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## THE IMPORTANCE OF GOVERNANCE IN BUSINESS MODELS

### Summary

Interorganizational relationships help firms to create value by combining resources, developing knowledge resources and facilitating access to foreign markets. In particular, one should highlight the importance of relationships from the perspective of knowledge creation and sharing. The main theoretical paradigms used to explain the reasons behind creation of interorganizational interrelationships are as follows: transaction costs economics, resource dependence, stakeholder theory, and learning theory. Governance may be important component of interorganizational networks. The impact of governance depends on the type of network. The successful adoption of a particular form of governance in a network may be attributed to the following factors: trust, size of network, goal congruence among the network members, the nature of the task of the network.

**Keywords:** organizations, governance, interorganizational relationships, networks, effectiveness.

### Introduction

Interorganizational relationships are commonly believed to help firms to create value by combining resources, sharing knowledge, increasing speed to market, and gaining access to foreign markets. Despite the popularity and benefits of interorganizational relationships, not all evidence is positive. Many of them fall short of meeting the expectations of their participants or fail for other reasons. Participants of these structures are often overoptimistic about the expected benefits.

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Interorganizational relationships are difficult to manage as a result of the complexities involved and the need to bring together different corporate cultures. The purpose of this article is to describe the theoretical paradigms explaining interorganizational relationship formation and discuss the potential advantages and disadvantages of participating in these relationships.

## **1. The basic paradigms of interorganizational relationships formation**

The theoretical literature on interorganizational relationships formation is fragmented. This reflects the multifaceted nature of these processes. The formation of an interorganizational structure often involves a mixture of motives, intentions, and objectives. The main theoretical paradigms used to explain the reasons behind creation of interorganizational interrelationships are as follows: transaction costs economics, resource dependence, stakeholder theory, and learning theory.

### **Transaction Costs Economics**

Transaction costs economics (TCE) focuses on how an organization should organize its boundary spanning activities so as to minimize the sum of its production and transaction costs. The production costs of organizations vary as a result of the scale of their operations, learning and experience effects, location advantages, and proprietary influences such as patents and trade secrets. Transaction costs also vary, and include expenses associated with arranging, managing, and monitoring transactions across markets.

The purest application of TCE is to the make buy decision. In a free market, it is typically cheaper for a firm to buy a generic product from a specialized firm. However, the decision will be different if the transaction costs are too high. TCE explains why an organization might choose to internalize the production of a component part even though its production costs are higher than those offered by the specialist firm.

In his early writings, O. Williamson identified markets and hierarchies as the two modes of organizing, and later acknowledged the additional role of interorganizational forms (Williamson 1975). An interorganizational relationship, such as a joint venture or a network structure, is an alternative to a market or an organizational hierarchy. Joint ventures, for instance, help firms to avoid the costs of opportunism and monitoring that are inherent in market transactions. Networks are more efficient than markets and hierarchies when a network arrangement minimizes the transaction costs for participating firms. Firms in the network benefit from specialization, which can lower the overall costs. Opportunism on the part of network participants is minimized through mutual trust and a desire to remain in the network.

### **Resource Dependence**

Resource dependence is a theory rooted in an open system framework, which argues that organization must engage in Exchange with their environment to obtain resources. This theory is different from the resource-based view of the firm. From a resource-based perspective rare and difficult to imitate internal resources are key to acquire and maintain competitive advantage. Hence, the focus of the resource-based view is internal. On the other hand, resource dependence theory focuses exclusively on resources that *must* be obtained from external sources for an organization to survive or prosper.

The need to acquire resources creates dependencies between organization and outside units, which may be suppliers, competitors, creditors, governmental agencies, or other. J. Child and D. Faulkner (1998) were among the first to notice that to successfully manage these dependencies, organization must increase its power relative to other organizations in its relevant environment. Participating in interorganizational relationships is one way to achieve this objective. If the firm does not have necessary resources to optimize its own competitive position it may chose to partner with other firms to plug a skill or resource gap. Another reason for the formation of interorganizational relationships may be the strategy to take advantage of complementary assets.

### **Stakeholder Theory**

This theory envisions organizations at the center of a network of stakeholders. A common perspective found in the stakeholder literature is that organizations are vehicles for coordinating stakeholder interests (Ogden, Watson 1999, pp. 526–538). This perspective is based on the notion that organizations are vehicles for coordinating stakeholder interests (Lando, Boyd, Hanlon 1997, pp. 110–141). As a result of their cooperative nature, organizations are inclined to form coalitions with stakeholders to achieve common objectives. These coalitions are referred to as constellations, networks, and strategic networks. These cooperative relationships can be a powerful mechanism for aligning stakeholder interests and can help to reduce environmental uncertainty.

