

How Can Organizational Capabilities and Performance Minimize Errors and Gain Legitimacy?

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Abstract

Recent advanced management discussion broadly favors the idea of dynamic capabilities in order to overcome potential rigidities of organizational capability building. The major question addressed in this paper is whether organizational capabilities and performance can actually minimize errors and gain legitimacies. We develop a conceptual model where structural inertia, liability of renewal and newness are identified as the main factors that influence organizational capability that generate rigidity that drive errors, reduce performance and loss of legitimacy. Therefore, our conceptual model aims to develop a unique approach to improve organizational performance in order to gain legitimacy.

Key words: structural inertia, liability of newness, liability of renewal, organizational capabilities, performance and legitimacy

I Introduction

1 Introduction

The idea of radical change in any organization has remained an important subject for many researchers in the field of organizations theory. Although, change in organizations in many cases is initiated in response to change in the environment, many scholars acknowledge that organizations may fail to adapt to the new environment. Various schools of thoughts have examined the issue of organizational change. We will examine several of

these research literatures in building our conceptual model of organizational change.

Population Ecology Theory has over the years become one of the central fields in organizational change studies. A central idea of population ecology can be summarized as the idea that environment effects on organization structure can result in organizational failure as measured by the survival of the organization (Hannan and Freeman, 1977). From this theory, two important issues for this study are the concept of the structural inertia and the liability of newness, (Hannan and Freeman, 1984, 1977; and Aldrich and Fiol, 1994).

We intend to discuss the idea of structural inertia in an organization and to extend it to the process of how a firm's adaption to a new environment influences its legitimacy. Part of this extension relies on the work of Aldrich and Fiol, (1994). They discussed the birth of new organizations as a critical time for the survival of an organization that they called the liability of newness. They argued that the struggle to survive during the liability of newness phase is essentially a struggle for the firm to gain legitimacy. Others have argued that whenever an organization initiates a major change it resets its organizational clock (Amburgey, Kelly and Barnett 1993). Although Amburgey, Kelly and Barnett, (1993) did not explicitly examine legitimacy, we contend that the clock is not only reset in terms of organizational capabilities but also organizational legitimacy. Our conceptual model will develop a unique approach to understand how to improve an organizations' performance in order to gain legitimacy. This requires that we also understand the relationship between organizational capabilities and organizational performance.

An important research literature that examines this relationship is the resource-based view of the firm. In the field of resource based view theory (RBV), resources are defined as "all asset, capabilities, organization's processes, firm attributes, information, knowledge, etc. controlled by firm" Barney (1986, 1991). Accordingly, Barney (1991) argued that in order to have a sustained competitive advantage resources have to be valuable, rare, inimitable and organized. Based on the idea of RBV, this paper will investigate how organization's capabilities, as one of the organization's resources, can actually improve its performance and gain legitimacies, as a competitive advantage. Leonard-Barton, (1992) showed a relationship between core capabilities and core rigidities in terms of managing new product

development. Accordingly, core capabilities are developed to aid in giving a sustained competitive advantage in one environment can inhibit innovation, in which case the core capabilities have become core rigidities, (Leonard–Barton, 1992).

Another conceptual research literature that examines environmental pressure on organizational change is the institutional economics literature. Douglass C. North, (1991) showed “institutions were humanly devised constraints that structure political, social and economic interaction”. Institutional theory does make a contribution to make an understanding of organizational change, which goes beyond the idea of inertia and persistence (Greenwood and Hinings, 1991). Greenwood and Hinings, (1991) argued that organizations follow certain templates that are institutionally determined and that interaction among institutional setting and organizations creates pressure for change. We believe that pressure for change will have an impact on organizational structure and organizational capabilities and hence organizational legitimacy. However, organizations can take advantage of these pressures for change even if they fail, provided they will learn from their failure. Learning from failure or success can be accomplished through a process that is “direct, indirect and vicarious”, (Barnett and Hansen, 1998; Terlaak and Gong, 2008; Mitsuhashi, 2011; Greve, 2005; Levinthal and March, 1993).

