Kicking up Dust: Growth as an Irrational Market Response

Troy A. Voelker
University of Houston, Clear Lake • Houston, TX

Abstract

This paper introduces the concept of irrational growth, defined as a growth strategy that cannot (or will not) succeed in generating economic profits. Growth is a frequently utilized performance indicator, yet examining strategy research, the relationship between growth and economic profits is complex. A theoretical foundation based on institutional theory suggests that growth is adopted regardless of likelihood of positive economic outcomes. Propositions for testing an institutional bias towards growth are developed and research directions are suggested.

Introduction

Researchers recognize that firm performance is a complex multidimensional measure (Baum & Wally, 2003). In the process of understanding performance, researchers often use recognized performance indicators (Combs, Crook, & Shook, 2005; Farjoun, 2002; A. D. Meyer, 1991; Venkatraman & Ramanujam, 1986). Two frequently examined performance indicators include economic profitability and firm growth. While the pursuit of growth and profitability differ, an assumption of business literature states that growth ultimately, or perhaps eventually, creates profitability. For instance, in a prescriptive study examining competition in the new millennium, business practitioners are advised to grow to succeed in globally competitive markets (Ireland & Hitt, 2005). Without challenging the prescription of 'grow to succeed,' we know that growth sometimes leads to excess. We need look no further than recent activity in the housing and financial sectors to observe growth fueled exuberance leading to ruin. Such episodes appear rather predictably in our markets — the most recent bubble will not be the last just as it was not the first. Given this, why do we unequivocally treat growth as a positive measure of performance? Why do our sophisticated markets and talented business leaders create and recreate growth fueled bubbles which inevitably burst?

The question posed examines a potential paradox within extant business literature (Poole & Van de Ven, 1989). Knowing that some firms grow to excess, why do we explore growth as a positive performance indicator? Should we not rather ask which conditions enable growth to lead to success and under which might growth
lead to excess? While some exploration of a growth/performance paradox occurs in diversification and agency studies (Jo & Kim, 2008; O’Brien & David, 2010; Sun & Cahan, 2009); in general business research treats growth as a desirable, positive performance outcome. Indeed, sales growth or some other growth measure often appears side by side with economic profitability in examination of firm performance (Combs et al., 2005). We know that growth itself is multi-dimensional and that, within one dimension of growth (e.g. sales growth), different and contradictory relationships between growth and other organizational measures manifest depending on how (and for how long) growth is measured (Weinzimmer, Nystrom, & Freeman, 1998). Accepting that growth, profitability, market performance, and survival are all routinely deployed performance measures (Combs et al., 2005), one would expect a significant positive relationship to exist between growth and profit indicators. As shall be demonstrated in the following section though, the relationship between growth and profitability is, at best, complicated. If the relationship between growth and profitability is not clear cut, research could generate a substantial contribution by embracing the complexity and variety of firm performance indicators (Venkatraman & Ramanujam, 1986). Rather than simultaneously using growth and profitability as separate but desirable goals, research should examine the conditions through which growth leads to profitability (Combs et al., 2005; Weinzimmer et al., 1998).

It is incorrect to suggest that growth is an inappropriate performance measure. Indeed, a sound theoretical foundation in resource dependency (Pfeffer & Salancik, 2003) and industry impact (Dess, Ireland, & Hitt, 1990) each demonstrate distinct paths between growth and profitability. However, in addition to these paths, there likely exist a number of alternates by which the growth agenda never reaches profitability, or worse wherein the growth agenda precludes profitability. In the following sections, an argument will be advanced and developed that growth itself may at times represent an irrational environmental response. I argue that, our market emphasis on growth and even our own research use of growth as a positive performance metric may hinder our ability to diagnose healthy growth from unhealthy growth. Worse yet, it is likely that our market infatuation with growth obstructs routine attempts to separate healthy and unhealthy market growth. Specifically, the purpose of this paper is to identify the obfuscating mechanisms preventing practitioners and academics from diagnosing irrational growth. Using an institutional theory perspective (J. W. Meyer & Rowan, 1977), several such mechanisms shall be identified along with possible research directions. It is the intent and hope of the author that such a contribution might stimulate more frequent investigation into the relationship between two commonly used performance measures (Kimberly, 1976).
Growth and Profitability

Valid reasons for advocating firm’s pursuit of growth strategies abound in the literature, but a comprehensive review of rational growth strategies is beyond the scope of this paper. However, a brief review of rational growth strategies is useful in both demonstrating the value of growth and creating the foundation for an institutionalized growth agenda developed later. The first of the two growth paths consists of growth as a means to an end, via resource control. The second path examines growth as an indicator of relative performance. The third path explores the legitimizing value of sales growth for nascent firms.

Resources, Power, and Market Control

From a resource control standpoint, growth emerges as a critical means to a profitability ends objective. Essentially, growth in this format provides one of two different benefits. First, through growth firms may acquire enough power to exert influence over their markets (Pfeffer & Salancik, 2003). The second positive outcome from growth involves the ability to achieve economies of scale. These growth outcomes are not mutually exclusive and often operate concurrently.

The field of industrial organization (IO) economics has long suggested size and growth strategies generate positive profitability outcomes for firms. Significantly large firms are generally more powerful vis-à-vis smaller suppliers and purchasers and can thus exert greater influence over the five forces than can smaller competitors (Porter, 1979). Further, within a given industry firms of similar size and disposition which are able to successfully enact barriers enjoy super-normal profits while simultaneously barricading themselves from incursion of smaller competitors or outside entrants (Porter, 1980). Empirical evidence suggests that such strategies are effective, although such barriers may backfire and prevent the once dominant firm from moving to a better fitting position during periods of technology transition (Siggelkow, 2001).