Stakeholder models are rather descriptive than prescriptive. They lead to a conclusion that firm alliances can facilitate goal congruence among a group of stakeholders, but they do not provide much advice with regard to the form alliances should take.

### **Learning Theory**

Another rationale for interorganizational relationships is that firms form partnerships to capitalize on opportunities for organizational learning. In the interorganizational relationship literature, one of the most widely cited motives for alliance formation is the acquisition of new technical skills or technological capabilities from partner firms. Because knowledge is often tacit and difficult to price, interorganizational relationships can be a very effective means of transferring

knowledge across firms. In a seminal article on networks and learning Kogut and others wrote: “Knowledge creation occurs in the context of a community, one that is fluid and evolving rather than rightly bound or static. The canonical formal organization with its bureaucratic rigidities is a poor vehicle for learning. Sources of innovation do not reside exclusively inside firms; instead they are commonly found in the interstices between firms, universities, research laboratories, suppliers and customers” (Powell, Kogut, Smith-Doernerr 1996, p. 118).

An important variable that helps determine how much a firm can learn through interorganizational relationships is firm absorptive capacity (Cohen, Levinthal 1990, pp. 128–152). Absorptive capacity is a firm’s ability “to recognize the value of new, external knowledge, assimilate it, and apply it to commercial ends” (Cohen, Levinthal 1990, p. 128). Absorptive capacity tends to develop cumulatively, is path dependent, and builds on prior experience.

The learning theory has some inherent weaknesses. First, it focuses on skill development and transfer, without focusing on the costs involved. Second, firms that enter into learning alliances risk the loss of proprietary information which is not within the intended scope of the alliance. Learning theory does not account for this contingency.

## **2. Organizational versus network governance**

Governance is a topic that has been studied for long. Traditionally, governance in business firms has focused on the role of boards of directors in representing and protecting the interests of shareholders. In public management, governance refers not to then activities of boards, but mainly, to the funding and oversight roles of government agencies. A critical role for governance, consistent with principal-agent theory, is to monitor and control the behavior of management, who are hired to preside over day-to-day activities of running the organization.

Most literature on organizational networks does not explicitly address governance. The reason is that networks are comprised of autonomous organizations and, thus, are essentially cooperative endeavors. Since networks are not legal entities, the legal imperative for governance is not present as it as for organizations. For goal-oriented organizational networks, however, some form of governance is necessary to ensure that participants engage in collective and mutually supportive action, that conflict is addressed, and that network resources are acquired and utilized effectively.

A focus of governance involves the use of different institutions and structures to allocate resources and to coordinate and control joint actions across the network as a whole. These interactions are different from operational links, which usually have the form of dyads.

Networks can be defined as groups of three or more legally autonomous organizations that work together to achieve not only their own goals but also a collective goal. Such networks may be self-initiated, by network members themselves or may be mandated or contracted, as is often the case in the public sector.

Most research on organizational networks can be broadly characterized by two basic approaches: the “network analytical” approach and the “network as a form of governance” approach. Network analytical approaches focus mainly on micro-level aspects of networks, building largely on work done by sociologists studying networks of individuals. The units of observation are set of objects called nodes, positions, or actors, and a set of relations among these objects referred to as ties or links. In network analytical approaches, the main objective is either to describe, explain or compare relational configurations or to use these configurations to explain certain outcomes. In this approach what gets analyzed and explained is not the network itself, but the “nodes” and “relations” that comprise the network (Graddy, Chen 2006, pp. 533-553). The unit of analysis is not a complete network but a node or a dyad. In these studies, findings are related to questions whether or not the way an actor is embedded in a network has an effect on the outcomes of the actor (such as level of innovation, performance, and learning) (Ahuja 2000, pp. 425–455). As a consequence, this body of literature tells nothing about the functioning of networks, because the networks themselves are seldom treated as the unit of analysis.

The network as a form governance approach, in contrast, does treat networks as the unit of analysis. Network is viewed as a mechanism of coordination, or what can be referred to as network governance. Starting with Williamson’s (1975) *Markets and Hierarchies*, literature has developed on different forms of governance. This literature challenged the conventional wisdom that markets is the only efficient system of nonhierarchical coordination. It was highlighted that other forms of coordination, such as networks, can equally achieve goals. The literature moved toward treating networks as discrete forms of governance, characterizing them as having unique structural characteristics. Networks started to be treated as a response to failures of markets, failures of hierarchical coordination, and the societal and technological developments. The implication was that networks in general can produce positive outcomes that would not be possible in a market or a hierarchy.