2 Situation in the Saudi Railway Industry

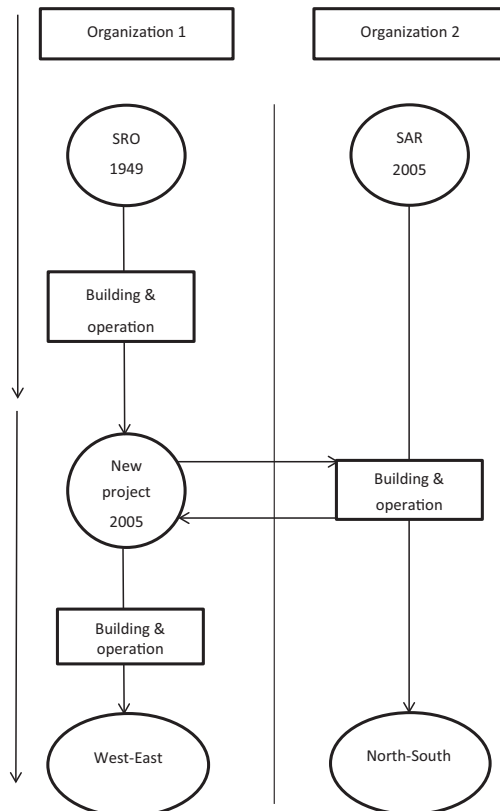
This paper introduces the railway companies in the Kingdom of Saudi Arabia by outlining the emergence of railway organizations. The development of a fully functioning railway system in Saudi Arabia is an important part of the kingdom’s continued development economically, politically and socially (The Saudi Ministry of Transportation; The Authority of The Saudi Railway 2005; Alriyadh Newspaper). As can be seen in figure 1, The Saudi Railway Organization (SRO) was launched 66 years ago by the Saudi–American Oil Company (ARAMCO). SRO went through different stages of change and development. Recently, and with the new initiation of projects, however, SRO couldn’t adapt to the new environmental demands. First, SRO failed to adapt to the new project that means that SRO could be exhibiting structural inertia. Second, this failure in the performance has impacted SRO’s legitimacy. Part of the impact on SRO’s legitimacy is seen

in figure 1.

The Saudi Railway Company (SAR) started around 2005 in order to work on a new project connecting the north of Saudi Arabia with the south. SAR, as a new name in the domestic transport market seeks to satisfy market requirements by providing the best advanced railway services encompassing transport of passengers, freight, minerals and transit services between the neighboring countries. SAR has the challenge of developing its capabilities and therefore SAR is seeking to establish its legitimacy as an organization.

The situation in the Saudi Railway industry, particularly the co-existing of SRO and SAR requires that we develop a conceptual model that can be used to explain both the failure and continued existence of SRO and the establishment and co-existence of SAR. As noted in the previous section there are several research literatures that examine issues of organizational change. We turn our attention to these research literatures in the next section.

Figure 1



II Literature review

1 Organizational issues in the railway systems, empirical studies of railway

There are only a few studies about institutional changes in the railway sector. One of these studies by Obermaier (2001) was investigating the impact of institutional change like privatization on the organizational structures and on the domestic and international markets. She found that fully privatized organizations were more efficient. A comparative study by Lodge (2003), was investigating the regulatory change in the railways in Britain and Germany. It argued that organizational learning and transfer processes could be better understood through an institutional perspective. This study also showed that institutions mattered as Britain and German adopted distinctively different regulatory regimes (Lodge, 2003). Given the importance of railway transportation in the movement of goods and people especially in developing examines, this leads of empirical studies of organizational issues emphasizing the need for finding study. We turn our attention in the next section to several research literatures on organization that can be used to develop a model to aid in our understanding of the situation of SRO and SAR