While growth and market share are not identical, they are overlapping concepts (Venkatraman & Ramanujam, 1986). From the resource dependence perspective, firm growth is a means to an endgame objective of profitability via market dominance. Growth eventually leads to a size benefit (Derfus, Maggitti, Grimm, & Smith, 2008) which may entail economies of scale, a superior portfolio of resources, or power achieved via resource dominance. In all cases, the growth strategy is one to position the firm for superior performance in some latter stage.
Firm Growth Given Industry and Environmental Effects

Where growth is a means to achieving profitability under a resource control perspective, growth represents an important indicator of a firm’s relative performance given specific industry conditions. It is recognized that industry profitability and environmental conditions such as munificence play a major role in the growth and profitability of firms and researchers are strongly advised to control for such effects in their studies (Dess et al., 1990). As an example, high-growth industries experience greater divergence in firm-growth rates and firms who identify markets with fewer direct competitors are often able to grow faster than competitors in more saturated markets (Greve, 2008). Additionally, firms who traditionally grow faster than the industry average often retain their relative high-growth status (Hall & Tochterman, 2008). Taken together, the ratio of firm sales growth to industry sales growth likely provides a meaningful distinction between growth and value firms. Greve (2008) cautions though, that firms who are economically troubled often evidence rapid sales growth rates.

We can assume that a firm’s growth relative to its industry possibly reflects the firm’s advantageous positioning and strategic orientation towards growth. In this case, firm growth is a solid candidate for performance indicators in single-industry studies or when controlled or compared against industry and environmental conditions. These recent findings echo the position advanced by Dess, Ireland and Hitt (1990), yet many multi-industry studies continue to use firm growth as a stand-alone indicator (Combs et al., 2005).

Growth and Nascent Firms

A third path exists for which growth represents a commonly used performance metric. Specifically, in the evaluation of start-ups, the development of sales growth represents one performance indicator used by investors (Heirman & Clarysse, 2005). Start-up firms face a higher mortality rate than established firms, often lack financial performance metrics comparable to established firms, and generally require evaluation of potential rather than performance (Singh, Tucker, & House, 1986). For the start-up firm, presence of legitimizing factors help overcome the liability of newness (Certo, 2003). In this area of study revenue growth is treated as a sign of legitimacy alongside prestigious firm connections, mature board structures, and other characteristics more common of established firms (Certo, 2003; Heirman & Clarysse, 2005; Singh et al., 1986). That sales growth functions as a legitimizing factor suggests an institutionalization of growth, given ambiguity nascent firms evidencing growth conform to a market norm.
The Growth-Profitability Conundrum

In the preceding section, growth manifests as a means to future profitability and as a corresponding outcome given industry and environmental conditions. This was not an exhaustive listing of the reasons or paths linking growth and profitability. Instead, these positions illustrate that growth and profitability are rationally linked concepts within the literature. Recognizing that there exist numerous paths to rationally link growth and profitability, one might expect a clear positive relationship between growth and profitability in business research.

Unfortunately, a sampling of business research suggests that the relationship between growth and profitability is anything but clear-cut. Table 1 depicts the results of thirty-two studies which included measures for some aspect of size/growth and some aspect of profitability. In each case, the Pearson correlation between the growth or size measure and the profitability measure appears. The correlations range from slightly negative to moderately positive. In many of the studies, the correlation between growth and profitability is nearly zero.

One observation is that the approaches used to measure performance vary greatly. While many studies use standard financial ratios like return on assets for profit indicators, others use differing techniques. That such variance in measures exists is recognized in the strategy literature with prior studies examining various dimensions (Venkatraman & Ramanujam, 1986) and approaches to investigate (Farjoun, 2002) performance or effectiveness (Steers, 1975). Indeed, in a comprehensive review of performance measures, Combs and colleagues (2005) determine that growth is one of four distinct dimensions of organizational performance alongside profitability, market returns, and survival. To that end this paper continues the established tradition of strategic management introspection on our use, focus and application of certain firm measures (Dess et al., 1990).

