incapable governments. Meyer et al. (2009) theorized that foreign firms would be more likely to choose joint ventures over greenfield entry when governments were incapable because foreign firms recognize they need access to the networks of relationships that local firms possess. Their analysis of data on 336 foreign direct investment projects in four countries that vary with respect to government capability produced results consistent with these predictions.

Xin and Pearce (1996) introduced the concept of *guanxi*, or instrumental-personal ties that can range from strong personal loyalties to ceremonial bribery, into the management literature. Their research found that executives built relationships with the powerful, at least in part, as a substitute for the support provided by capable governments (see also, Millington, Eberhardt & Wilkinson, 2006). Further, Pearce (2001a) found that personal relationships were critical to managers because they were the primary available means for building and sustaining organizational work under the incapable transition governments in her study. That is, if firms cannot rely on capable legal-rational governments they will do business only with those they personally know will not cheat them. Peng (2003) observed that under the rapidly changing policies in China the organizations with executives who had more extensive personal ties with government officials and other executives outperformed

organizations with executives having fewer relationships. These studies all support the claim that the less capable the government the more organizations will rely on relationship-based strategies.

### **Dysfunctional Organizational Behaviors**

Scholars have documented some of the organizational behavioral costs of executives' relationship-based strategies. Employee perceptions of procedural justice and the role of performance in rewards and promotions appear to be undermined in those organizations relying on relationship-based strategies. Pearce, Bigley and Branyiczki (1998) found that employees reported that their organizations had low procedural justice in transitional Lithuania, mirroring the relationship-based practices of Lithuania's incapable early transition government. Chen, Chen and Xin (2004) found that Chinese executives' external relationships of personal dependence were replicated inside their organizations in greater use of personal relationships rather than meritocratic universalism. They also found that relationship-based management practices produced low employee perceptions of procedural justice, which in turn caused low employee trust in management. To summarize, these studies provide persuasive empirical evidence that the less capable the government, the lower are employees' perceptions that their organizations are just and meritocratic, mediated by their organization's use of relationship-based strategies.

Furthermore, Pearce (2001a; 2001b) reported the results of a wide-ranging empirical comparative study of several countries concluding that a lack of capability led to several dysfunctional employee and managerial organizational behaviors due to the use of relationship-based strategies by these organizations. For example, she reported that harsh distributive bargaining and distrust of coworkers and supervisors were characteristic of supervisor-subordinate relationships within these organizations. Similarly, Haraszti (1977) reported that communist Hungarian workplaces were dominated by haggling between supervisors and subordinates. Gregory (1989)

reported distrust and other dysfunctional organizational behaviors in the Soviet Union, as did Walder (1986) in the People's Republic of China.

Employee distrust and fear of exploitation seem to result directly from the use of relationship-based organizational strategies. For example, Xin and Pearce (1996) found that family and friends of powerful government officials were hired to maintain their patrons' favor which undermined managers' use of meritocracy to evaluate employees. Similarly Chen, Fan, and Wong (2006) reported that in China organizations had fundamentally conflicting strategic orientations (relationship-based vs. capability-based), and these conflicts exacerbated intra-organizational interpersonal conflicts. Employees could not discover whether relationship-serving or capability-serving actions should take priority in any given instance.

Employees who must work surrounded by secrecy and distrust will seek to protect themselves (Axelrod, 1984). This can be reflected in employee withholding of information, cheating, and other self-protective actions. This is supported by the in-depth participant observation study by Haraszti (1977) who reported pervasive withholding of information in the organization he observed. He described the ways that supervisors in his factory withheld the amount of money they had available to award to employees as bonuses because these supervisors felt they needed to keep a reserve to "pay" employees to work on products or services that government ministers could demand at any time. Gregory (1989), Haraszti (1977) and Pearce (2001a) all documented widespread employee and managerial cheating and exploitation of others at workplaces operating under incapable governments. Work relationships characterized by pervasive distrust led to self-protective behaviors that foster conflict, and make communication and collaborative problem solving difficult. Thus, this empirical research suggests that the relationship-based strategies fostered by less capable governments lead to greater employee distrust, use of distributive bargaining, withholding of information, exploitation of others, conflict, and cheating. These studies suggest that important

employee organizational behaviors can be influenced by government and other institutional features, not just by management policy or the immediate interpersonal environment that dominates research in organizational behavior.

### **Organizational Size**

The impact that incapable governments have on organizations in terms of limited bureaucratization and a strategic focus on relationships also has an effect on organizational size. Redding (1990) observed that the overseas Chinese organizations he studied in Southeast Asia needed to cope with unpredictable and hostile governments, and one of their strategies was to keep their organizations small to better escape the attention of predatory government officials. Pearce (2001a) found that dependence on personal relationships in transition Lithuania, Czechoslovakia and Hungary limited the size of independent organizations in those countries. When relationship-based strategies dominate, managers could only place individuals they personally trusted into key positions within the organization. Moreover, relationships with key external supporters often could not be delegated because they were based on the personal relationship between the two parties. Together these limited an organization's potential growth.