2 Institutional economics and organizational change

Kingston and Caballero (2009), did a comparative study on theories of the institutional change aiming to build a new theory. They compared various theories with respect to how these examined the causes, process, and outcomes of institutional change, (Kingston and Caballero, 2009). An important conclusion from their study was that some of the theories indicated the importance of deliberate action in the birth of institutions usually through some political process, while other theories saw institutions as emerging through a more bottom up evolutionary process, (Kingston and Caballero, 2009). For our paper on organizational change, both the top down deliberate action of political actors and the bottom up evolutionary process will contribute to the change process. This interaction of deliberate with an emergent process can be further understood through the study of institutional change by Holm, (1995). He argued that “the problem of institutional change

can be solved if institutions are seen as a nested system, that is, interconnected, multilevel system in which each action-level or arena simultaneously is a framework for action and a product of action", (Holm, 1995). For our study, we contend that in this multi-level system deliberate action at one institution level, may stimulate emergent action or reactions at another institutional level.

On the level of organizational change, Greenwood and Hinings (1996), examined how radical organizational change could be understood by combining element of the old and new institutionalism in one framework. They examined how an individual organization will retain, adopt, and discard what they termed templates for organizing, which developed on the institutionalized context of an "organizational field" or what might be termed an industry. They posited that internal dynamic of an organization will strongly influence the ability to respond to pressure for change that originate from institutional sources. Haveman (1992), examined the proposition that "change is detrimental to organizational performance and survival chances". She proposed that organizational change could be beneficial to organizational performance and survival chances under certain conditions. She suggested that if the organizational change occurs in response to a dramatic restructuring of environmental conditions and if that organizational change effort builds on established routines and competences then the organization may be able to adapt and survive.

Therefore, environmental change increases the likelihood of pressure for change, which can be adapted to or not. We assume that pressure for change has an impact on organizational performance either negatively or positively. This impact can be negative or positive based on the level of adaption to the new environment.

3 Population Ecology and organizational change

Hannan and Freeman (1984), argued that formal organizations have two important advantages over other collective actors: their ability to perform reliably and to account rationally for their action. They also argued that organizational reliability and accountability require organizational structures that are reproducible or stable over time. These structures however, are characterized by institutionalizations and standard routines that give organization stability but can generate resistance to change, (Hannan and

Freeman, 1984; Kelly and Amburgey, 1991). According to Hannan and Freeman, two features are important to organizational structure these are the organization's core (goals, forms of authority, core technology and marketing strategy) and the organization's peripheral that is established to protect an organization's core from uncertainty in the environment.

Hannan and Freeman (1984), contended that change in core features of an organization are fundamentally more difficult and also impactful in comparison to change in peripheral features. They developed an argument based on concept which they term structural inertia which they define as occurring when "structures of organizations have high inertia when the speed of reorganization (core feature change) is much lower than the rate at which environmental conditions change" (Hannan and Freeman, 1984). Structural inertia varies with organizational age and size. They also predicted that core feature change will increase the probability of organizational failure.

In population ecology theory when an old organization fails to adapt to the new environment it usually ceases to exist. An organizational change occurs at the population level as waves of new organizations better suited for the new environment outcome and replaces the old organizations. New organizations are always vulnerable however to the liabilities of newness and such pressures are especially severe when an industry is in its formative years.

An important study by Aldrich and Fiol (1994), examined the strategies that entrepreneurs follow in order to successfully legitimacy. They showed that as increasing numbers of organizations enter an emerging industry their collective actions will raise the legitimacy along two dimensions. First, is cognitive or knowledge about the new activity. They argued that at its highest form cognitive legitimation is achieved when the product, process, or service offered by the entrepreneurial organization is taken for granted. Second, is sociopolitical or as they argued "the value placed on an activity by cultural norms and political authorities", (Aldrich and Fiol, 1994). In their study they also recognized a multi-level, nested structure for legitimacy. In Table 1 we replicate the four levels of social context as proposed Aldrich and Fiol (1994), which founding entrepreneurs must work in in order to build trust, reliability, reputation and institutional legitimacy (Aldrich and Fiol,

1994). A study by Karlsson (2012), extended the concepts of liabilities of newness and legitimacy to entrepreneurs with different characteristics. He argued that legitimacy concerns have a bearing on experienced entrepreneurs diversifying into new fields of business as well as the emerging start-up entrepreneurs.