### **3. Forms of network governance**

Based on literature review on whole networks, network governance forms can be categorized along two different dimensions (Provan, Fish, Sydow 2007, pp. 479–516). First, network governance may or may not be brokered. At one extreme, networks may be completely governed by the organizations that comprise the network. Every organization would interact with every other organization to govern the net-

work, resulting in a dense and highly decentralized form. At the other extreme, the network may be highly brokered, with few direct organization-to-organization interactions, except regarding operational issues such as the transfer of business, clients, information on services, etc. Instead, the network governance would occur through a single organization, acting as a highly centralized network broker, or lead organization, regarding the issues that are critical for overall network maintenance and survival. At the mid-range a single organization might take on some key governance activities while leaving others to network members.

A second distinction regarding governance can be made in brokered networks by focusing on whether the network is participant governed or externally governed. Participant-governed networks may be governed either collectively by the members themselves (i.e. shared) or by a single participant that takes on the role of the lead organization. Externally governed networks are governed by a unique network administrative organization (NAO).

#### **Participant-Governed Networks**

The simplest and most common is participant governance. This form is governed by the network members themselves with no separate and unique governance entity. Governance in this form can be accomplished either formally; for instance, through regular meetings of organizational representatives, or more informally, through the ongoing uncoordinated efforts of those who have a stake in a network success.

#### **Shared Participant-Governed Networks**

These networks depend exclusively on the involvement and commitment of all or majority of the organizations that comprise the network. Shared-governance are common in health and human services. Only by having all network members participate, on an equal basis, will participants be committed to the goals of the network. In business, shared governance may be used in smaller, multi-firm strategic alliances and partnerships designed to develop new products or to attract new business in ways that could not be otherwise accomplished through the independent efforts of network members (Venkatraman, Lee 2004, pp. 876–892).

When network governance is shared, network members make all the decisions collectively and manage network activities. Power in the network is more or less symmetrical. There is no distinct, formal administrative entity.

#### **Lead Organization-Governed Networks**

The inefficiencies of shared governance may mean that far more centralized approach is preferred. In business, lead organization governance often occurs in vertical, buyer-supplier relationships, especially when there is a single, powerful, often large, buyer/supplier and several weaker supplier/buyer recipient firms.

In lead organizational governance, all major network-level activities and key decisions are coordinated through a single participating member. Thus, network

governance becomes highly centralized and brokered, with asymmetrical power. A lead organization provides administration for the network and/or facilitates the activities of member organizations in their efforts to achieve network goals, which may be aligned with the goals of the lead organization. The role of the lead organization may emerge from the members themselves, based on the criteria of efficiency and effectiveness, or it may be granted, often by an external funding source.

#### **Network Administrative Organization**

A third form of network governance is the NAO model. The basic idea is that a separate administrative entity is set up specifically to govern the network and its activities. Although network members still interact with one another, the NAO model is centralized. The network broker, i.e. NOA plays a key role in coordinating and sustaining the network. A NAO is established either through mandate or by the members themselves, for the exclusive purpose of network governance. It may be modest in scale, consisting only of a single individual, often referred to as the network facilitator or broker, or it may be a formal organization. This latter form may be used as a mechanism for dealing with unique and complex network-level problems and issues.

#### **4. Network governance and effectiveness**

The presumed performance benefits of networks have attracted attention of policy-makers, academics and practitioners. After a period of network euphoria, questions have arisen as whether and under what conditions are actually performing in such a way so that the costs of collaboration are justified. Many authors have taken for granted that benefits of networks are substantial. The study of whether and under what circumstances networks are actually effective has received much less attention. This issue is especially important when the network as a whole is the unit of analysis.

In many studies the concept of network performance is poorly specified. The key question is which criteria should be used when assessing the performance of the network. Although the criteria such as 'efficiency', 'effectiveness' or 'goal attainment' are mentioned most commonly one can also hear of other criteria, such as quality, productivity, survival, learning, and so on. Thus, it is impossible to have clear scientific directions regarding which criterion to use to assess either an organization or a network. One can identify two approaches to deal with this issue. The first approach is to try to argue that one criterion is superior to another. The second possibility is to take a multidimensional stance towards effectiveness, such as the balanced scorecard approach.

Kenis and Provan have identified three performance factors: (1) the form of the network, (2) whether network is mandatory or voluntary, and (3) the developmental stage of the network (Kenis, Provan 2009, p. 446).