Zucker (1986) argued that large organizations become more impersonal and formal in order to build a sufficiently predictable environment for action among people who do not know each other. Thus, strategic dependence on personal relationships limits the application of legal-rational impersonal treatment within organizations, and thereby tends to keep organizations small enough so participants can know all of those on whom they depend. Capable governments build impersonal legal-rational substitutes for personal relationships and so facilitate the growth of large bureaucratic organizations. Organizations can and do grow large under less capable governments, however, they do not do so through developing their technological or market capabilities. How they do so is described below.

## **Differing Competitive Orientations**

Some of the most interesting studies address the differing competitive orientations of independent organizations under governments of relative capabilities. Here we introduce research on how government capability affects strategic responsiveness to technological and market changes, innovation, and the strategic value of heterogeneous business groups. Incapable government decreases the ability of organizations to respond to competitive markets. Because under incapable governments, managers must devote time to managing relationships with government officials to protect their resources from expropriation, and securing access to markets due to inferior or missing infrastructure and institutional support, and because managerial attention is limited (March and Simon, 1958), managers are less able to respond to non-governmental issues such as technological changes and competition in product and service markets. Capable governments enable the creation of routines and standard operating procedures (Cyert and March, 1963; Nelson and Winter, 1982) for responding to much of the environment, preserving limited managerial attention for responding to competition and technological change.

As governments become more capable and more able to enforce the rule of law, Peng (2003) argued that entrepreneurial firms and foreign entrants drive a general move away from a strategic focus on managing relationships and towards a focus on competing on the basis of firm capabilities and competitive resources. Murtha and Lenway (1994) proposed that ambiguity under incapable governments leaves management systems inefficient and focused on coping with government, preventing organizations from developing the technical and product-market advantages that would foster out-country investment. Similarly, Young (2005) suggested that organizations arising under less capable governments are less able to compete globally based on technical and market capabilities because of their dependence on personal relationships for competitive advantage in their home countries. There is growing empirical research to support these arguments. For example,

Whitley, Henderson, Czaban, & Lengyel (1996) found that continued dependence on the state in transitional Hungary prevented firms from competing with others in their industry and led to only limited changes to products and organizational structures. Newman (2000) found that the unpredictable environment created by the extreme governmental changes taking place in transition Central and Eastern Europe overwhelmed the ability of independent organizations to make adaptive technological, process, product or market changes. Spicer (2002) documented how the design and structuring of investment funds in early transition Russia evolved out of a highly politicized process. Governments, not technology or market-focused strategic business decisions, drove these investment fund organizations. These studies all demonstrate that the less capable the government, the less independent organizations are able to adapt to technological change and respond to product or service markets.

This has implications for innovation, a growing research interest. There is evidence that innovation requires the meritocracy, long-term investments, and cooperative workplaces fostered under more capable governments. Certainly, the most innovative companies across diverse industries, from telecommunications and aerospace to biotechnology, reside in those countries that have the most capable governments (Technology Review, 2004). There are a number of possible reasons for this, but the failure of incapable governments to provide support for innovation is likely key. Murtha and Lenway (1994) speculated that the uncertain property rights that exist under incapable governments impeded the emergence of new technologies because ownership rights for any innovations would be uncertain, preventing innovators from benefiting from their efforts. Evans and Rauch (1999) proposed that capable government bureaucracies encourage entrepreneurship by providing useful information and public investments that increase the likelihood and effectiveness of private investments. Moreover, they note that by creating predictable environments, capable governmental bureaucracies decrease risk and make otherwise risky investments more attractive.

Murphy, Shleifer and Vishny (1991) argued that less capable governments produced fewer entrepreneurs because talent is drawn to the more profitable activities of rent-seeking and expropriation rather than the riskier and less profitable activities of entrepreneurship and innovation.

The evidence seems to indicate that the less capable the government the fewer innovations produced by its independent organizations and this has important implications for research in the field. Research on innovation seems only to address those organizations operating in the handful of countries with capable governments (e.g., Fagerberg, Mowery & Nelson, 2006). Most research has focused on organizational designs and incentives that foster exploration or innovation, yet without capable governments these management systems will not be considered. Hence, we currently understand the impact of government on innovation in a limited way. Future research could examine the impact of government capability (particularly in the context of less capable governments) as a predictor of innovation.

