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# How leaders influence organizational effectiveness

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ABSTRACT

The flexible leadership theory explains how top executives and other leaders can influence the financial performance of a business organization. Three key determinants of financial performance are efficiency, adaptation, and human capital. A wide range of leadership behaviors, management programs, structural forms, and external initiatives can be used to influence these performance determinants. Management programs and systems are usually more effective when they are mutually compatible and appropriate for the situation. Effective performance requires a cooperative effort by the multiple leaders in an organization, and they must be flexible and adaptive as the situation changes. The theory provides a way to integrate findings from several different and largely separate literatures.



## 1. Introduction

Interest in strategic leadership has been increasing in recent years (Boal & Hooijberg, 2000; Canella & Monroe, 1997; Finkelstein & Hambrick, 1996; Hitt & Ireland, 2002; Zaccaro & Klimoski, 2001). One of the most important research questions is how top executives influence the financial performance and survival of an organization. Relevant research has been conducted by scholars in several distinct subfields, including leadership, strategic management, human resource management, and organizational change.

The core leadership literature provides only limited insights about strategic leadership. Most empirical studies on leadership effectiveness during the past half century involved middle or lower-level managers rather than top executives (Osborn, Hunt, & Jauch, 2002; Yukl, 2006). The key research question was to discover how an individual leader can influence followers to do more work or perform better than initially expected. During the past too much of the empirical research on leadership behavior was guided by theories of transformational and charismatic leadership (e.g., Bass, 1985; Conger & Kanungo, 1998; Shamir, House, & Arthur, 1993). Evidence from a large number of studies indicates that transformational leadership can enhance subordinate motivation and performance (see Lowe, Kroeck, & Sivasubramaniam, 1996). Nevertheless, these leadership theories are too narrowly focused to explain how top executives influence the financial performance of a large corporation (Klein, Dansereau, & Hall, 1994; Yukl, 1999). Most successful firms do not have a CEO who is considered charismatic, and a visionary CEO is no guarantee that a firm will avoid financial disaster (e.g., Bennis & Nanus, 1993; Collins, 2001; Finklestein, 2003; Hogan, Raskin, & Fazzini, 1990; O'Connor, Mumford, Clifton, Gessner, & Connelly, 1995; Sandowsky, 1995).

The literature on strategic management, strategic human resource management, and organizational change provides additional insights about the influence of top executives on firm performance. Succession studies find evidence that a CEO can have a moderate amount of influence on the financial performance of an organization (Giambatista, Rowe, & Riaz, 2005; Lord & Maher, 1991; Thomas, 1988). Studies of executive discretion identify situational constraints that limit CEO influence on firm performance (e.g., Burt, 1992; Hambrick & Finkelstein, 1987). Studies of strategic decisions provide additional insights about the influence of top executives on firm performance (e.g., Eisenhardt, 1989; Finkelstein & Hambrick, 1996; Mintzberg, Raisinghani, & Theoret, 1976). Studies of organizational change describe how top executives can implement new initiatives or major changes effectively (e.g., Beer

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& Nohria, 2000; Hambrick, Nadler, & Tushman, 1998; Kotter, 2002). Studies of strategic human resource management show that management programs and systems can be used to enhance human capital and firm performance (e.g., Hitt & Ireland, 2002; Huselid, Jackson, & Schuler, 1997; Wright & Snell, 1998). Each of these different perspectives on strategic leadership is narrowly focused, and only limited progress has been made in integrating them into a more comprehensive theoretical framework.

A theory of strategic leadership should explain how top executives influence the organizational processes that determine a firm's financial performance and long-term survival (Boal & Hooijberg, 2000; Finkelstein & Hambrick, 1996). The explanation should take into account the influence of top executives on strategic objectives, competitive strategy, the formal structure, management systems and programs, the corporate culture; and the members' skills and motivation. The theory should also include relevant aspects of the situation that influence the actions and decisions of top executives (Osborn et al., 2002). The theory should take into account how multiple leaders in an organization share power and interact to influence performance (Gronn, 2002; Pearce & Conger, 2003). Finally, the theory should help to bridge the gulf between the leadership and management literatures. The "flexible leadership theory" (FLT) was formulated in response to the need for a more comprehensive theory of strategic leadership that integrates relevant ideas from several distinct literatures.