Interestingly with the size/growth measures, one-year, three-year, five-year, and cross-sectional size measures manifest (although size typically functions as a control not a performance indicator). Thus, some of the complexity in resolving the growth-profitability conundrum involves determination of appropriate measurement metrics (see Weinzimmer et. al (1998) for a discussion of ramifications for varying measurements of growth dimensions). The use of size as a control raises an interesting and perplexing observation. Given that the relationship between size is inconsequential (Gerhart & Milkovich, 1990) and even negative (Balkin, Markman, & Gomez-Mejia, 2000), one wonders why an indicator of increasing size (growth) would be a valid and useful performance variable?
<table>
<thead>
<tr>
<th>Authors</th>
<th>Year</th>
<th>Journal</th>
<th>Sample</th>
<th>Growth Measure</th>
<th>Correlation</th>
<th>Performance Measure</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearce et al</td>
<td>1987</td>
<td>SMJ</td>
<td>42</td>
<td>Subjective</td>
<td>.54</td>
<td>ROA</td>
<td>Self Report</td>
</tr>
<tr>
<td>Slater and Olson</td>
<td>2000</td>
<td>SMJ</td>
<td>278</td>
<td>Self report</td>
<td>.49</td>
<td>Market</td>
<td>Self Report</td>
</tr>
<tr>
<td>Garg et al</td>
<td>2003</td>
<td>SMJ</td>
<td>105</td>
<td>Self report</td>
<td>.46</td>
<td>ROA</td>
<td>Self Report</td>
</tr>
<tr>
<td>Russo and Fouts</td>
<td>1997</td>
<td>AMJ</td>
<td>486</td>
<td>1-year sales</td>
<td>.45</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Sarkar et al</td>
<td>2001</td>
<td>SMJ</td>
<td>70</td>
<td>Self report</td>
<td>.43</td>
<td>ROA</td>
<td>Industry Centered</td>
</tr>
<tr>
<td>Lumpkin and Dess</td>
<td>1995</td>
<td>AMJ</td>
<td>32</td>
<td>Self report</td>
<td>.36</td>
<td>ROI</td>
<td></td>
</tr>
<tr>
<td>Cronin and Page</td>
<td>1988</td>
<td>EJOM</td>
<td>101</td>
<td>2-year sales index</td>
<td>.33</td>
<td>ROA</td>
<td>1-Industry</td>
</tr>
<tr>
<td>Crossland and Hambrick</td>
<td>2007</td>
<td>SMJ</td>
<td>1464</td>
<td>1-year sales growth</td>
<td>.30</td>
<td>ROA</td>
<td>U.S. Firms</td>
</tr>
<tr>
<td>Brown and Perry</td>
<td>1994</td>
<td>AMJ</td>
<td>234</td>
<td>3-year sales</td>
<td>.29</td>
<td>ROA</td>
<td>Fortunes “Most Admired”</td>
</tr>
<tr>
<td>Brush et al</td>
<td>2000</td>
<td>SMJ</td>
<td>3320</td>
<td>1-year growth</td>
<td>.25</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Balkin et al</td>
<td>2000</td>
<td>SMJ</td>
<td>74</td>
<td>1-year sales</td>
<td>.23</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Geringer et al</td>
<td>2000</td>
<td>SMJ</td>
<td>324</td>
<td>10-year</td>
<td>.22</td>
<td>ROA</td>
<td>Japan</td>
</tr>
<tr>
<td>Finkelstein and Boyd</td>
<td>1998</td>
<td>AMJ</td>
<td>600</td>
<td>5-year std sales</td>
<td>.2</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Crossland and Hambrick</td>
<td>2007</td>
<td>SMJ</td>
<td>1464</td>
<td>1-year sales growth</td>
<td>.19</td>
<td>ROA</td>
<td>German Firms</td>
</tr>
<tr>
<td>Crossland and Hambrick</td>
<td>2007</td>
<td>SMJ</td>
<td>1464</td>
<td>1-year sales growth</td>
<td>.18</td>
<td>ROA</td>
<td>Japanese Firms</td>
</tr>
<tr>
<td>Hambrick and Cannella</td>
<td>2004</td>
<td>SMJ</td>
<td>3168</td>
<td>1 year sales growth</td>
<td>.17</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Gedajlovic and Shapiro</td>
<td>2002</td>
<td>AMJ</td>
<td>334</td>
<td>5-year sales</td>
<td>.17</td>
<td>ROA</td>
<td>Japan</td>
</tr>
<tr>
<td>Derfus, Maggitti, Grimm and Smith</td>
<td>2008</td>
<td>AMJ</td>
<td>281</td>
<td>1-year sales</td>
<td>.15</td>
<td>ROA</td>
<td>11-industries</td>
</tr>
</tbody>
</table>
Table 1
Sample of Growth/Size vs. Profitability Measures cont’d.

<table>
<thead>
<tr>
<th>Authors</th>
<th>Year</th>
<th>Journal</th>
<th>Sample</th>
<th>Growth Measure</th>
<th>Correlation</th>
<th>Performance Measure</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baum and Walley</td>
<td>2003</td>
<td>SMJ</td>
<td>318</td>
<td>4-year growth</td>
<td>.13</td>
<td>ROA</td>
<td>Self Report</td>
</tr>
<tr>
<td>Rajagopalan and Datta</td>
<td>1996</td>
<td>AMJ</td>
<td>410</td>
<td>4-year sales</td>
<td>.13</td>
<td>Composite</td>
<td></td>
</tr>
<tr>
<td>Love and Nohria</td>
<td>2005</td>
<td>SMJ</td>
<td>100</td>
<td>1-year reduced slack</td>
<td>.1</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Peng</td>
<td>2004</td>
<td>SMJ</td>
<td>1211</td>
<td>1-year growth</td>
<td>.09</td>
<td>ROE</td>
<td>China</td>
</tr>
<tr>
<td>Jensen and Zajac</td>
<td>2004</td>
<td>SMJ</td>
<td>1329</td>
<td>Acquisition activity per year</td>
<td>.06</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Hambrick and Cannella</td>
<td>2004</td>
<td>SMJ</td>
<td>3168</td>
<td>1 year acquisition</td>
<td>.05</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Liao</td>
<td>2005</td>
<td>CompRev</td>
<td>107</td>
<td>Reduction of Force</td>
<td>.05</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Richard and Shelor</td>
<td>2002</td>
<td>IJoHRM</td>
<td>4774</td>
<td>1-year sales</td>
<td>-.01</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Gerhart and Milkovich</td>
<td>1990</td>
<td>AMJ</td>
<td>70,684</td>
<td>1 year sales</td>
<td>-.05</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Coombs and Gilley</td>
<td>2005</td>
<td>SMJ</td>
<td>406</td>
<td>1-year sales</td>
<td>-.06</td>
<td>ROA</td>
<td></td>
</tr>
<tr>
<td>Nixon et al</td>
<td>2004</td>
<td>SMJ</td>
<td>364</td>
<td>Sales per employee</td>
<td>-.06</td>
<td>Market</td>
<td></td>
</tr>
<tr>
<td>Durand and Vargas</td>
<td>2003</td>
<td>SMJ</td>
<td>162</td>
<td>2-year growth</td>
<td>-.09</td>
<td>Composite</td>
<td>DEA Efficiency</td>
</tr>
<tr>
<td>Nixon et al</td>
<td>2004</td>
<td>SMJ</td>
<td>364</td>
<td>Reduction of Force</td>
<td>-.1</td>
<td>Market</td>
<td></td>
</tr>
<tr>
<td>Robinson and McDougal</td>
<td>2001</td>
<td>SMJ</td>
<td>115</td>
<td>3-year average</td>
<td>-.13</td>
<td>ROS</td>
<td></td>
</tr>
<tr>
<td>Balkin et al</td>
<td>2000</td>
<td>AMJ</td>
<td>90</td>
<td>1-year sales</td>
<td>-.17</td>
<td>ROA</td>
<td></td>
</tr>
</tbody>
</table>
Additionally, there is a valid long-standing question as to what constitutes an appropriate measure of growth or size (Kimberly, 1976). The majority of the studies sampled appear to emphasize size as a function of sales, although some exceptions exist. Growth is often a focus on change in sales, although the relevant time dimension varies from 1-year to larger increments. What is important though is a consistent utilization of size (typically via sales) and growth (typically via change in sales) as a resource control proxy or performance indicator respectively. As strategists, we generally eschew use of raw financial numbers favoring ratios stated in reference to some other format. Yet in research practice most of the studies sampled utilize raw metrics — some exceptions clearly exist, Nixon et al. (2004) use a productivity measure of sales per employee rather than a static single indicator. The sample presented here produces remarkably similar findings to other more complex studies of growth measures (Weinzimmer et al., 1998). Studies continue to use one-year or raw metrics over more complex growth measures (e.g. Weinzimmer et al. 1998 recommend a growth slope measure), which is perplexing given evidence that different methods of measuring sales growth produce different and sometimes contradictory linkages to other commonly used organizational measures.

