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WHY MANAGEMENT MATTERS MOST

When a country or a company starts to fall behind in innovation performance and productivity growth, its leaders should focus on developing new managerial skills rather than chasing promising new technologies. The current dilemma facing the Netherlands is a classic case.

Dutch innovation performance and productivity growth is falling behind. Dutch businesses are focusing on restructuring and cost reductions. Dutch politicians have been too concerned with short-term government expenditures. Research at Dutch universities is failing to fuel the knowledge economy. On top of these rather worrying factors, the position of the Netherlands in the Global Competitiveness Index of the World Economic Forum is disappointing. The Netherlands has fallen from the top ten – and this could have serious consequences for the Dutch welfare state.

The Dutch innovation debate so far has concentrated on technology-related macrovariables, like below-average private investment in R&D or the low numbers of available scientists and engineers. The central thought is that for a small country to innovate, it should invest in only a few promising core technologies, such as nanotechnology or biotechnology. Particularly striking is the strong bias towards technological innovation and the total ignorance of what Daft (1978) called “administrative innovation”.

But there is strong evidence from around the world that managerial capabilities and organising principles, not just technological know-how, are key to innovation. One can think of Richard Branson’s superior visioning ability, which has enabled him to understand the future evolution of markets and technology, and create new opportunities to serve both current and new customers. Other examples are the superior “industry foresight” of Dell (direct delivery without intermediaries in the PC market), Ikea (direct delivery and self-assembly by the client in the furniture market), Xerox (paperless office) and Southwest Airlines (cost efficiency and focusing on a

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IN BRIEF

- The current focus on technological innovation will not help the Dutch economy regain its vitality and strength.
- Managerial and organisational innovation are at least as important as technological innovation for long-term business success.
- Business cultures that encourage variety, exploration and self-organisation are needed.
- Top management, government, business schools, consultants and the general public all have a role to play in building such cultures.

particular value chain in the airline business). These examples highlight how the ability of top management to imagine the future - and develop capabilities to meet that future - can lead to competitive advantage.

Expanding worldwide competition, fragmenting markets and emerging technologies are forcing established firms to renew themselves continuously by transforming stagnant businesses and creating new sources of wealth. Hamel and Prahalad (1994) contend that instead of “more of the same” or “try harder” approaches (how to be better), organisations should fundamentally reconsider their core activities (how to be different).

Building managerial capabilities

The first step lies in mobilising “dynamic capabilities”. The key attributes of dynamic capabilities are (Volberda, 1998):

- **Broad knowledge base:** The ability to combine knowledge from across different core technologies often distinguishes innovative companies. Take 3M, for example. When consumer research showed that customers complained about rusting steelwool pads, experts from 3M’s adhesives, abrasives, coatings and non-woven technologies divisions got together to create Never Rust plastic soap pads.
- **High absorptive capacity:** The ability to recognise the value of new, external knowledge from beyond the periphery of the firm, assimilate and apply it to commercial ends is crucial.
- **Broad managerial mindsets:** Managers must have the ability to identify and support new ideas. By relying on routines, managers concentrate on their own specialised areas and avoid the need to construct new activities. Consider the experiences of firms such as NCR, for example. Due to its continued focus on established lines of business (electromechanical cash registers) and its reluctance to experiment, NCR was outperformed by others. Likewise, Sharp was able to develop

dynamic capabilities in the electronic calculator industry while TI was held back by its limited managerial mindsets, which were narrowly focused on the semiconductor market.

• **High-level learning:** Dynamic capabilities, such as flexible manufacturing or fast product development, cannot be purchased off the shelf but require strategic vision, development time and sustained investment. They take time to identify, nurture and leverage, and tend not to be the kind of assets that managers can turn on or off. Dynamic capabilities must be built rather than bought. Skill acquisition and learning are fundamental issues.

Managerial roles in capability development

Developing dynamic capabilities is not exclusively the role of the manager. While managers do indeed dominate this process in many situations, every employee participates in principle.