Finally, Khanna and his colleagues have provided persuasive evidence that organizational forms will differ depending on the capability of the government (Khanna & Palepu, 2000a; Khanna & Palepu, 200b; Khanna & Rivkin, 2001). They found that large heterogeneous business groups dominate the economies of countries with less capable governments because these groups produce critical resources that are provided by more capable governments elsewhere. For example, without strong capital markets and strong disclosure laws, it is difficult to know the financial health of independent organizations, making loans riskier; but if the organization is a member of a large business group, the banker can be assured that the entire group provides security for the loan. Business groups share a brand name, raise capital jointly, lobby government officials as a unit, and pool human and financial resources. In capital markets, group banks or group reputation substitute for trusted and reliable regulatory and enforcement mechanisms; in supplier and customer markets, group experience and the ability to share knowledge of potential exchange partners compensates for

weak commercial laws; and in labor markets, rotation of top talent and internal labor markets within groups substitutes for reliable educational or credentialing systems. Fogel (2006) also found that family-controlled business groups dominate under less capable governments. That is, this research demonstrated that the less capable the government the more likely business groups are to have a competitive advantage over non-grouped independent organizations.

### **Capability, Corruption and Government Capture**

Government incapability also influences the strategies of independent organizations by providing more opportunities for favored organizations to gain government-supported competitive advantages over their rivals. This research has focused on competitive advantages through corruption and through government (or in this literature called “state”) capture. Because large organizational size provides more resources for corrupt payments and government capture, these strategic objectives, not any technological imperatives, will drive organizational size under incapable organizations. Corruption is the misuse of public office for private benefit or gain. Increasingly management scholars have been interested in how governmental corruption might affect independent organizations (e.g., Martin, Cullen, Johnson & Parboteeah, 2007; Oliver, 1991; Rodriquez, Uhlenbruck & Eden, 2005; Uhlenbruck, Rodriquez, Doh & Eden, 2006; Zelner, 2001). Corruption is associated with governments’ inability to prevent local officials from misusing their offices for their private benefit (Rose-Ackerman, 1997). Because those who make offers intended to corrupt government officials often do so as agents of independent organizations, corruption is receiving increasing interest in the strategy and international management literatures.

Doh, et al. (2003) proposed that those independent organizations which exploit corrupt governments for private gain often ignore the substantial long-term organizational costs of government corruption. They note that, in addition to the direct costs of the bribes themselves, bribes increase officials’ incentives to create additional bribe-generating red tape and delays. Uslander and

Badescu (2004) suggest that the weakened commercial environment, inadequate infrastructure, misdirected entrepreneurial talent and less educated and impoverished local populations that are characteristic of societies with corrupt governments impose substantial indirect costs on organizations. Other indirect costs include the loss of the protection of the courts for these illegal payments and the possible involvement with organized crime that illegal actions can entail. Managing such complications requires managers to depend more heavily on their personal relationships, and as Young (2005) argued, and Meyer and Altenborg (2008) found, this corruption-driven emphasis on relationship-based strategies can undermine a firm's ability to compete on the basis of their competencies in innovation, technology, or providing superior services or products. Thus, Rodriguez, Uhlenbruck and Eden (2005) argued that the more pervasive and arbitrary the government corruption, the more difficult it is for organizations to meet the technological and product market demands they need to stay viable, so that the greater the proportion of an organization's operations in the most corrupt countries, the less the organization is able to pursue a capability-based strategy. These essays lay a rich theoretical groundwork for future research on the effects of corruption on management and organizations.

Further, scholars of corruption find that the smallest businesses find corruption to be the most costly, since they do not generate sufficient revenue for substantial payments. Often, in response small businesses choose to move underground into the informal sector. For example, Johnson, Kaufmann, McMillan and Woodruff (2000), found that the managers of manufacturing organizations operating in very corrupt countries systematically hid their output from government officials. This type of response to government corruption is easier for small enterprises. However, staying small and hidden prevents organizations from gaining access to capital at competitive rates, and in other ways limits their growth (Kaufmann & Kaliberda, 1996). Large organizations with thousands of employees and many millions in revenue can afford bribes and the more expensive forms of

influence over government officials that small organizations generally cannot. For example, Vander Velde and Svendsen (1994) found that rich Pakistani farmers obtained extra irrigation water through bribes, which bankrupted the smaller farmers who received less water than they needed. The data from these studies suggest diverging strategies pursued by independent organizations when faced with government incapacity-fostered corruption. Larger and wealthier organizations tend to seek official protection and favor as a competitive advantage, while smaller organizations seek to avoid predatory corrupt government officials by remaining small and operating in the informal sector as much as possible.

