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CO-EVOLUTION OF FIRMS AND THEIR BUSINESS ENVIRONMENTS: A REVIEW AND RESEARCH AGENDA

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Abstract
Firms, institutions, and markets do not evolve – they co-evolve, which means they reciprocally influence each other's evolution. Co-evolutionary theory in organizational analysis explicitly addresses this two-way interaction between firms and their environments, capturing both (firms') adaptation to, and influence on, the environment. The co-evolutionary process plays out differently in different settings; the notions of path-dependence, embeddedness, and complementarity are key to understanding these differences. In this paper, we review extant research on co-evolutionary theory, and its implications for management research. To that end, we conclude with potential research questions that can inform and advance the debate co-evolutionary theory.

Key Words: Co-Evolutionary Theory, Emerging Markets, Institutional Economics, Strategic Management.

Introduction

The 2008 mortgage crisis was emblematic of yet another model of development that failed its peoples, and its mercenaries (Whitley, 2009). But, even as the world was reeling under recessionary woes, there was an interesting development in the hinterlands of East. China and India not only remained largely unaffected by the recession, but also generated robust growth rates during the recession. These events – growth and resilience of alternate market models, against the backdrop of crumbling capitalist bastion– have made one thing amply clear: the U.S model was not the only plausible model to emulate. As Khanna succinctly puts it, "At some level there have always been opportunities to learn from other countries' experiences, but the sheer variety on offer today is perhaps a distinctive feature of the current few decades" (Khanna T. , 2009). The question that economists and management scholars are now asking is: how did these different models of capitalism *evolve* the way they did? Recent studies have shed light on this important question; Hall and Soskice (2001), for instance, make the distinction between Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs), and posit that differences in coordination mechanism in these economies lead to the differences in labor, product and capital markets. These differences, in turn, create distinct incentives structures for firms, to which firms respond by acquiring certain competencies to suit the institutional environment.

Though keenly debated, the basic framework forwarded by Hall and Soskice is generally accepted. However, using such a framework that alludes to firm-level adaptation alone, misses out entirely on a critical dimension of evolution: the impact of firms' actions on the environment. If the economic system is viewed as an ecosystem in which firms, institutions, and interest groups thrive, interact, and affect each other's development, then understanding the impact firms make on the environment is equally important as knowing how environment shapes firms. The question to be asked, therefore, is not how different models of business and its environment *evolve*, but how these different models *co-evolve.*

Theoretical Underpinnings of Co-evolutionary Theory

How do firms and their environments interact, and thereby, evolve over time? Co-evolutionary theory aims at answering this fundamental questionby explicitly addressing the two-way and long-term interaction patterns between firms and their environment, capturing both adaptation to, and more active influencing of, environment (Dieleman & Sachs, 2008). In doing so, researchers exploring co-evolution have used two dominant lenses to study the phenomenon – to assess the impact of the environment on the firm, researchers have used theories of institutional economics. On the other hand, to explicate on the impact of firm on the environment, strategic choice theory has been the preferred lens.

New Institutional Economics

New Institutional Economics (NIE) studies institutions, and their interaction with organizational arrangements. Institutions are the rules of the game in the society. They are the humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange, whether political, social or economic (North, 1990; Scott B., 2009). Institutions include both formal and informal rules such as written rules and agreements that govern contractual relations and corporate governance, constitutions, laws and rules that govern politics, government, finance, and society more broadly, and unwritten codes of conduct, norms of behavior, and beliefs (Elster, 1989;North, 1990). Organizational arrangements include different modes of governance that agents implement to support production and exchange. These institutions include markets, firms, and the various combinations of forms that economic actors develop to facilitate transactions. Organizational arrangements also include contractual agreements that provide a framework for organizing activities, as well as the behavioral traits that underlie the arrangements chosen (Menard & Shirley, 2005; Williamson, 1998).

NIE has turned two propositions: 1) institutions do matter, and 2) the determinants of institutions are susceptible to analysis by the tools of economic theory (Williamson, 2000). The second proposition, in particular, has been the underpinning factor for the acceptance of NIE as against the old Institutional Economics (Menard & Shirley, 2005).The main concept underlying NIE is transaction costs of exchange, which implies that unlike the neo-classical concept, markets are subject to friction. As Coase (1960) points out:

> In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.