Table 1 entrepreneurial Strategies to promote new industry development. Aldrich and Fiol 1994.

Level of Analysis	Type of legitimacy	
	Cognitive	Sociopolitical
Organizational / trust	Develop knowledge base via symbolic language and behavior.	Develop trust in the new activity by maintaining internally consistent stories.
Intraindustry / reliability	Develop knowledge base by encouraging convergence around dominant design.	Develop perceptions of reliability by mobilizing to take collective action.
Interindustry / reputation	Develop knowledge base by promoting activity through third party actor.	Develop reputation of a new activity as a reality by negotiating and compromising with other industries.
Institutional / legitimacy	Develop knowledge base by creating linkages with established educational curricula.	Develop legitimacy by organizing collective marketing and lobbying efforts.

We assume that, environmental pressure for change at any level for any organization will affect its capabilities, performance and as result it will also affect its legitimacy. From Holm's (1995) study, we recognize that organizational change can occur in a multi-level nested manner. Hence, we differ with traditional population ecologies on the fate of old organizations. Rather than cease to exist, we contend that their organizational legitimacy clock is reset. They are confronted with a liability of renewal¹ that is similar to the liability of newness confronted by new organization.

1 Liability of renewal: whenever an old established organization tries to minimize errors to gain legitimacy through organizational learning to enhance organizational capabilities and improving its performance.

4 Organizational learning and organizational change

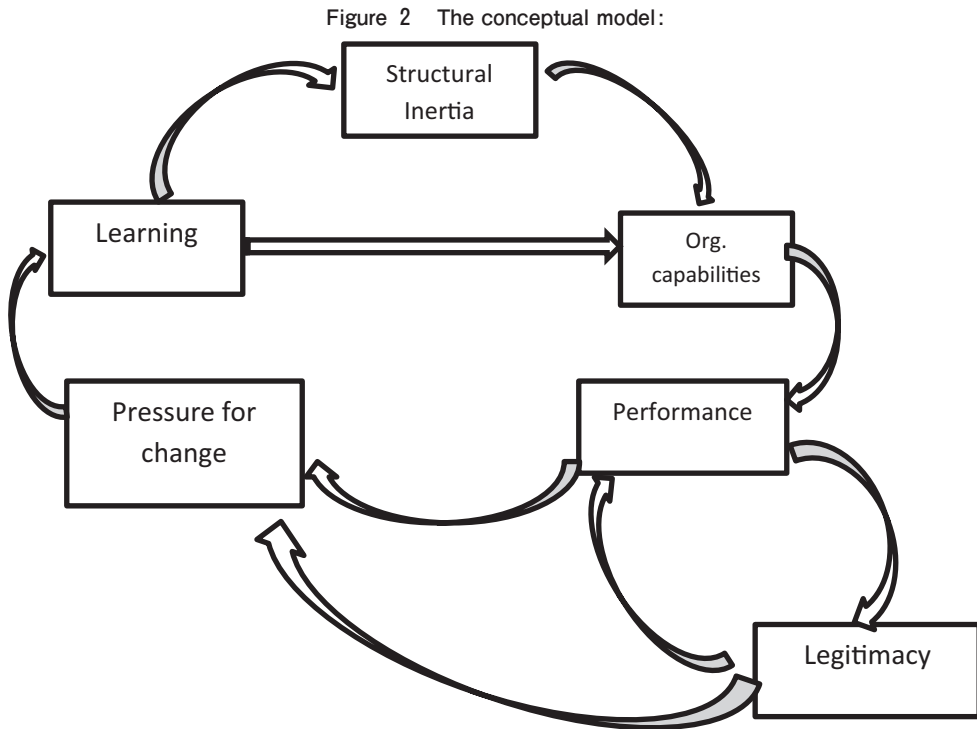
A key element which links the liability of newness with the liability of renewal is the extent to which organizations can learn. Studies in organizational learning are also another important aspect in our paper. In this section we focus on a unique aspect of organizational learning that is learning from failure. This is important because in the population ecology literature failure leads to the demise of the organization, whereas in the resource based view failure leads to lower performance and this leads to adaptation through capability building activities. Capability building activities become an important issue in how organizations learn from failure. Although there are only few studies on learning from failure, those that examined the subject indicate that this is an important type of learning. One study focused on learning from failure and indicated that this kind of learning is essential to adaptation. They argued that such learning complements learning from success, (Joel and Kristina, 2007). Desai (2010), examined the moderating role of knowledge gained through an organization's operating experience as a way that organizations can learn from failure.