The emphasis on sales as an indicator of size or increased sales as an indicator of performance should be confusing. Using sales, is a firm with greater sales larger or more productive than their competition? The single indicator sales may not adequately answer that question without comparison of other relevant measures such as the firm’s assets or industry growth (Dess et al., 1990). Tackling sales growth as an indicator of performance is equally confusing. If a firm experiences sales growth, has it increased productivity of its assets or perhaps shifted its business model from a volume driven to margin driven model (or vice versa)? Does the resulting change imply improvements to the profitability of the firm or merely change the relative importance of margin/volume as ROA performance drivers — a function ascertained through Du Pont analysis (Burns, Sale, & Stephan, 2008). In practice we apply a number of ratios in examination of firms, as educators we mandate their use, as theorists we argue for complex and multidimensional investigation of performance (Dess et al., 1990; Venkatraman & Ramanujam, 1986), yet in research we often utilize raw figures of sales as proxies for size and performance. This is, in part, the critique offered by Combs et al. (2005) when they call for multiple measures for single constructs (such as growth), more complex mediating models examining antecedents of performance, along with a challenge researchers to “build a body of knowledge around each dimension,” (p. 281) of organizational performance. Given the heightened sophistication of statistical modeling techniques available today, is
our predilection towards raw numbers for sales and sales growth an indicator of an institutional bias towards sales growth?

Changing focus towards the correlations evidenced in the research, there are several patterns. First, several of the strongest positive correlations between growth and profitability occur in studies using one or more self-reported measures. This suggests that senior executives believe a relationship exists between growth and profitability, a point which I address later in this paper. When asked to evaluate their growth or profitability, executives consistently link these concepts together in their survey responses. The implication here is that an implicit theory of the growth/profitability linkage exists in corporate management. That this belief is both widely held is evidenced by the self-reporting studies, but not clearly linked in archival studies of accounting or market performance, offers strong evidence of an institutionalized growth agenda in management. I return to this argument in this paper’s first two propositions.

Second, the next group of strongest positive correlations appear in samples which restricted access along some specific parameter such as appearance on a most admired company list (Brown & Perry, 1994), restriction to a single industry (Cronin & Page, 1988), or restriction to Japanese firms (Gedajlovic & Shapiro, 2002; Geringer, Tallman, & Olsen, 2000). Third, the wildest fluctuation in correlations appear in studies using a one-year growth measure, in these studies the correlation ranges from quite positive (Russo & Fouts, 1997) to moderately negative (Balkin et al., 2000).

Perhaps the most intriguing observation to emerge from this sample of studies is something which does not appear in Table 1. While all of the studies used some measure of sales, growth, or size alongside economic performance only two of the listed studies theorized on the relationship between the two, and one only in passing. Baum and Walley (2003) initially intended to use a single construct of ‘firm performance’ which would have consisted of financial reporting measures for sales growth and economic profits. In their description of their dependent variables, they note that the factor analysis for the intended scale failed to solidify to a single dimension. This resulted in the decision to use separate dependent variable measures for growth and profitability.

In the other situation, the relationship between growth and profitability was the specific motivation for the study (Brush, Bromiley, & Hendrickx, 2000). Taking an agency theory perspective, Brush et al. theorized that slack resources might explain the difference between rational (i.e. profitable) growth and growth without profit (or worse, growth resulting in economic losses). Brush et al demonstrated that
when growth occurred without free cash flow, profitability ensued. For firms with free cash flow, growth resulted in little more than ‘kicking up dust.’ That is, growth for firms with free cash flow seemingly consists of managerial action to justify use of the slack resources even though the actions themselves are valueless (or worse erode value) for shareholders. In the latter case, the growing firms wound up worse off than their pre-growth condition. These findings provide evidence for the existence of irrational growth, providing suboptimal economic benefits to the shareholders.