Two analytical areas developed from Coase's conceptualization of transaction costs: the analysis of the 'institutional environment', expounded by Douglass North, and the analysis of 'institutional arrangements', or 'institutions of governance' expounded by Oliver Williamson. At a basic level, the backgrounds of both the approaches are similar. They rest on the fundamental understanding that economic activity takes place within a 'neo-institutional' system characterized by positive transaction costs, and bounded rationality (Furubotn & Richter, 2008). The institutional environment is defined jointly by the rules of the game (the formal constraints: constitutions, laws, and property rights) and the conditions of embeddedness (the informal constraints: sanctions, taboos, customs, traditions, and codes of conduct) (Granovetter, 1985). The institutions of governance are market, quasi-market, and hierarchical modes of contracting, more generally of managing transactions and seeing economic activity through to completion. The interaction between the institutional environment and governance mechanisms determines the economic efficiency of exchange and incentives for investments in durable assets, both physical and human (skills) (Menard & Shirley, 2005). Thus, according to the institutional view, the environment shapes the way firms evolve over time.

Strategic Choice Theory

Strategic choice theory (Child, 1972; 1997) argues that unlike the propositions set forth by institutional theory, organizations are not passive entities subject to the forces of isomorphism; instead, organizations have the ability, and a degree choice, to shape the environment in which they operate. Therefore, strategic choice is essentially a 'political process in which constraints and opportunities are functions of the power exercised by decision makers in the light of ideological values' (Child, 1972). Further, strategic responses depend upon three factors: agency of the managers, constraints laid down on the power of managers by the environment and the organizational value systems.

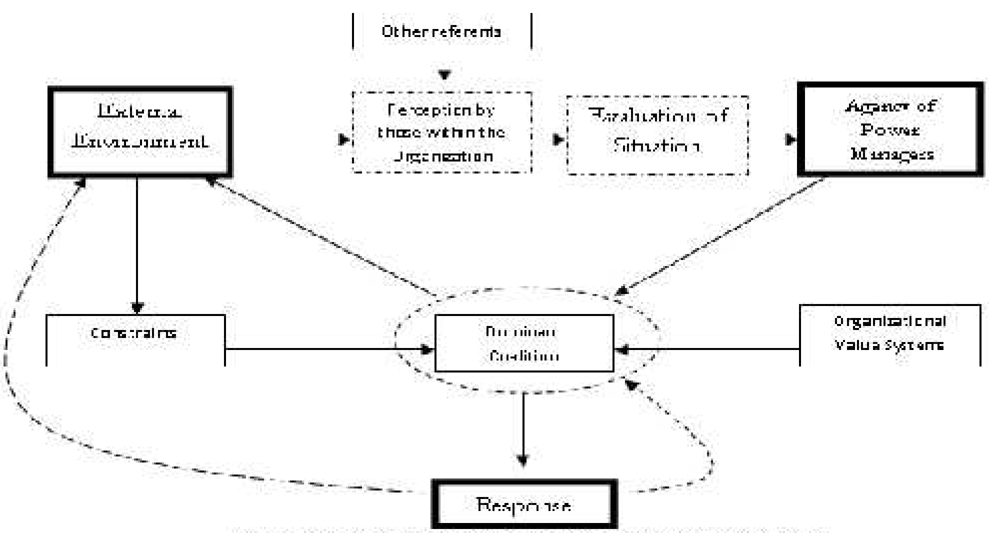

Figure 1: Political perspective to strategic choice (Child, 1972)

The dominant coalition may respond to environmental pressures in two ways: 1) they can respond to the institutional demands directly, and the response could be any one as noted by Oliver (1991). These responses, however, could affect the environment in ways which were not intended by the dominant coalition, and 2) the dominant coalition can decide to change the environment itself instead of changing the structure of the organization. The key implication of strategic choice theory is that 'management should take into account the multiple ways in which organizations interact with their environments through the process of mutual adaptation between the organization and its environmental domain' (Lewin & Volberda, 1999).