In addition to learning from failure, organizations can learn through others' actions. A study by Terlaak and Gong (2008), developed a model of inferential vicarious learning that explicates how a firm can learn whether to adopt a practice whose value varies across organizations. By examining variation from samples of adopter, nonadopters, abandoners, and nonabandoers, an organization can learn from the success or failure of others (Terlaak and Gong, 2008). Further they found that "incomplete samples may allow more accurate inferences than a complete one". In another study on vicarious learning it was proposed that managers who have encountered an event or situation in the past that has similar characteristics to some current event may actually learn less from the current situation since it falls below their attention threshold, (Mitsubishi, 2011). This suggests that vicarious learning may be incomplete and may be a source of greater variation in organizational capability change attempts.

The concept of organizational capability has attracted a lot of interest primarily in the field of strategic management. In the resource-based view (RBV) organizational

capabilities have been identified as “one major source for the generation and development of sustainable competitive advantages” (Barney, 1991).

Here we assume that organizational learning can be helpful and impactful on increasing organizational capabilities. As result, high organizational capabilities will make any organization to perform well and increase likelihood of gaining legitimacies. Our conceptual model shows that the organizational capabilities can be a source of errors as well as source of legitimacies. This paper therefore aims to develop an alternative approach to minimize errors and as result gain legitimacies. Our model can be seen as flow in figure 2:



Conceptual model can be characterized as holding to eight fundamental relationships. There are summarized as following:

Relationship 1: *Structural inertia has a relationship on organizational capabilities*

Relationship 2: *Organizational capabilities have a relationship on organization's performance.*

Relationship 3: *Organization's performance has a relationship on organization's legitimacies*

Relationship 4: Organization's legitimacies have a relationship on organization's performance.

Relationship 5: Organization's performance and legitimacies have a relationship on pressure for change.

Relationship 6: Pressure for change has a relationship on learning.

Relationship 7: Learning has a relationship on structural inertia.

Relationship 8: learning has a relationship on organizational capabilities as well as organization's performance.

III Conceptual Model and Propositions

We have examined several research literatures that are important in building our conceptual model. We have identified the relevant variables that followed from each of the research literatures in terms of the relationships among the variables. In the next section we turn our attention to the relationship among these variables and set forth propositions that should guide future research.

1 Structural inertia and organizational capabilities

According to population ecology, whenever organizations adapt to a new environment in response to pressure for change that may cause organizational failure. According to Larsen and Lomi (2002), the theory of structural inertia has two main counter-intuitive implications. A key finding from their study was that the very same process that aid survival can make organization more resistant to change. The second key finding for our study is that organizational change is risky in and for itself. As noted this is because it disrupts the routines that provide stability. This stability comes from the fact that these routines act as organizational memory and the competencies stored are often called into question and this, in turn can affect the internal and external bases of institutionalization and legitimation (Larsen and Lomi, 2002). Casto (1994), provided a set of boundary conditions that helps to understand both organizational inertia and adaptation in organizational structures. He found that "in the case of ambiguity, economic, political, and

cultural factors all affect organizational structuring and the determinants of inertia, change, and adaptability”, (Ocasto, 1994).

