

Chapter 7

ORGANIZATIONAL DESIGN, LEARNING, AND THE MARKET VALUE OF THE FIRM

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Abstract: We compare market returns associated with firms' creation of new units focused on e-business. Two aspects of organization design - governance and leadership - are considered with regard to exploitation- and exploration-oriented organization learning. We find that exploitation in governance (high centralization) is associated with a lower mean and variance in returns; that exploitation in leadership (appointment of outsiders) is associated with the same mean yet higher variance; and, among units exhibiting both modes of learning, the variance of returns are *not* equal.

Key words: Organization design, organizational learning, exploration, exploitation, variance.

1. INTRODUCTION

Scholars of organization studies agree that organizational effectiveness depends in large measure on the demonstrated ability of the organization to maintain a balance between two distinct yet complementary modes of organizational learning known as exploration and exploitation (March, 1991, 1995; Levinthal and March, 1993; Sorenson & Sorensen, 2001; Sorensen, 2002; Hunter, 2003). The former is characterized by the experimentation with new ideas, paradigms, technologies, strategies, and knowledge. The latter is characterized by the elaboration, refinement, and improvement of existing capabilities and ideas. In organization design, these learning modes are reflected in the impact of firm choices such as delegation of authority,

leadership and governance, incentives, and internal processes on firm performance.

Organization structures may lead to one type of learning, such as decentralized, autonomous structures to encourage exploratory goals like innovation and new product development, and centralized structures to achieve efficiency and economies of scale (Burns and Stalker, 1961; Hedberg et al, 1976). Organization structures may also exhibit or seek to strike a “balance” between these two modes of learning, e.g. by combining firm-wide incentives that encourage broad search and exploration with an active hierarchy that provides stability or exploitation (Rivkin and Siggelkow, 2003) or via a switch between centralization and decentralization at various points in time (Siggelkow and Levinthal, 2003).

In franchise governance systems firms achieve the exploration/exploitation balance by maintaining a mixture of company-owned franchises that are more likely to focus on exploitation, and independent operator franchises that are more entrepreneurial (Sorenson and Sorensen, 2001). In firms within a single governance structure, Vera and Crossan (2004) argue that leaders must achieve the balance themselves by performing roles involving both “transactional” (the institutionalization, reinforcement, and refinement of existing routines) and “transformative” (changing the existing strategy and routines) behaviors.

Incentives also promote or are indicative of different types of learning. A balanced approach may be achieved by combining decentralized decision making with a strong identification with top management goals (Child, 1984; Nagar, 2002). Another approach is to rely on compensation schemes that reward company-wide performance (Harris and Raviv, 2002) over both the short and long-term.

Finally, other studies focus on the role of organizational processes and the two types of learning. Firms pursue control and reliability while simultaneously developing new, innovation-enhancing competencies (Sutcliffe et al, 2000). Firms employ design elements to balance the need to search broadly for new possibilities in its environment as well as to stabilize around a good set of opportunities once discovered (Rivkin and Siggelkow, 2003). Firms may adapt over time by changing processes by “opening up” (exploitation generating exploration) or “focusing” (exploration encouraging exploitation) (Holmquist, 2004).

Recent studies propose that successful organization designs achieve the required dual focus by some mixture of structures, processes, incentives, and leadership (e.g., Benner and Tushman, 2003). A structure that encourages exploration, for example, is mitigated by incentives that foster exploitation. This contrasts with older studies of organization design that imply that consistent or “pure” designs are optimal. While organization design scholars