This bifurcation of organizational strategies provides barriers to the growth of successful entrepreneurial organizations, since the near-simultaneous transition from a small, informal and invisible undertaking to a large and influential organization must be extremely difficult. The only smaller firms likely to make such a transition would be those that do not need to seek invisibility because they have existing ties to powerful government patrons, perhaps through family or other connections. This means that the more corrupt the government, the less entrepreneurial organizations will be able to grow into large firms, and the more corrupt the government, the more entrepreneurial organizations that make the transition from small firm to large will have done so through ties to powerful officials. Since few will be able to do this, government incapacity and corruption appear to impede the growth of entrepreneurial ventures. Thus, all of the government policies intended to create economic growth, such as creating new-business incubators or providing seed capital, cannot help those successful new ventures to capitalize on their success when operating under incapable and corrupt governments.

Incapable governments also are more easily captured by independent organizations with the means to do so for their private gain. Recently scholars have begun to address the issue of state capture, or the capture of the policy making and enforcement systems of incapable governments and

the harnessing of those policies and systems by powerful independent organizations for their own benefit. The ability to gain favorable government treatment can be a powerful competitive advantage for capturing firms. Kaufmann and Kraay (2000) conducted a large, comprehensive executive survey of state capture in 175 countries and found that those independent organizations or business groups that were able to capture government policy had significantly higher performance than those that could not capture public policy for their own private benefit. Government capture would be possible only for the largest and wealthiest organizations.

In summary, incapable governments provide more scope for gaining competitive advantages through official favor. Capable governments make it more difficult for their own local officials to grant personal favors, since officials of capable governments are themselves more constrained by law (Evans & Rauch, 1999). Under incapable governments organizational performance is more dependent on a strategy of capturing local officials through corruption or government policy than on producing better products or services. This suggests that the less capable the government the more likely that independent organizations will seek competitive advantages through the capture of government officials' favors or public policy for their private benefit.

This research identifies an important theoretical gap in the strategy literature. While there is research on the lobbying and public relations activities of independent organizations (e.g., Hillman and Hitt, 1999), theories of management are only now beginning to examine the strategic capture of government policy for private ends (see Holburn & Vanden Bergh, 2008). Clearly it is more flattering to managers to document how they vanquish their rivals in free and fair marketplaces rather than to describe how they use government officials and policy to gain private competitive advantage. Yet such behavior is well documented in in-depth case studies, and in newspapers, throughout the world, and so merits greater scholarly attention. This is just one example of how our understanding of the impact of government capability on organizational strategy is in its infancy,

with significant questions remaining to be answered by future research. One such question is how organizations that have adopted a government capture strategy in their home country might globalize. Another question is whether large globalizing firms might seek to operate in nations with incapable governments because the prospect of capturing government policy is higher in such contexts (see, for example, Oliver, 1991).

### **APPLICATION: THE WEALTH OF NATIONS**

Attention to the effects of governments on organization and management can provide insight into many pressing societal concerns. We address one such concern here—why some countries are so much wealthier than others. The problem of why some nations are so much wealthier than others has long been addressed by economists (e.g., Knack & Keefer, 1995; Smith, 1993 [1776]; Kaufmann, Kraay, & Zoido-Lobaton, 1999, 2000), political scientists (e.g., Muller, 1988; Waterbury, 1983) and sociologists (e.g., Bates, 1981; Snyder & Kick, 1979; Evans & Rauch, 1999), with a comprehensive review of this literature by Martinussen (1997). While some scholars propose that poorer nations have little chance of gaining in relative wealth (Wallerstein, 1979), others have provided evidence for the wealth-creating effects of cultural values (Weber, 1988; Huntington, 2004), economic growth (Chernery et al., 1974), capital markets (Leff, 1976), trade policies (Behrman & Srinivasan, 1995), geography (Diamond, 1997), developmental government policies (Evans & Rauch, 1999), low corruption (Rose-Ackerman, 1999; Mauro, 1995), and property rights (De Soto, 2000), among many others. This important work has demonstrated the role of geography, physical resources, market institutions, and government policies on national wealth creation and has produced valuable insights and important policy changes that have had materially positive effects.

We propose that governance quality also has powerful effects on national wealth creation through its facilitation of the kinds of managerial behavior that both generate and disperse wealth. Drawing on the literature reviewed here, we propose that organizations also have an important role

to play in generating a nation's wealth. Others have suggested as much without delving deeply into how organizations might do this. For example, Schumpeter (1942) and Rostow (1960) suggested that better governments fostered risk-taking entrepreneurial behavior, while Evans & Rauch (1999) proposed that government policies which promoted and assisted private organizations were superior to ones focused on regulation and state-owned organizations for producing products.

While there are rich countries governed by both corporatist and liberal-market governmental ideologies, there is no question that the richest countries have the most capable governments, and also have the largest independent organizations. Of the fifty largest business firms (by market valuation) all but three are in the countries with the largest per-capita gross domestic product (France, Germany, Japan, Switzerland, the Netherlands, the United Kingdom and the United States; Forbes, 2004). Even countries with comparatively small populations, such as Switzerland and the Netherlands, can host the largest independent for-profit and non-profit organizations if they have capable governments.