Hannan and Freeman (1984), contended that changes in core features of an organization are fundamentally more difficult and also impactful in comparison to change in peripheral features. Organizational capabilities are considered a core feature if they provide strategic differentiation for the organization (Leonard-Barton, 1992). Case studies on firm capabilities and adaptation have primarily served to greatly explicate sources and causes of structural inertia and why firms are not able to adapt. Leonard-Barton, (1992) argues for example, that “core capabilities can become core rigidities that can lead to organizational failure”. As we noted we see this duality in Larsen and Lomi (2002), emphasized when they suggest that the “moving parts” of an idealized organizational system as representing the dynamic duality between organizational inertia and the evolution of capabilities.

Therefore, we infer that structural inertia may decrease organizational capabilities. Hence, whenever an organization has high level of structural inertia it will decrease its organizational capabilities. This leads us to our first proposition:

***Proposition 1:** Structural inertia has a negative relationship on organizational capabilities.*

2 Organizational capabilities and organization's performance

Meyer (2010), defined organizational capability as extending well beyond the sum of the skills and talent that an organization has in its ranks. Based on the idea of resource-based view, we intend to investigate how organization's capabilities, as one of the organization's resources, can actually improve its performance as one of the organization's competitive advantages. In a theoretically outstanding work on the RBV, Grant (2002), attempted to conceptualize a comprehensive framework for organizational resources. He indicated that relationships among tangible and intangible resources will often result in organizational capabilities and that these can be used to develop a competitive advantage in organizational performance. Another study emphasized that again the combining of various organizational resources are seen as developing capabilities that generate competitive

advantage (Tuan & Takahashi, 2009). They also emphasized that “among the possible relationships between organizational capabilities, competitive advantage and performance, a direct relationship between organizational capabilities and competitive advantage likely exists rather than a relationship straight from that to performance” (Tuan & Takahashi, 2009). This has important implication for the development of propositions 3 and 4.

Singh, Chan and McKeen (2006) , built their own theory on the knowledge management capability to improve organization’s performance. They found that organization should pay attention to investing more in its knowledge processes to improve its performance. We assume that high organizational capabilities at all levels will lead to high performance. This leads to our second proposition:

***Proposition 2:** Organizational capabilities have a positive relationship on organization’s performance.*

3 Organization’s performance and organization’s legitimacies

Organizational legitimacy is a normal reflection of the relationship between an organization and its environment, which can be measured by an organization’s performance. Our conceptual model develops a unique approach to understanding how to improve an organization’s performance in order to gain legitimacy. We assume that if an organization performs reliably and accountably (Hannan and Freeman, 1984; Kelly and Amburgey, 1991) that leads to gain legitimacy along two dimensions. As we noted in developing proposition 2 that Tuan & Takahashi (2009), indicated that the relationship between organizational capabilities and organizational performance may not be straightforward. We contend that one complicating element is the relationship between organizational performance and organizational legitimacy. As we noted before two dimensions of legitimacy are cognitive and sociopolitical, (Aldrich and Fiol, 1994). Another study showed an important connection between categories of human behavior in order to find the intersecting point between and the liability of newness and legitimacy (Dahl, 2012). This requires that we also understand the relationship between organizational capabilities and organization’s performance. Environmental pressure for change and

organizational capabilities at any level in any organization will affect its performance and as a result it will also affect its legitimacy. We are assuming that high organizational capabilities will make any organization perform well and increase the likelihood of gaining legitimacies. On the other hand, legitimacy also can affect performance especially under certain organizational practices become normative, in that case legitimacy gains can become more important than performance improvements (Guo, 2012). Further the relationship between performance and legitimacy is affected by the type of environmental contingency or crisis. In a study on crisis Breitsohl (2009), found that “crises are indeed characterized by a loss in legitimacy, the specific dimensions depending on the type of crisis” (Breitsohl, 2009).