Identifying and building capabilities is traditionally viewed as a hierarchical process with the CEO and top management playing a central role. Examples of such a top-down approach include GE’s corporate revitalisation, guided by its CEO Jack Welch, and Philips’ corporate change initiated by Jan Timmer and further accelerated by Cor Boonstra. What is unique about these companies is the fact that their CEOs drove the entire process of capability development, starting by introducing new concepts, communicating them in an understandable manner. New capabilities such as speed, simplicity and market responsiveness were consequently passed down the organisation almost as an order or instruction to be followed.

Not every firm, however, can simply copy this top-down approach, given that strategy in large complex firms is often less centralised. Perhaps the most effective process of capability development is through originating, developing and promoting strategic initiatives from front-line managers lower down the organisation. Front-line managers typically have the most current knowledge and expertise and are closer to the sources of customer information critical to new capabilities. Prahalad and Ramaswamy (2003) refer to these kinds of innovation as “co-creation”. An example of a more bottom-up process of capability development can be found in 3M. In this highly innovative firm, the role of top management is limited to sponsor, coach or mentor; innovation clearly derives from initiatives at the bottom. Not surprisingly, the names of successive CEOs at 3M are relatively unknown, while the inventors and “intrapreneurs” of the lower levels of the company have received the most attention (for example, Scotch tape, invented by Dick Drew; or Post-It Notes, by Art Fry).

A shared ideology can help facilitate capability development among various parts or subcultures of the company by

specifying broad, tacitly understood rules. Japanese companies like Canon and Honda try to enhance cross-cultural capabilities through dialogue, camp sessions or brainstorming seminars held outside the workplace, and even drinking sessions. Hewlett-Packard’s corporate values like trust and respect for individuals, uncompromising integrity and teamwork (the HP Way), or 3M’s culture of tolerance for failure and bias for action, helped these firms to easily develop capabilities for innovation.

Organising principles

Three organising principles must underpin any innovative organisation (Volberda and Lewin, 2003). First, the internal rate of change must equal or exceed the external rate of change (competitors, technology, customers etc). This implies a keen awareness that co-existing rivals trigger each other’s adaptations. Organisations that have historically been exposed to more competition are likely to have developed greater capabilities for regulating their internal rate of change.

Firms that can build to order, leapfrog their competitors in new product introductions or improvements or detect and exploit emerging trends ahead of their competitors are examples of this. 3M, for instance, continually reassesses the barriers to innovation that tend to develop over time. To avoid stagnation or rigidity, it has a formal goal of having 30 per cent of its sales derived from products that are new or have been substantially modified in the past four years. HP and Motorola are also pursuing structures and cultures that are more focused on building new competencies. Like 3M, these companies decentralise decision-making at the team and divisional level, and encourage spin-off projects. For example, 70 per cent of HP’s sales are represented by products introduced or substantially modified in the past two years.

Second, innovative organisations optimise self-organisation. This does not mean, however, that individuals or units can pull in all directions at will or break all the rules. But it does mean that no central controller is necessary. This approach requires a fundamental departure from the command-and-control philosophy of traditional, hierarchical bureaucratic organisations.

Third, innovative organisations balance innovation and knowledge creation (exploration) with improvements in productivity and processes improvements, efficiency and product enhancements (exploitation). Levinthal and March (1993) contend that the long-term survival of an organisation depends on its ability to “engage in enough exploitation to ensure the organisation’s current viability and engage in enough exploration to ensure its future viability”. Most firms seem to

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exhibit an asymmetric preference for short-term exploitation improvements. Corporate icons such as GM, IBM, Xerox and DEC have fallen into this trap. They became “prisoners” of their deeply ingrained routines and seemingly irreversible, fixed assets, turning their formerly distinctive competencies (big cars, mainframe computers, copiers, minicomputers) into obstacles to changing direction.

These three principles require continuous attention. It is exactly this feature of continuous attention that distinguishes successful, long-lived organisations that are permanently able to innovate from the non-innovating organisations with a short-term exploitation focus.

Demanding environments and strategic regulations

How can these managerial capabilities and organising principles of innovation be enhanced within Dutch private and public firms? In this section we will discuss the creation of demanding internal and external “selection” environments for innovation and the design of strategic regulations conducive to innovation.