Co-Evolutionary Theory: Literature Review
There havebeen several studies that look at micro-level responses to institutional forces, attributing organizational action to a combination of environment and agency (See table 4.1 for details).

Study	Micro-Level Responses
Albert Hirschman(1970)	exit, voice, or loyalty
DiMaggioand Powell(1983)	isomorphism: coercive, mimetic and normative
Christine Oliver(1991)	acquiescence, compromise, avoidance, defiance, and manipulation
Thomas Lawrence(1999)	Membership and standardization strategies
Child and Tsai(2005)	passive, reactive,proactive
Michael Witt(2006)	acquiescence, abatement, diminution, exit
Khanna &Palepu(2007)	Replicate, adapt, compete, collaborate, accept, change market context, enter, exit, or wait
Kraatz&Block(2008)	eliminate, compartmentalize, balance, recreate new institutional order
Carney et.al(2009)	institutionalvoids,institutionallock-in, institutional escape

Table 1: Major Studies of Firm-Level Responses to Institutional Pressures

The metaphor of co-evolution, however, has been applied to the field of management only recently (Lewin & Volberda, 1999; Volberda & Lewin, 2003) though the notion has been used quite often in the past. The basic premise on which co-evolutionary theory rests is that neither institutional not strategic choice theories act in isolation. Firms and their environment are both part of a larger system (Scott, 2002) and influence each other's evolution. Consequently, co-evolutionary theory aims at combining both proactive and adaptive corporate strategies into an integrated framework. Although insights derived from co-evolutionary studies have deepened our understanding of the two-way interaction between firms and their environment, the number of empirical studies in this area remains modest. Moreover, much empirical work in the area of co-evolution has focused primarily on a competitive-market scenario, where evolutionary processes of selection and adaptation occur only under competitive conditions (see for example Meyer & Rowan, 1977;Scott R. W., 1983;Flier, Van Den Bosch, & Volberda, 2003; Lampel & Shamsie, 2003). But recent, albeit few, empirical studies over the past decade have attempted to study co- evolution in an emerging-economy context. These studies are critical to the development of a robust theory of co-evolution, which must take account of diverse firm-environment interactions, especially in contexts emerging in the ex-communist countries. Recent research on different models of capitalism (see for example Hall & Soskice, 2001;Crouch, 2005, Amable, 2003;Boyer, 2005; Redding & Witt, 2008) has demonstrated that co-evolutionary dynamics between firms and their environments often shape differently, owing to the diversity in history (North, 1990;Acemoglu & Robinson, 2012), embeddedness(Granovetter, 1985), and institutional complementarities (Aoki, 1994). These insights call for exclusive study of emerging markets, rather than extrapolating conclusions derived from studies conducted in developed economies.

On these lines, in their study of Asian Family Business Groups (FBGs), Carney and Gedajlovic(2002) explain how institutional environment and a specific organizational form (FBGs controlled by ethnic Chinese entrepreneurs) co-evolved in the South East Asian region. In building their framework, the authors have distinguished between exogenous and endogenous forces that shape the business environment; market forces and institutional pressures are treated as endogenous, while non-local social, economic, political and technological influences are treated as exogenous – 'forces that emanate from outside a business system, but which nevertheless impact in important ways upon firms and their environments'. Carney and Gedajlovic's key findings are that first, given path-dependence and lock-in, once businesses adapted to their environment, they influenced and recreated their institutional context. Hence, ASEAN's FBGs were both a product and a source of their institutional environments. Second, feedback from firms to the environment is both self-reinforcing and self-limiting, which means that a) what works in one condition may not work later, since strategies can change the very condition that engendered them, and b) practices developed in one context may be locked-in, while other capabilities are locked-out. This means that firms' ability to adapt to changing environments diminishes with time. On similar lines, Rodrigues and Child's (2003) study examined how firms and their respective contexts developed in a highly institutionalized environment. Their study of Telemig, a telecommunications company from Brazil, showed that 1) dynamics of new practice and adaptation that lead to new forms and changes in a competitive regime are different from those that take place in an institutionalized environment, and 2) managerial intentionality persists even in highly institutionalized environments, where membership in political networks increase firms' ability to exercise strategic choice. The key contribution of the researchers is the inclusion of a political dimension into the process of co-evolution. The framework that the authors develop from their study helps

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conceptualize co-evolution as a three-level process, elucidating the relationships between policies, form, process, and performance, across micro, meso and macro levels.