The simple table of studies presented here mirrors the results of a more complex meta-analysis on organizational growth developed by Combs et al. (2005). They find a significant, albeit modest, positive correlation between sales growth and accounting measures of profitability. They also note a stronger significant, positive correlation between sales growth and subjective measures of firm performance. Additionally, they find a similarly strong positive correlation between subjective measures of firm performance and accounting based profitability measures. Combs and colleagues (2005) conclude that sales growth and accounting profitability each distinctly signal positive performance to heads of firms. The table presented in this study then, echoes their more deliberate investigation of performance measurement — growth in sales “feels” like positive performance to practicing managers. However, given the far weaker (albeit positive) relationship between sales growth and accounting profitability, there is clearly non-overlapping domain space wherein sales growth diverges from profitability. Combs and colleagues (2005) challenge researchers to examine the boundaries of performance measures, in this study an institutional framework is offered as an explanation of why those boundaries (for sales growth) have yet to be explored.

Irrational growth is an understudied phenomenon in the literature. The remainder of this paper examines the institutionalized positive disposition towards growth, provides a discussion of some of the possible causal agents for irrational growth, and includes a series of propositions for studying institutional biases towards irrational growth. Growth strategies should not be abandoned, but study of both rational and irrational growth is needed. The institutionalization of growth obfuscates examination and identification of the pathways towards irrational growth. Exploration of the manifestations of an institutionalized growth agenda should produce a more comprehensive series of prescriptions from the strategy and organizational theory literature.
The Institutionalization of Growth

One of the primary reasons for the existence of the firm is to create wealth for the ownership of the firm. This position is most strongly advocated amongst shareholder theorists (Aupperle, Carroll, & Hatfield, 1985) who, taken to an extreme, argue that creation of shareholder wealth is the sine qua non of the firm (Friedman, 1970). An alternate explanation is offered by stakeholder theorists (Prahalad & Hamel, 1994) who argue that the firm exists to balance the needs of myriad diverse stakeholders, of whom the shareholder represents only one interested party. While these positions are often argued in opposition, evidence suggests that a successful stakeholder focused strategy generates economic profits, thereby satisfying both shareholder and stakeholder theorists (Waddock & Graves, 1997). Under each theory, the firm is accepted as profit seeking. While differing from classical economic expectations of profit maximization Nelson and Winter (1982) argue that, under conditions of uncertainty and bounded rationality in evolutionary economic systems, profit seeking represents the ultimate objective of the firm.

It is from this position that the boundaries for rational and irrational growth emerge. The easier of the two to define, rational growth exists when the growth agenda of the firm successfully leads to the generation of long-term profits. Irrational growth, by contrast, involves situations where the growth agenda either will not, or cannot, result in the generation of profits. At the risk of diverting the reader into theories of fraud and malfeasance, Enron reported substantial revenue growth for consecutive years up to its eventual bankruptcy.

Fraudulent reporting of growth is an overly simplistic example of irrational sales growth. It bears mention because of the reason the fraudulent depictions of sales growth continued for years at Enron. Within our market system, growth is a sign of organizational health or a return to organizational health. Such extreme deception as that exposed for Enron and similar organizations provides some indication of just how deeply our institutions trust growth as a performance indicator.

Indeed a significant negative correlation exists between firm sales growth and return on assets for firms issuing restatements of their financial data (Arthaud-Day, Certo, Dalton, & Dalton, 2006). While Arthaud-Day and colleagues (2006) specifically focus on years prior to the Enron scandal, their study evidences a linkage between sales-growth projections and problematic firms. A similar finding in Greve (2008) notes that high sales growth is a characteristic of economically troubled firms. When firms face economic troubles, they appear to emphasize sales growth which may simply grow — but not fix — their problems.
Beyond the obvious cases of irrational growth via fraudulent reporting, there also likely exist a number of firms engaged in growth patterns for which profit is simply unreasonable. It is not the intent of this author to opine on exactly where the boundaries between rational and irrational growth specifically lie. Rather, it is the intent to argue that such a line exists and that existing theory may help uncover both the general locations for such boundaries as well as the institutionalized sources leading to selection of irrational growth strategies.

**Institutional Theory**

Institutional theory examines how society imbuces meanings upon the structures and processes of an enacted social environment beyond their objective functions. Institutionalization, alternately, represents the process by which individual actors come to accept shared meanings of society (Scott, 1987). Growth, via socioeconomic expansion, has been an institutionalized social objective emerging as a response to changing cultural values following World War II (Schofer & Meyer, 2005). Schofer and Meyer (2005) observe that these changes included increased educational system utilization, increased prominence of scientific institutions, increased democratization, and increased world polity. Growth objectives have been explained as a function of the agency-owner interaction designed to avoid the trap of low firm performance (M. W. Meyer & Zucker, 1989). If growth has been institutionalized, institutional theory posits that growth will become part of the rationalized society and organizations which enact policies and procedures aligned with these institutionalized values will be rewarded and legitimized (J. W. Meyer & Rowan, 1977).

For much of its history, institutional theory has focused on the emergence and use of structures within a society (Tolbert & Zucker, 1996), however its original conception also incorporated the institutionalization of processes (J. W. Meyer & Rowan, 1977). From an institutionalized perspective the processes, procedures, and strategies considered appropriate become institutionalized and firms which conform to these prescriptions are generally recognized as more legitimate than non-conformers (Deephouse, 1996). Effectiveness is a necessary, but not sufficient prerequisite for institutionalization. Indeed, for rationalization to occur it only requires that effectiveness can be demonstrated in some discreet set of circumstances (Tolbert & Zucker, 1996).