Further, since organizational size can be artificially inflated by relationship-based strategies or governmental interventions, a better indicator of the importance of large independent organizations to aggregate national wealth would be to see which countries have the most innovative and rapidly growing independent organizations. These lists again are dominated by the same few rich countries with the most capable governments. Governments which are capable host the largest and most innovative organizations (whether for-profit or non-profit). They also govern the wealthiest nations. The absence of such organizations from the poorest countries with the least capable governments is one of their starkest features. This suggests that the role played by large independent organizations, and the managerial behaviors that sustain them, in fostering the wealth of nations needs to be better understood.

Drawing on the previous arguments, we contend that large capability-focused organizations not only create more wealth, they also are more effective than small ones in dispersing it, producing greater national wealth. There is a long-established body of evidence suggesting that large organizations help to disperse wealth-creating knowledge rather than limit it to an elite group (see Donaldson, 2001, for a review). Because large organizations must inherently become more legal-rational if they are not to break apart into loosely connected fiefdoms (Boisot and Child, 1988; Redding, 1990), organizations decentralize as they grow. Further, the Aston Group found that greater organizational size leads to greater specialization, with more individuals developing a deeper expertise in a particular subject (Pugh, Hickson, Hinings & Turner, 1969). Once organizations grow larger than a few hundred employees, they become more specialized and must decentralize decisions to lower organizational levels, producing more knowledgeable professionals and middle managers (Child, 1972). The larger the organization the greater the bureaucratization and so the greater the proportion of managers and professionals who develop the technical and market knowledge on which such organizations depend.

The specialization and decentralization of capability-focused organizations make individuals' investment in expertise more profitable than in organizations in which personal relationships are more important to success. This makes professionals and middle managers critical to organizational performance (driving up their compensation), and their greater autonomy enables them to gain the skills and knowledge necessary to establish their own entrepreneurial ventures. Under capable governments, large technically innovative organizations breed new organizations started by former employees, as the old Fairchild Semiconductors bred the spin-offs that later became known collectively as Silicon Valley. Only those countries with capable governments provide an environment that encourages successful entrepreneurial organizations to grow large and bureaucratic based on their own innovations and performance, independent of government patronage.

Governments affect national wealth through organizations in other ways as well. For example, generalized distrust in others has long been associated with greater national poverty (Inglehart, 1999), and there is evidence that the quality of government is responsible for this lack of trust. Rao, Pearce and Xin (2005) found a correlation of  $r = .84$  between trust of coworkers and government quality. They argued this was because the trust-producing predictability of bureaucratic organizations was undermined by incapable and corrupt governments that produced distrust via arbitrary treatment. Pearce, Branyiczki, and Bigley, (2000) reported greater distrust of co-workers in the less capable and less stable (and poorer) countries of transitional Hungary than in the (richer) United States. Further, Gambetta (1988) argued that the powerful actively fostered distrust in incapable and corrupt Sicily because distrust enhanced their personal power.

Many consider withholding information to gain power over others by making the withholder the sole necessary source of the information an organizationally dysfunctional political tactic (Mulder, de Jong, Koppelaar and Verhage, 1986; Feldman, 1988). Certainly, organizations are more effective when they can move information to those who need it (Baskin and Aronoff, 1989). Withholding information creates bottlenecks and results in decisions made without all of the relevant information (Galbraith, 1973; Lawrence and Lorsch, 1967). This in turn results in poorer quality decisions, and so poorer organizational performance. Further, if specialists do not share information, organizations can not gain the benefits of specialization. Recently, King and Sznajder (2006) argued that Poland's post-communist economic success was based on improving government capability before encouraging direct foreign investment. Taken together, the work of these scholars provides support for our argument that governments that are less capable, fostering organizations that depend on relationship-based strategies, produce poorer organizational performance, and thus poorer countries.

In summary, the more capable a country's government, the more likely it is to have organizations that compete on their capabilities, innovate, grow, and disperse knowledge and skills. These organizations may be large and bureaucratic, or entrepreneurial and growing. They have meritocratic management practices that foster trust, decentralization and the open communication of work-relevant information. The arguments presented here, summarizing and generalizing from a vast literature on the effects of governments on organization and management, suggest that the presence of the largest, most innovative organizations in countries with capable governments is no accident. The widespread wealth of the richest nations depends on government that encourages the presence of decentralized bureaucratic organizations that compete on the basis of their capabilities rather than on their relationships with the powerful or their ability to capture government policy.