Exploring co-evolution in transition economies further, Suhomlinova's(2006) study deals with the process of co-evolution from a 'survival' perspective. The author argues that survival is the *raison d'être* for organizational change, and that survival depends upon its 'fit' with the environment. The notion of fit includes not only an economic but also a sociological dimension. In her study, Suhomlinova develops a model for understanding micro-meso level linkages comprising of four variables at the micro level (product strategy, distance to market, exchange strategy, and control), and three (variables competition, control structure and exchange structure) at the macro level. However, unlike previous studies of co-evolution [such as (Rodrigues & Child, 2003)]Suhomlinova has included the State at the meso level instead of relegating it to the macro level. The model is a significant contribution to the theory of co-evolution since this is the only model I have come across that clearly delineates micro and meso level variables.

Studies on co-evolution have often divided the research landscape between micro, meso and macro levels, and an implicit assumption is that the meso level acts as an intermediate change-affecting level between the firms and the State. Another important assumption that co-evolutionary studies make is that pressures on the environment arise from the aggregate actions of firms, since individual firms are too insignificant to make an impact on the meso or micro level. Consequently, co-evolutionary studies have focused on the collective impact that firms have on their environments. Carney et al. (2009), for instance, have extended the co-evolutionary theory to the Varieties of Capitalism (VoC) framework (Hall & Soskice, 2001) demonstrating how firms' collective actions feed back into the system to shape institutional development. The authors delineate three processes that are fundamental to the process of co-evolution: 1) filling institutional voids, 2) retarding institutional innovation, and 3) deploying institutional escape. Filling institutional voids is more of an adaptive strategy undertaken by firms to deal with the high levels of transaction costs in an economy emanating from missing market institutions. The concept of institutional voids, as used in recent literature, was first proposed by (Khanna & Palepu, 1997), and has been widely used as a theoretical lens for the study of strategy in emerging markets (Hoskisson, Eden, Lau, & Wright, 2000). Retarding institutional innovation has more to do with path-dependence and lock-in. As firms adapt to their contexts, certain capabilities get locked-in, while some are locked-out. As the context changes, firms try to maintain their fit, which in turn, retards institutional development. Hence, the hypothesis that as markets develop, inefficient forms of organizations will be weeded out by market forces (Khanna &Palepu, 1999) may not hold true, since firms may not let market development happen at all. The third process, deploying institutional escape, involves circumventing institutional arrangements either through membership in political networks, or through the development of complex organizational structures. Another way of institutional escape is through the development of hybridized firms, as evidenced from the Asian states, through 'the process of crafting new institutional solutions by recombining elements drawn from a repertoire whereby new forms differ but resemble old forms' (Carney, Gedajlovic, & Yang, 2009). But Dieleman and Sachs (2008) have challenged the assumption that only collective actions can affect the environment; in their analysis of the interactions between the Salim Group and the Indonesian government, the authors make three major contributions to the field of co-evolution: 1) they demonstrate how individual corporations can, and do, influence, shape, and modify institutional regimes 2) they document factors that affect the degree of strategic choice the corporations can exercise and 3) they observe that corporations and institutions may not always be mutually exclusive. Finally, one of the most important contribution to co-evolutionary theory is the relational framework developed by Child, Rodrigues, and Tse(2012). In this contribution, the authors assess the role of power as an evolutionary driver. The framework supporting their thesis elucidates the relationships between the organization and external parties. Using an event-history model, the authors list out the specific organizational and environmental responses and their impact on each other. The key contribution of this work are 1) power resources can be utilized to influence co-evolutionary processes, 2) but power alone cannot generate co-evolution; for power resources to work, there has to be an established relational framework and there have to specific proposals for change in both the firm and its environment.