Growth is not inherently irrational, but some firms pursue growth for irrational reasons. Indeed, there are certainly examples which link growth and profitability and the preceding sections of this paper advance theory-driven explanations of a
positive relationship between growth and profitability. This meets a precondition for the institutionalization of growth; growth is rational, viable, and desirable in certain circumstances. Institutional theory explains why rational, effective growth once institutionalized leads to the adoption of growth strategies for irrational reasons.

A number of explanations describe why firms comply with institutionalized expectations. Recognizing that ideas gain legitimacy because they are perceived to be effective (J. W. Meyer & Rowan, 1977) and demonstrate effectiveness in some settings (Tolbert & Zucker, 1996), organizations are legitimized for conforming to institutionalized behaviors. From a growth perspective, this is to say that firms evidencing growth will be viewed as valued, proper, and behaving in a rational manner (J. W. Meyer & Rowan, 1977). This suggests, in part, that firms might enact an irrational growth strategy simply because growth is recognized as rational and, therefore, the firm and its managers are rewarded for pursuing a valued behavior (Scott, 1987). Alternately, uncertainty influences the salience of institutionalized behaviors. DiMaggio and Powell (1983) observe that “when goals are ambiguous, or when environment creates symbolic uncertainty, organizations may model themselves on other organizations” (pg. 151). Certainly, in complex, dynamic business environments goals and outcomes become abstract and uncertain. In such settings the economizing firm might simply choose to imitate strategies of fellow companies rather than investigate alternative options (Nelson & Winter, 1982; Tolbert & Zucker, 1996).

While institutionalization suggests that coercive (pressure by legitimizing institutions), mimetic (voluntary adoptions of perceived effective practices), and normative (professionalization) isomorphic processes influence homogeneity (Scott, 1987), this does not suggest that conformity itself is rational from an efficiency standpoint. Because of bounded rationality (March & Simon, 1958; Roberts & Greenwood, 1997), firms are at best efficiency seeking as opposed to efficiency maximizing (Nelson & Winter, 1982; Roberts & Greenwood, 1997). The strategies which are rationally efficient for some firms may not be rational for all firms; nonetheless legitimacy ensures adoption (Tolbert & Zucker, 1996). Because isomorphic firms are legitimized and rewarded by the environment (Deephouse, 1996), firm survival itself relies on factors other than efficient coordination and control of resources (J. W. Meyer & Rowan, 1977).

This view differs substantially from traditional theories of competition which suggest that market forces weed out inferior competitors (Barney & Hesterly, 1996). Under an institutional perspective, isomorphic firms may survive despite inferior economic performance, resulting in permanently failing firms (M. W. Meyer & Zucker,
1989). Undermining confidence in the market as an efficient corrective mechanism, it is suggested that markets are only effective at selection during the earliest years of an industry (DiMaggio & Powell, 1983). In later stages, social connections to influential parties and other factors enable otherwise ineffective firms to persist. In such cases, the market may not correct inefficiency for prolonged periods of time.

The preceding paragraphs advance institutional theory as an explanation for the blanket acceptance of sales growth as a valid indicator of performance. The argument also demonstrates that economically rational efficiency is not a prerequisite for legitimacy under an institutional framework. Having established this, I turn to more detailed examination of the processes and mechanisms through which an institutionalized growth agenda manifests and reifies business practice. This examination focuses on ramifications for managers, markets, and academics with appropriate propositions emerging for each.

**Managerial Outcomes**

As previously indicated, some studies have investigated growth strategies as an irrational outcome. Particularly Brush et al (2000) use an agency theory perspective arguing that conflict between the goals of the agent and goals of the owner lead to selection of irrational growth strategies. The agency perspective appears as a routine explanation in studies conducted by finance and accounting scholars (Jo & Kim, 2008; O’Brien & David, 2010; Sun & Cahan, 2009). While recognizing that agency explanations offer important insight into managerial behavior, it is also quite possible that managers acting in ambiguous situations make decisions apparently rational because of mimetic isomorphism.

In this paper, the institutional perspective emerges as an alternative, or perhaps parallel, explanation. Under an institutional perspective, managers may elect growth for efficient reasons. However, irrational growth, under an institutional perspective may be chosen for legitimacy, normative pressure, or reward reasons (Corcoran & Shackman, 2007; Heugens & Lander, 2009). In essence, under the institutional perspective, the agent-manager may elect irrational growth because it is perceived as the correct course of action and not necessarily to maximize agent benefits at owner costs (Brush et al., 2000). Two institutional arguments for managerial actions are advanced, both of which stem from the assumption that managers perceive an expectation to generate economic profits.

First, the manager perceives an expectation to generate economic profits but is uncertain of exactly how to achieve this outcome. Lacking certainty in attain-
ing the objective and facing increasingly complex competitive environments replete with heightened ambiguity and dynamism, managers face extreme difficulty in linking potential strategies to economically profitable outcomes. Particularly when the managed firm may not conform to the profitability-norm, the uncertain manager often relies on common industry recipes (McDonald & Westphal, 2003).