However, just as attention to the effects of governments on independent organizations can provide insight into the positive role that organizations play in national wealth creation, it can also provide insight into the potentially negative role organizations can play in undermining a nation's capacity for wealth creation. The crisis in the global financial system that began in 2007 and subsequent deepening recession starting in 2008 provide an excellent though unfortunate example.

We noted earlier the importance of capable legal-rational organization-supporting institutions to the functioning of the economy and the growth of organizations, but we have also noted the incentives organizations have to capture those institutions for their own benefit. This suggests an important contradiction in the relationship between governments and organizations. Organizations rely on meritocratic governments, but they have individual incentives to subvert impersonal meritocracy. This contradiction is compounded by the impact that rules and regulations have on concerned parties. Fligstein (1996) said that rules and regulations are never neutral. Because economic actors are not homogenous in their needs, resources, and position vis

a vis other firms, all rules and regulations tend to favor some actors over others. This inherent partiality draws economic actors into the political arena, and the result is a continuous process of political contestation over the content of laws, their applicability to specific firms and markets, and the appropriate extent of government enforcement (Fligstein, 1996; 2001).

This review suggests that under incapable governments, these political contests result in government capture by the most powerful firms, and government institutions take on the role of furthering the ends of these powerful firms. We proposed that such capture ultimately hurts the growth of other organizations in those societies and creates conditions that undermine wealth creation. Here we would suggest that although capable governments are better able to balance these competing demands and resist pressure from powerful firms in order to create more impartial institutions, recent economic events suggest they are unable to do so completely. Thus, under many capable governments financial regulations that provided stability to the banking system, but which placed constraints on profit-making opportunities for powerful firms, were gradually relaxed as large financial firms used their influence, both political (through campaign contributions) and personal (through their relationships with regulators) to advocate for rules they found more beneficial. Eventually such actions created the conditions that undermined the nation's banking institutions, with profoundly negative repercussions for national wealth in advanced economies with relatively capable governments.

This series of events suggests slightly different dynamics for capable versus incapable governments. Under incapable governments, state capture by powerful organizations appears more likely to stifle economic growth generally. Under capable governments, where effective and rational bureaucratic institutions enable markets to function for a wide range of organizations, the process may be more cyclical. The economy grows and a wide variety of organizations may flourish, but over time powerful firms capture relevant key institutions,

incrementally undermining the rationalized economy. Eventually such capture can cause systemic problems that hurt the broader economy and undermine wealth creation. Such a cycle suggests that government capability is not a steady state, but must be actively maintained. Individuals with personal relationships to government officials and powerful organizations will continue to seek opportunities to make governments more responsive to their particular needs for the sake of competitive advantage. Even under capable governments, such efforts will have some level of success, and to the extent that this success undermines the general efficacy of the market-supporting institutions that capable governments provide, this success has important implications for all organizations operating under such governments. A view of organizations that keeps governments in mind reminds scholars that the political strategies organizations pursue come with great risks, both to the general operation of the economy and to the firms that pursue those advantages. Yet research on these effects is still in its infancy, and much work is needed to fill out our understanding of the important role that governments play in organizational outcomes.

## **CONCLUSION**

This review and organization of the large literature addressing governmental effects on organization and management suggest promising lines of research in the fields of strategy, organization theory, and organizational behavior, in addition to having policy implications. Here we sought to organize literature from a wide range of social science fields that have addressed the effects of governments on organizations and management by identifying two governmental dimensions that lead to different strategic, organizational and behavioral effects, summarized in the Figure. There are clear differences among governments in their ability to supply legal-rational supportive contexts for independent organizations. Governments also differ in their ideology with respect to their level of involvement in organizations' strategies and management.

We summarized some of the important effects on organizations operating under these governments.

This review has implications for management and organization-focused research. There has been important work demonstrating that governments are more important strategic factors for those working under corporatist and under incapable governments. However, since the earliest strategy theories developed in countries with more liberal-market and capable governments, it is not surprising that so much corporate strategy theorizing has placed less emphasis on the importance of governments. We hope this review brings more attention to this issue. Likewise, corporate strategies of government capture and use of corruption for strategic advantage also have not received the mainstream attention that such strategies deserve, given their prevalence in so many countries. This neglect may be due to the difficulty of studying such illicit and unflattering strategies. Yet, their importance in an increasingly globally integrated world cries out for attention.

Similarly, for far too long organization theory has developed in either a sterile de-contextualized world in which organizational size and form are the result of solely technical considerations, or in an overwhelmingly contextualized one in which the institutional environment is seen as an undifferentiated whole. This review suggests that in the former case, important explanatory variables are missing, and in the latter, opportunities to make testable predictions have been missed. Here we singled out government as one powerful institution that we argue has distinct effects on organizational forms and practices. Our claims that governments matter for understanding such diverse issues as organizational size, bureaucratization, innovation and entrepreneurship provide many opportunities for future research.