The same authors claim that the successful adoption of a particular form of governance in a network may be attributed to four key structural and relational contingencies (Kenis, Provan 2008, p. 237):

- trust,
- size (number of participants),
- goal congruence,
- the nature of the task.

Trust appears to be a critical factor for network performance and sustainability. According to Provan and Kenis, it is the distribution of trust that is critical and whether or not it is reciprocated among network members (Kenis, Provan 2008, p. 238). One of the key issues is whether trust is widely distributed across members (i.e. a high density of trust relation) or is it only narrowly distributed, occurring only in dyads or small groups of network members. For the network to perform efficiently trust cannot be simply a collection of dyad-based relationships. This is particularly important for the shared governance. In the case of lead organization governance, the trust density may be lower because this type of governance is essentially built around a collection of dyadic ties.

#### **Number of network participants**

The key problem of governance of any network is that the needs and activities of numerous organizations must be coordinated. As the number of units in the networks increases, the number of potential relationships increase exponentially, which requires a very complex governance. In such a case the best solution appears to be centralization of governance activities around a broker organization, either a lead organization or an NAO. In these governance forms there is no requirement of direct involvement of all organizations to take decisions relevant for the network as a whole. By centralizing governance, participants no longer have to interact directly with each other, but they rather interact with the lead organization or NAO in order to coordinate network needs.

#### **Network goal consensus**

Organizations form collaborative relationships for many reasons that are related to specific goals of individual network participants. However, in the goal-directed networks also network-level goals influence the actions of organizations. Goal consensus has important consequences for network governance. Goal consensus is an advantage in building network-level commitment. However, networks can also be effective with moderate levels of goal consensus. The critical issue is how network relationships are governed. Lead organizations take most strategic and operational decisions and for this reason they are best suited to making decisions



about network-level goals, in particular when network members are less able to resolve conflict on their own.

### **Need for network-level competencies**

Organizations join or form networks for a number of reasons, including access to resources and markets, availability of new technology, addressing complex problems of cooperation and logistics. However, whatever the specific reasons, all organizations are seeking to achieve something that could not be achieved independently. In this context it is important to know how to achieve competencies required to achieve network-level competencies. Two issues need to be taken into consideration here: (1) what is the nature of the task performed by network members, (2) the external demands and needs faced by the network. From internal perspective, if the network's task requires a lot of interdependence among network members, then the governance needs to facilitate such type of activities. External tasks may include protecting the network from radical environmental changes such as new regulations, reduction of available financing or bridging, including lobbying, searching new members, acquiring financing. Lead organizations are better suited to address network-level demands and needs than are shared-governance arrangements.

### **Conclusions**

Governance is one of the key factors influencing the efficiency of organizations functioning in different types of networks. Despite the recognition of this phenomenon, there is no agreement as regards the paradigm explaining the forces behind the need and the benefits of governance. The importance of governance depends on the type of the network. It appears to be the strongest in lead organization-governed networks. The need for governance in a network may and its effectiveness depends on the following factors: trust, size of network, goal congruence among the network members, the nature of the task of the network.

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## **RELACJE NADZORU ORAZ ICH WPLYW NA EFEKTYWNOŚĆ ORGANIZACJI**

### **Streszczenie**

Istnienie więzi pomiędzy organizacjami gospodarczymi wspomaga procesy kreowania wartości poprzez łączenie zasobów, rozwój zasobów wiedzy i ułatwianie dostępu do rynków zagranicznych. W szczególności należy wyeksponować znaczenie relacji z perspektywy kreowania wiedzy i dzielenia się nią. Główne paradygmaty wykorzystywane do wyjaśniania przyczyn, dla których firmy wchodzą w zróżnicowane relacje, to: teoria kosztów transakcyjnych, teoria zależności od zasobów, teoria tworzenia wartości dla interesariuszy i teoria uczenia się organizacyjnego. Nadzór może być istotnym elementem determinującym sposób funkcjonowania związków międzyorganizacyjnych (sieci). Wpływ nadzoru zależy od rodzaju sieci. Skuteczna adaptacja określonej formy nadzoru zależy od następujących czynników: wzajemne zaufanie uczestników sieci,

kompatybilność realizowanych przez nich celów, wielkość sieci, rodzaj zadań realizowanych przez sieć.

**Słowa kluczowe:** organizacje, zarządzanie, relacje międzyorganizacyjne, sieci, efektywność.

*Tłumaczenie Włodzimierz Rudny*