One such recipe is the growth strategy. Through growth the firm signals its intention for profitability since there are examples of firms (J. W. Meyer & Rowan, 1977) where rational growth generates profitability. Because the institutional environment (in this case the business segment) perceives the growth signal as an intent to comply with the profitability norm, the institutional environment rewards isomorphism signaling behavior even where rational profit efficiency fails to manifest. Under this assumption, the manager complies with the isomorphic growth agenda because the reward system signals the manager that the growth agenda is sanctioned and considered proper and adequate (J. W. Meyer & Rowan, 1977). This suggests that:

Proposition 1: Managers conforming to the isomorphic growth agenda will be compensated commensurably regardless of degree of economic profitability

While the afore-mentioned situation applies to managers of firms below industry-leading profitability standards, a more profound situation confronts managers of unprofitable firms. In this second case, rather than facing difference by degree of isomorphism, the manager faces complete non-compliance with the profit-norm. This sends signals to the business sector and owners of the deviancy of the manager from the role specific expectations which results in general downgrading of perception of the manager and firm (Deethouse, 1996).

Faced with the inconsistency of their performance vis-à-vis institutional expectations, the manager must confront and address this dissonance. In this case, the manager is likely to indicate their intent to conform to the institutional expectation via reform (J. W. Meyer & Rowan, 1977). As the firm is already out of compliance with the profit-norm and lacking certainty of outcomes from selected strategies, the agent-manager is likely to signal their intent for compliance via isomorphism with institutionally recognized prescriptions, in this case the growth agenda. One of the common ways an actor conveys intent to reform is through rhetoric (Sillince, 2005). In this case, one might expect public statements and documents to contain rhetoric which signals intent to comply with the growth agenda. Common forums for such signaling activity include letters to shareholders, press releases, and interviews with
news media. Both the frequency and language utilized in such activities will signal intent for future isomorphism. Therefore:

Proposition 2: Managers of unprofitable firms will utilize reform rhetoric replete with isomorphic growth language more frequently than will managers of rationally efficient firms.

**Market Outcomes**

In this section, attention turns towards the market as an enforcement mechanism. A fundamental assumption of classical economics is that markets are at least semi-strong efficient (Barney & Hesterly, 1996), that is to say that markets do a relatively effective job at discriminating between effectiveness and ineffectiveness. Institutional theorists question this assumption, noting that an aggregation of boundedly rational, satisficing individuals is unlikely to add up to a rational effective market (DiMaggio & Powell, 1983). Rather, markets reward isomorphic tendencies which may, or may not, reflect efficiency. The firm is thus rewarded for social compliance as much as for efficient and effective means of production (J. W. Meyer & Rowan, 1977).

Several institutional theorists directly address issues of market effectiveness in the face of institutional pressures. DiMaggio and Powell (1983) argue that the selection processes in markets work best in nascent markets or during the earliest years of a market's existence. Meyer and Rowan (1977) argue that markets are normally efficient where output is easily measurable and they theorize that all organizations exist on a continuum anchored by measurability and ambiguity of performance outcomes. However, they caution "it is important not to assume that an organization's location on this continuum is based on the inherent technical properties of its output" (pg. 354). The position asserts that complexity, dynamism, and ambiguity may cause even a relatively 'objective' measure such as sales and profitability to become complex and difficult enough to require trust and confidence in the adherence to institutionally prescribed roles and behaviors. Because of this, markets themselves may become ineffective in weeding out inefficient firms.

Additional evidence suggests that markets are, at best, weak mechanisms for controlling inefficiency. Specifically, the era of corporate conglomerates in the United States represents a prolonged model of corporate inefficiency which required decades to correct (Davis, Diekmann, & Tinsley, 1994). For a number of years following World War II, U.S. firms engaged in a pattern of unrelated acquisition leading to highly diversified conglomerates. This strategic approach was embraced at
virtually all levels of business with a number of prominent models for managing the firm-as-portfolio developed (Hofer & Schendel, 1979). Davies et al. (1994) note that by 1980 only 25% of all Fortune 500 firms operated in a single SIC industry while over 50% operated in three or more. This trend in unrelated diversification continued unabated in the face of mounting evidence that such practices generated sub-optimal economic profits (Amihud & Lev, 1981; Bettis, 1981; Rumelt, 1982).

A unique industry emerged in the late 80’s which specialized in buying, splitting, and selling off diversified firms (Davis et al., 1994). Even as this correction began, corporations continued unrelated diversification strategies (Davis et al., 1994) and institutions continued to argue the legitimacy of conglomeration in some form or fashion (Hill, Hitt, & Hoskisson, 1992; Prahalad & Bettis, 1986; Ramanujam & Varadarajan, 1989). Ultimately by 1990, most of the conglomerate mania had subsided and the majority of Fortune 500 firms operated in one or two SIC codes (Davis et al., 1994). This episode of irrational growth persisted for well over 30-years, providing an example of market inability to control irrational, institutionalized practices.

While the current market has learned the lessons of conglomerate growth, markets, regulating agencies and public perception still reward isomorphism (Deephouse, 1996). These rewards include legitimacy which can lead to increased access to and reduced costs for resources (J. W. Meyer & Rowan, 1977). As was argued with managers, markets are ill equipped to determine ex ante which strategies and firms will prosper. Thus, markets will reward institutionally compliant strategies and signaling activities. These rewards persist regardless of whether economic profits emerge as the outcome of institutionally prescribed strategies. This argument is consistent with the position of Hall and Tochterman (2008) who argue that investors are likely to overstate future values for growth firms, thus leading to inappropriate market pricing. To the extent that growth strategies are an isomorphic legitimate activity markets will consider growing firms as signaling compliance with profit-norms whether or not those firms actually generate requisite profits. Thus, I expect:

Proposition 3: Firms whose growth patterns fail to achieve profitability standards will receive similar market rewards as firms whose growth patterns lead to profitability.