Although the effects of governments on trust and related organizational behaviors is the least developed of the literatures we reviewed, it does point to promising opportunities for further research. All of the affect, attitudes and behaviors associated with the relationship-based strategies

prevalent under less capable governments have been linked to poorer organizational performance. If supported by subsequent research, these arguments would have important implications for capability-based organizations considering off-shore expansion and contracting in countries with less capable governments. Particularly, for those organizations dependent on capability-based strategies and high levels of organizational performance, this work suggests the need to learn more about how operating in locations with less capable and more corrupt governments affects the organizational behaviors and performance they may take for granted.

Finally, we believe this review has implications for public policy. We provided an extended example of one application, the wealth of nations. We proposed that large, growing, and innovative capability-based organizations were critical to high levels of national wealth, and that one of the ways government can affect national wealth is through its facilitation of such organizations and the spin-offs they generate. We also discussed the mixed motives that organizations' managers have for impersonal legal-rational government and personal influence over government policy. Similar additional examples could have been provided. For example, government capability needs to be addressed before attempts to dismantle business groups, and policies to encourage entrepreneurship need to address capability and corruption first. The foregoing research and theory of the effects of governments on organization and management may not be wholly correct, but the important theoretical and practical implications that can be derived from them suggest that governments deserve a more prominent place in our work. As an area of research, the important role of governments in strategy, theory, and organizational behavior holds great promise.

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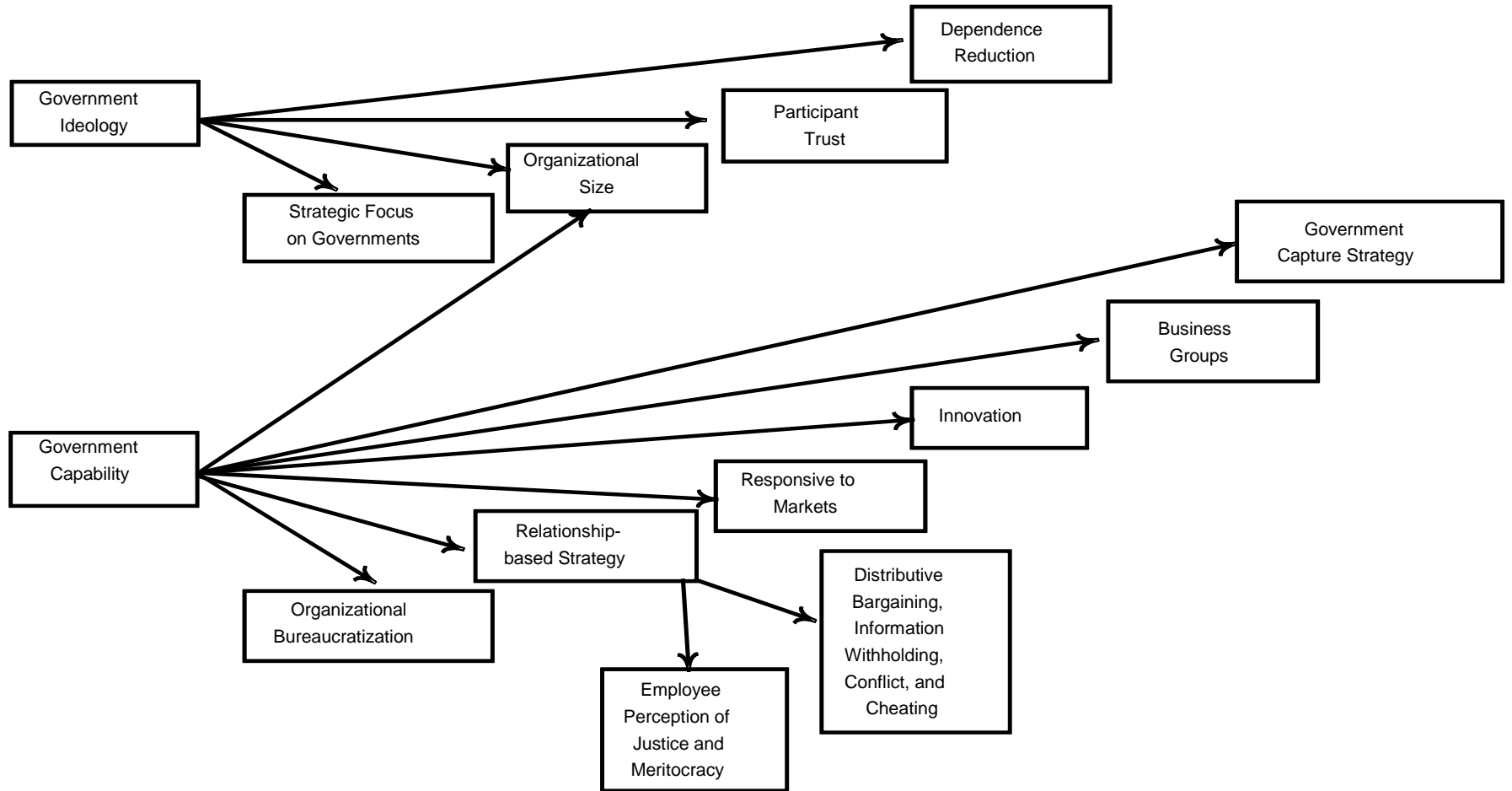
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**Figure: Effects of Governments on Organization and Management**