We believe that institutional change have an impact on legitimacy of an organization that leads to a decrease in performance and vice versa. Here we assume that organizational legitimacy can be impactful on many levels including organizational level. This leads us to our third and fourth propositions:

***Proposition 3:** Organization’s performance has a positive relationship on organization’s legitimacies.*

***Proposition 4:** Organization’s legitimacies have a positive relationship on organization’s performance.*

4 Organization’s performance, legitimacies and pressure for change

Following the notion of “for each action there is an equal and opposite reaction”, we believe that decreasing in an organization’s performance which causes loss of organizational legitimacy will lead to pressure for change. Environmental change, which causes in many cases organizational failure, increases the likelihood of pressure of change that can be adapted to or not. We assume that pressure for change has an impact on organization’s performance negatively or positively. In this paper, we assume that organization failure leads to pressure for change. This leads us to our fifth proposition:

***Proposition 5:** Organization's performance and legitimacies have a negative relationship on pressure for change.*

5 Pressure for change and learning

A key element which links the liability of newness with the liability of renewal is the extent to which organizations can learn. Here, one aspect of the links between the liability of newness and the liability of renewal is that an old organization seeks to learn from failure. In the population ecology literature failure leads to the demise of the organization whereas in the resource based view failure leads to lower performance and this leads to adaptation through capability building activities. The other aspect of the links between the two liabilities is that a new organization seeks to learn capabilities in order to gain legitimacy. Both aspects can be done through a process that is "direct, indirect and vicarious", (Barnett and Hansen, 1998; Terlaak and Gong, 2008; Mitsuhashi, 2011; Greve, 2005; Levinthal and March, 1993). This leads us to our sixth proposition:

***Proposition 6:** Pressure for change has a positive relationship on learning.*

6 Learning, structural inertia, organizational capabilities

As Levinthal and March (1993), noted learning has a recognized relationship with organizational capabilities. "Learning processes, however, are subject to some important limitations. As is well-known learning has to cope with confusing experience and the complicated problem of balancing the competing goals of developing knowledge (i. e., exploring new capabilities and exploiting current competencies in the face of environmental change and the tendencies to emphasize one mode of learning or the other" (Levinthal and March, 1993). Further, not only is the learning differentiated by goal, that is exploratory or exploitative (March 1991), but it is also differentiated by means, that is direct, indirect and vicarious. As we noted earlier Terlaak and Gong (2008), vicarious learning can occur as firms observed how practice varies across other relevant firm is organizational capabilities and performance.

Successful learning of new processes leads to a decrease in structural inertia and as a result an increase and enhancement of both organizational capabilities and performance. In terms of exploration and exploitation in organization learning, March (1991), developed an argument that “adaptive processes by refining exploitation more rapidly than exploration are likely to become effective in the short run but self-destructive in the long run”. Levinthal (1995), emphasized that “the successful balance of the processes of exploration and exploitation requires understanding the power of aggregation and parallelism in organizational learning”, (Levinthal, 1995). First we assume that exploitative learning can increase structural inertia. Second exploratory new learning processes will increase and enhance both organizational capabilities and performance. The result of both types of learning can minimize errors and gain legitimacy, however this depends on the situation. This leads us to our seventh and eighth propositions:

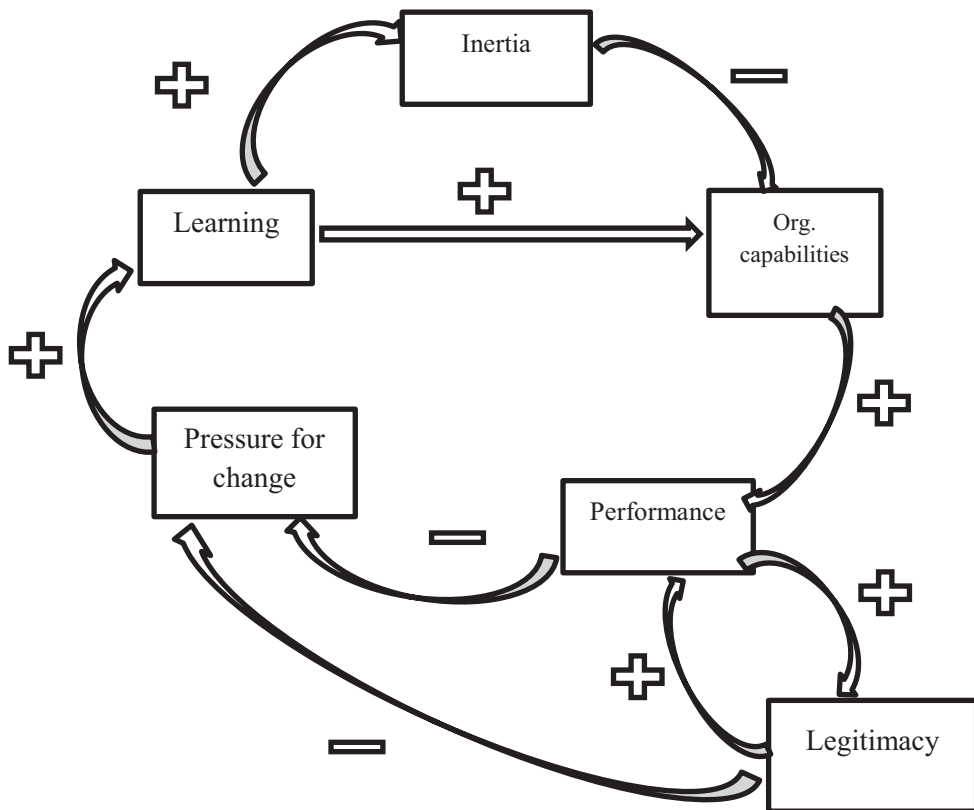
***Proposition 7:** Learning has a positive relationship on structural inertia if the learning is exploitative.*

***Proposition 8:** Learning has a positive relationship on organizational capabilities if the learning is exploratory.*

7 Summarizing of propositions and conceptual model

Our propositions as developed in this paper can be summarized as follows: low structural inertia and high organizational capabilities will make any organization perform well and increase its likelihood of gaining legitimacies and are shown in figure 3 below. Our conceptual model shows that the organizational capabilities can be a source of errors as well as a source of legitimacies based on the organizational learning processes. This paper therefore aims to develop a more comprehensive approach to understand how organizations attempt to minimize errors and as result gain legitimacies.

Figure 3 The conceptual model:



IV Expected result and conclusion

After applying the above conceptual model and the propositions, we expect to find that the Saudi Railway industry situation has two main areas of concern that lead an organization to minimize errors and gain legitimacy:

First, when the old organization (SRO) failed to adapt to the new environment we expect that is because of its structural inertia that caused decrease in the organizational capabilities and performance. We expect to find, that this organization is losing its legitimacy and that increase its pressure for change and learning from failure. Although this organization failed to adapt to the new environment but its survival leads to the liability of renewal. From our conceptual model we expect to find that this organization can

minimize its errors and increase organizational capabilities, performance and as result regain legitimacy. Therefore, we expect this organization to reset its own clock and to pay much more attention to the learning process that reflects on increasing its capabilities to perform well.

Second, the new organization (SAR) is trying to gain cognitive and sociopolitical legitimacies. As a rival in a market where an older established organization is still surviving even through it is losing legitimacy, our conceptual model expects that the new organization has a liability of newness and it should pay more attention towards enhancing its organizational capabilities as well as improving performance. In terms of gaining legitimacy the new organization should focus on levels of social context by building trust, reliability, reputation and institutional legitimacy to gain both cognitive and sociopolitical legitimacies.

Our conceptual model shows the process of how organizations whether in a state of newness or renewal are expected to minimize errors and enhance organizational capabilities as well as improve performance to gain legitimacy. Our model also emphasizes the learning process as a way to increase organizational capabilities that in turn leads both organizations to perform well and re/gain legitimacy.

In the future research, we will apply this model to the Saudi Railway situation and focus on how integrating across the two organizations can enhance organizational capabilities as well as improve performance to gain legitimacy.

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