Selection environments create the context in which innovations are assessed on their viability and their expected contribution to competitive advantage. Prevailing benchmarks regarding profitability, incentive structures and power relations determine which innovative processes, products and services are selected. External selection environments consist of various “actors” including: (a) customers, distributors and users; (b) suppliers for materials, labour, capital and equipment; (c) competitors for both markets and resources; and (d) regulating groups, including governmental agencies, unions and interfirm associations. In the end, these actors select successful innovations.

Internal selection environments are located within the boundary of organisations and determine the variety of new innovations within the firm. To develop an internal selection environment conducive to innovation, managers must find ways to encourage and nurture new ventures and projects. Johnson & Johnson is an example of a corporation that has developed mechanisms to set up new units. This encourages entrepreneurs to pursue their ideas in new separate divisions, while the older, more established divisions provide continuity and stability. This system carries costs, such as the difficulty of integrating the new ideas back into the old organisation. But it also brings important benefits, as new ideas are typically insulated from the inertia of the centre, and have the possibility to flourish without being suffocated.

The great majority of the existing regulations in the Netherlands do not enable innovation and productivity

growth. In contrast to operational regulations, strategic regulations should be based on the central idea that “less is more”. These regulations must create a demanding competitive context, leading to a sustainable competitive advantage for those firms that are able to comply. Porter and Van der Linde (1995) have criticised the relationship between regulations and competitiveness as a fixed trade-off, “ecology versus the economy”, based on a “static view of environmental regulation, in which every thing except regulation is held constant”. Indeed, such a view does not take into account the possibilities of using regulations to foster innovation, productivity growth and strategic renewal of organisations.

Look at regulation in the pulp and paper industry, for instance. Regulation in the US forces firms to install costly end-of-pipe treatment systems. In Scandinavia, however, regulation permits more flexible approaches, enabling firms to focus on the sources of pollution in the production process itself. This approach stimulated Scandinavian firms to develop innovative pulping and bleaching technologies that not only met emission standards, but also raised productivity and created first-mover advantages for these firms in the industry.

At company level, top management must be involved in prioritising and continuously assessing managerial capabilities and organising principles. Progress on these managerial and organisational innovations should be reported. Shareholders and other stakeholders have to assess their impact on competitive advantage. Moreover, to improve the scientific underpinning of methods of assessment, research institutions, business schools and consulting firms have to put this issue higher on their agenda. Most innovation tools and tests have focused on the technological knowledge base. They have ignored the managerial and organisational determinants of innovation. Public recognition of major innovations is also clearly needed. Instead of narrowing down innovation efforts in business to the “big seven” R&D intensive companies in the Netherlands, it is much more challenging to publish management and organisation rankings on the outstanding innovation performance of organisations in both the private and public sector.

Rethinking the Dutch innovation agenda

To conclude this essay, we provide five agenda items for improvement and diffusion of managerial capabilities and organising principles of innovation in the Dutch economy.

• **What do to?** Given the under-utilisation of existing knowledge in the Netherlands, investments in the absorption of knowledge (and its successful application) should have a higher priority than investments in technological innovation.

• **How to do it?** Build managerial capabilities (broad knowledge base, absorptive capacity, managerial experimentation, higher learning) and management roles (hierarchy, teams, shared norms) to increase the assimilation of knowledge and its utilisation for innovation. Develop new organisational principles that increase internal rates of change, nurture self-organisation and higher levels of exploration and exploitation within firms.

• **Who is involved?** Top management has to create a proper organisational context to foster entrepreneurship and innovation. Government agencies have to focus on innovation and productivity, and enable strategic regulations. Research institutes, business schools and consulting firms must focus not only on technological knowledge, but also on managerial and organisational knowledge.

• **For what purpose?** The Netherlands has to return to the ranks of the top ten most innovative and productive countries in the world.

• **How to build enthusiasm for innovation?** Create public awareness and recognition of the societal relevance of outstanding managerial capabilities and organising principles. Develop proper assessment tools for innovations in management and organisations. Enhance reporting on the progress of such innovations, and include this information in annual reports, along with financial indicators.

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