**Table 1: Research on the Effects of Governing Ideology**

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**Strategic Focus on Governments**

Biggart & Guillen, 1999  
Biggart & Orru, 1997  
Child and Yuan, 1996  
Dobbin, 1994  
Griffiths and Zammuto, 2005  
Hamilton & Biggart, 1988  
Hassard & Sheehan, 1997  
Henisz & Delios, 2002  
Keister & Zhang, 2009  
Kogut, Walker and Anand, 2002  
Kornai, 1989  
Kristensen, 1997  
Murtha & Lenway, 1994  
Schröter, 1997  
Spencer, Murtha, and Lenway, 2005  
Thomas and Waring, 1999  
Whitley, 2000

**Organization Size**

Chandler, Amatori, and Hikino, 1997  
Burawoy and Krotov, 1992;  
Pearce, 2001a  
Redding, 1990  
Stark, 1989

**Participant Trust:**

Pearce, 2001a  
Pearce, 2001b  
Rao, Pearce and Xin, 2005  
Walder, 1986,

**Dependence Reduction**

Keister, 2004

**Table 2: Research on the Effects of Government Capability**

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**Organizational Bureaucratization**

Boisot & Child, 1988  
Drori, Jang, & Meyer, 2006  
Evans & Rauch, 1999  
Kalev, Shenhav & De Vries, 2008  
Meyer & Rowan, 1977  
North, 1990  
Parsons, 1956  
Pearce, 2001b  
Pearce, Branyiczki, & Bigley, 2000  
Walder, 1986  
Weber, 1947

**Organizational Size**

Demirgüç & Maksimovic (1998)  
Pearce, 2001a  
Pearce & Branyiczki, 1997  
Whitley, Henderson, Czaban, & Lengyel, 1996  
Zucker, 1986

**Relationship-based Strategy**

Henisz & Delios (2002)  
Hitt, Bierman, Uhlenbruck & Shimizu, 2006  
Li & Zhang (2007)  
Luo & Chung (2005)  
Millington, Eberhardt, & Wilkinson (2006)  
North (1990)  
Pearce (2001a)  
Peng (2003)  
Peng & Heath (1996)  
Peng & Luo (2000)  
Redding (1990)  
Rao, Pearce & Xin (2005)  
Ring, Bigley, D'Anno & Khanna (2005)  
Rodriguez, Uhlenbruck & Eden (2005)  
Xin & Pearce (1996)

### **Relationship-based Strategy Mediates Employee Perception of Justice and Meritocracy**

Cook, Rice & Gerbasi (2004)  
Chen, Chen, & Xin (2004)  
Pearce (1997)  
Pearce, Bigley, & Branyiczki (1998)

### **Relationship-based Strategy Mediates Distributive Bargaining, Information Withholding, Conflict, Cheating**

Axelrod (1984)  
Chen, Fan, and Wong (2006)  
Gregory (1989)  
Haraszti (1977)  
Pearce (2001a; 2001b)  
Walder (1986)

### **Responsiveness to Markets**

Hitt, Ahlstrom, Dacin, Levitas & Svobodina (2004)  
Murtha & Lenway (1994)  
Newman (2000)  
Pearce (2001a)  
Peng (2003)  
Spicer (2002)  
Whitley, Henderson, Czaban, & Lengyel (1996)  
Young (2005)

### **Innovation**

Evans & Rauch (1999)  
Murtha & Lenway (1994)  
Murphy, Shleifer, & Vishny (1991)  
Ring, Bigley, D'Anno & Khanna (2005)  
Treisman (2000)

### **Business Groups**

Fogel (2006)  
Guillen (2000)  
Khanna (2000)  
Khanna & Palepu (2000a; 2000b)  
Khanna & Rivkin (2001)

## **Government-capture Strategy**

Evans & Rauch (1999)

Dethier (2000)

Hellman, Jones & Kaufmann (2003)

Hellman, Jones, Kaufmann & Shankerman (2000)

Kaufmann and Kraay (2000)

Rodriguez, Uhlenbruck & Eden (2005)