Several gaps exist in the current body of research on co-evolutionary theory. First, the most common and glaring issue is the conception of co-evolution itself. Most scholars have treated co-evolution as a lens that integrates strategic choice and institutional theory. While this is one feature of co-evolutionary theory, it is not the only defining dimension of co-evolution; rather, any theory on co-evolution must move beyond the 'co-evolution of strategies' to include in its analyses the 'co-evolution of firms and environments'. While the latter is the stated purpose of co-evolutionary research, it has seldom received that kind of treatment it should, in terms of outlining explicitly the cause-effect relations between firms and environments[1]. Emblematic of such approach is the study undertaken by Rodrigues and Child (2003) in which the authors

[1] *Exception being the recent work of Child, Rodrigues, and Tse(2012)*

explore 'co-evolution' in an institutionalized environment. The study yields interesting insights into how firms can increase the level of strategic choice they can exercise in a highly regulated environment, but does not go on to explain how firm-level actions, in an institutionalized environment, trigger change in the environment and vice-versa. This point is similar to the one raised by Pache and Santos where they suggest probing further into two questions: how do organizational responses shape the structuration of fields, and how current organizational responses shape future responses (Pache & Santos, 2010).

Second issue relates to the means and nature of feedback, as explored in the literature on co-evolution. First, political ties are often cited as the most important means through which firms can affect the environment. This line of thought invariable points to a crony model of co-evolution. While political ties are indeed an important resource on which firms can leverage, they are not the only one through which firms can alter the context in which they operate. I believe that political ties continue to play a key role in the co-evolution process, but the importance of such networks is increasingly marginalized against a backdrop of growing market forces (Ghemawat & Khanna, 1998). This is especially true for a country like India where democratic pressures, and a free press can seriously undermine the legitimacy of both the government and corporations involved in such ties. Second, the nature of feedback, as discussed in the literature has highlighted the unintended outcomes of firm-environment interaction, magnifying the role of serendipity in the co-evolutionary process. Institutions and firms are part of a complex system, and changes in one institution often lead to unintended changes in others owing to the phenomenon of complementarity. Governance issues in East Asian economies are a case in point; weak financial institutions coupled with authoritarian regimes forced firms to develop relational governance models. But as markets develop, and as the governments try to bring in more efficiency in the capital markets, the same relational model of governance acts as an obstacle to transparency of information, thereby retarding development of financial institutions (Carney & Gedajlovic, 2002; 2009). But, if a theory of co-evolution has to find application in business practice, it must be able to delineate clearly how firms can knowingly alter the context in which they operate, and the nature of the linkages between firm and institutional actions at different levels of the system.

The third aspect missing in extant literature is the interactions between elements of the environment, or the organizational field. The economic side of institutional theory has explored this aspect of interactions, albeit within an institutional domain. Hall and Soskice (2001), for instance, have demonstrated how interactions between capital markets and labor markets affect the type of innovation that may take place in an economy. Research on VoC has shed light on such intra-institutional interactions, but economic forces act along with sociological and political forces, and hence, there is need to understand how each of these domains interact with each other. I believe that greater insight into the interactions between economic, political and sociological forces is key to the development of a robust co-evolutionary theory.

Future Research

I argue for adopting a qualitative approach with case study as the research method of choice for further investigating the topic of co-evolutionary theory because the nature of the problem demands the use of cases to build theory.A case study is an empirical inquiry that investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident(Yin, 2003). More importantly, however, qualitative and quantitative methods are not simply different ways of answering the same question. Rather, each has its own strength and limitation, and their suitability depends on the question under research. Several researchers (for example see Eisenhardt & Graebner, 2007;Maxwell, 2005, and Yin, 2003) have noted that case study research is particularly useful for phenomena-based research questions that explore 'how' and 'why'. According to Yin (2003) and Benbasatet. al. (1987), a case study research is particularly useful when:

a. The phenomenon under study is broad and complex.
b. It is of the type in which the theory and research are at their early, formative stages.
c. A holistic in-depth investigation is needed.
d. The phenomenon cannot be studied outside the context in which it occurs because there exist "sticky," practice-based problems where the experiences of the actors are important and the context of the action is critical.