The flexible leadership theory is conceptualized primarily at the organizational level, and it includes four sets of variables: (1) organizational effectiveness, (2) performance determinants, (3) situational variables, and (4) leadership decisions and actions. The effectiveness of an organization is defined as the extent to which it is able to survive, perform its mission, and maintain favorable earnings, financial resources, and asset value. Key indicators for business firms include long-term profit growth, return on investment, and stock returns. Effectiveness depends on three primary performance determinants: (1) efficiency and process reliability, (2) human capital, and (3) adaptation to the external environment. The performance determinants are influenced by the decisions and actions of a firm's leaders. The relative importance of the performance determinants, and how difficult it is to influence them, are affected by aspects of the situation such as the type of organization or industry, turbulence in the external environment (resource availability, intensity of competition, economic, political, or technological change), and constraints on executive action (involving oversight by owners or government agencies, or stemming from legal restrictions). The key propositions of FLT are presented in the following sections, along with examples of relevant theory and research that support the propositions.

## 2. Efficiency and innovative adaptation

The determinants of organizational performance have been studied for several decades and are a central topic in the literature on management and organization theory (e.g., Barnard, 1968; Katz & Kahn, 1978; Lawrence & Lorsch, 1969; Melcher, 1976; Mintzberg, 1979; Thompson, 1967). Insights about the determinants of organizational performance are also provided by the literature on corporate strategy (e.g., Barney, 1991; Peteraf, 1993; Porter, 1980; Teece, Pisano, & Shuen, 1997; Zajac, Kraatz, & Bresser, 1999) and by many practitioner-oriented books based on studies of effective firms (e.g., Collins, 2001; Collins & Porras, 1997; Joyce, Nohria, & Roberson, 2003; Kaplan & Norton, 1996; Yukl & Lepsinger, 2004). Taken together, these sources provide ample evidence that financial performance for business organizations depends jointly on the efficiency of internal processes and timely adaptation to external threats and opportunities.

**Proposition 1.** *Efficiency and innovative adaptations jointly determine the financial performance of a business organization.*

**Proposition 2.** *The relative importance of efficiency and innovative adaptations depends on the type of organization and aspects of the external environment.*

### *2.1. Efficiency*

Efficiency is the extent to which the organization minimizes the cost of people and resources needed to carry out essential operations. Business firms have many different types of costs, including employee compensation, expenses for materials, supplies, facilities, energy, inventories, shipping, marketing, and services provided by vendors, subcontractors, and consultants. Efficiency also depends on process reliability, which is the extent to which work processes are conducted without unnecessary delays, errors, or accidents. Key indicators of efficiency include the costs as a percentage of revenues, costs relative to those of competing companies, and employee productivity relative to labor costs. Case studies and survey research provide evidence that reducing unnecessary costs can improve a company's performance (e.g., Ebben & Johnson, 2005; Ghosn & Ries, 2005; Hammer & Champy, 1993; Key, Reed, & Sclar, 2005; Lieberman & Demester, 1999).

There are many ways to improve efficiency, and they include redesigning work processes, using new technology, reducing the cost of energy or materials, reducing excess inventory, and reducing the cost of labor or outsourcing jobs to low wage countries. Efficiency is facilitated by relevant cultural values, including the desirability of reliability, meeting deadlines, error-free performance, adherence to rules and procedures, controlling costs, and responsible use of resources (Miron, Erez, & Naveh, 2004). It is easier to improve efficiency when the organization's operations are relatively stable for a considerable period of time rather than constantly changing (Tushman & Romanelli, 1985). It is more difficult to improve efficiency if there are constraints on the reduction of costs (e.g., mandated quality standards and safety requirements, laws for minimum wages and benefits, requirements for guaranteed employment, shortages of necessary inputs such as materials or energy).

Efficiency is especially important when the competitive strategy of the organization is to offer its products and services at a lower price than competitors (Porter, 1980, 1996). This "cost leadership" strategy is most common for generic products and services