Research on co-evolutionary theory 'fits' the criteria set forth for employing case studies. Co-evolutionary processes are essentially questions of how and why. Moreover, owing to the large number of entities involved, and the overwhelming relations between them, the phenomenon is complex, demanding in-depth investigation in real-life setting. The choice of case studies is also corroborated by extant literature. In their seminal work on co-evolution in organizational analysis, Lewin and Volberda(1999) advice researchers to conduct in-depth case studies for understanding the dynamics of co-evolution. Similarly, most empirical studies in this area have followed Lewin and Volberda's (1999) advice. As Dieleman and Sachs (2008) observe:

> In order to show corporate evolution in tandem with its context, an in-depth and long-term perspective is necessary. Further, studying non-linear dynamics in organizations usually calls for multiple levels of

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analysis. For these reasons most research using a coevolutionary framework utilizes an in-depth, longitudinal case study methodology.

Below is the list of recent empirical studies that directly explore the co-evolutionary process, albeit between diverse elements.

Study	Focus	Design
Child et.al (2012)	Role of power in co-evolutionary process	Single case, longitudinal study of Yantian International Container Terminals in China
Ahlstrom and Bruton (2010)	Co-evolution of institutions and entrepreneurial firms	Multiple cases; 10 start ups in Russia, studied over two time periods
Dieleman and Sachs (2008)	Co-evolutionary dynamics between a single firm and the environment in emerging economies	Single case, longitudinal study of the Salim Group in Indonesia
Funk (2008)	Co-evolution of technology, institutions, and industry structure	Single case of global telecomm industry
Pajunen and Maunula (2008)	Co-evolutionary perspective of internationalization process	Single case, longitudinal study of Orion Diagnostica in Finland
Madhok and Liu (2006)	Co-evolutionary dynamics in Multinational Firms	Multiple case studies of MNCs
Kim et. al (2004)	Evolution and restructuring of business groups	Two cases of Korean Chaebols
Rodrigues and Child (2003)	Co-evolution in an institutionalized environment	Single case, longitudinal study of the Telemig in Brazil
Flier, Bosch, and Volberda(2003)	Co-evolution in strategic renewal behavior	Multiple case studies of in Multiple settings
Lampel and Shamsie(2003)	Emergence of new organizational forms	Single case, longitudinal study of the Hollywood industry
Carney and Gedajlovic(2002)	Co-evolution of organizational strategies and institutional environment	Multiple case studies of Family Business Groups in East Asian economies
Huygens et.al (1998)	Co-evolution of firm capabilities and competition in an industry	Single case, longitudinal study of music industry Multiple cases; 6 companies from the British music industry

Table 2: List of Recent Empirical Studies on Co-Evolution and the Design Employed

Based on the above observations, we suggest the following research questions:

- Development, measurement and validity of a construct for co-evolution
- In what ways do environmental forces (economic, social, political, and institutional) exert pressure on firms?
- How do firms experience environmental pressure?
- How do firms react to environmental pressures?
- How does firms' response affect:
    a. Firms' future responses
    b. Firms' future strategies
    c. The way firms experience future pressures
    d. The development of the industry in which the firm operates
    e. Environmental forces
- How do co-evolutionary patters differ institutional environments?
- How can firms formulate strategies to actively manage environmental pressures and co-evolutionary behavior?

Conclusion

Over the past decade, co-evolutionary theory has provided several insights into organizational analysis (for recent advances see Stine , Gotsopoulos, & Suarez, 2015; Breslin, 2016). However, the theory has far greater potential to influence both management practice, and economic analysis. Explicit knowledge of co-evolutionary processes between firms, markets and institutions will yield deeper insights into what it takes to develop a robust market economy. At the micro level, the knowledge of 'how *do* firms co-evolve' is a precursor to the larger and pertinent question that mangers want to know 'how *can* firms co-evolve'. Answering these questions, however, is an uphill task, since co-evolutionary theory in organizational analysis is currently in its nascent stages. To fill this gap, and take the research agenda forward, the researcher has reviewed extant literature in the area and identified key gaps in literature. Specifically, the researcher has identified three core areas where further research can add value: developing a robust construct for the phenomenon of co-evolution, 2) understanding the nature and mechanism of feedback, and 3) developing insights into the nature of the interaction between environment and micro-level entities such as firms. Moreover, based on the review of existing studies, we suggest that initial phase of the research can adopt a qualitative methodology to develop theoretical foundations and propositions.

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