Proposition 4: Market analysts will classify less profitable firms similarly to profitable firms to the extent that each firm manifests similar growth rates.
Academic Outcomes

Institutional theorists argue that education and academia play an important role in the maintenance and propagation of institutional prescriptions. The education system performs an important role in the sedimentation of prescriptions. Educational systems provide crucial means by which institutional prescriptions are treated as a given by institutional newcomers (Tolbert & Zucker, 1996). As emerging best practices move to trends through mimetic isomorphism (DiMaggio & Powell, 1983), professional and educational organizations incorporate these practices into the curricula taught to entering members. In this manner, these prescriptions become legitimized through the adoption of the education system (J. W. Meyer & Rowan, 1977). The educational process produces people who tend to view the same things the same way (DiMaggio & Powell, 1983). DiMaggio and Powell (1983) further note Perrow’s commentary that educational systems produce a pool of interchangeable people. This is consistent with observation that the old world order has been replaced with a new educated elite order replete with common knowledge derived from common institutional backgrounds (Schofer & Meyer, 2005).

Defending the argument that the institutionalization of growth manifests in business education requires evidence supporting the positive evaluation of growth by academics. While a comprehensive examination of growth as an institutionalized academic force is beyond the scope of this paper, a perusal of research suggests that such evidence exists. Schofer and Meyer (2005) argue that a socioeconomic growth agenda forms the foundation of post World War II institutional change. Growth strategies receive significant coverage in textbooks, possibly more so than operational strategies. A growth orientation is demanded for competing in the emerging global economy (Ireland & Hitt, 2005). Firms that successfully become market leaders may achieve the distinction of also becoming celebrity firms (Rindova, Pollock, & Hayward, 2006). Mishina, Pollock and Porac (2004) argue that growth is “a performance variable worth considering” (p. 1179). Firms following an internal or external grand strategy for growth are perceived as better performing than firms following a retrenchment or stability strategy (Pearce, Robbins, & Robinson, 1987). Growth to achieve increased market share is thought to reduce overall risk to the firm (Woo, 1987). Growth is considered as a valid strategy to stave off acquisition (Hanson, 1992).

The literature treats growth positively, yet not without caveats. Ireland and Hitt (2005) note the importance of alignment of resources and compatibilities in
fulfilling the growth objective. Market share turns out to not reduce risk in all categories as originally theorized (Woo, 1987) and the stability strategy, while lower in performance, did not differ significantly in self reported performance evaluation (Pearce et al., 1987). Academics are often among the first to observe the irrational trends in business as noted in the conglomerate episode (Amihud & Lev, 1981; Bettis, 1981; Rumelt, 1982). Thus, the key to the institutional function of growth isn’t the universal recommendation of growth, but rather the overall positive glow attached to growth. Because growth receives an overwhelmingly positive treatment within education systems, emerging practitioners confronted with ambiguous and uncertain environments are likely to consistently utilize strategies and prescriptions which they have been taught are effective (if only in some circumstances).

DiMaggio and Powell (1983) assert that individuals educated in the same institutional system are likely to perceive things the same way. Financial elites, matriculating from a system which emphasizes portfolio theory, are more likely to pursue unrelated diversification strategies (Jensen & Zajac, 2004). CEO’s are likely to mirror the strategies of peers during periods of below-par returns (McDonald & Westphal, 2003). American educated managers are likely to prefer the same generic strategies and their selection heuristic differs notably from Japanese educated counterparts (Song, Calantone, & Di Benedetto, 2002). MBA educated cohorts and business educated elites are more likely to center on contingency-fit criteria than are non-business educated elites or non business educated graduate students (Priem & Rosenstein, 2000). Each of these studies provides some indication that the prevailing logic of institutional prescriptions taught in business academics influence the choices of tools and strategies employed by business elites. To the extent that growth is one of the prescriptions receiving positive regard in business curricula, we should expect that business educated individuals will prefer the growth agenda relative to other options.

Proposition 5: Business educated students will typically regard the growth strategy as more preferable to other strategies

Proposition 6: Business educated students will typically regard growing firms more positively than firms using retrenchment or stability strategies.
Research Directions

The preceding sections advance an argument for the existence of irrational growth strategies. This paper offers institutional theory as the explanation for the election of irrational growth strategies and the theory also explains why firms may perceive growth as rational and effective regardless of outcome. Therefore, a research agenda should explore business and academic manifestations of institutionalized growth.

The first four propositions argue for the existence of an institutionalized growth prescription within the business sector. Archival research opportunities abound for investigation of these propositions. Proposition 1 (involving managerial compensation) and Proposition 3 (involving market valuation) are each testable using publicly available financial data. Support for each of these propositions requires evidence that firms and managers enacting growth strategies fare as well with respective indicators regardless of profitability outcomes. Partial support exists if firms, and managers of firms, matching the growth norm but lacking in the profitability norm exceed indicators for firms who match the profitability norm but lack in the isomorphism to the growth norm.

Proposition 2 (executive rhetoric) and Proposition 4 (analyst and media evaluations) are each testable using content analysis techniques for published documents and transcripts. Letters to shareholders, media interviews, changes in analyst recommendations, and media portrayal of firms and managers of firms each offer insight into the way the manager interacts with the public as well as the way the business sector as a whole regards the firm and firm managers. Broad support for these propositions will include evidence indicating that poor performing managers more prominently signal growth strategies. Additionally evidence of strong support exists if analysts and the media react more positively to growth rhetoric and signaling than to other strategic options regardless of firm profitability. Partial support suggests that managers of poor performing firms invoke growth rhetoric at least as often as other reform strategies or if analysts and the media evaluate high growth but low profitability firms more preferably than low growth and high profitability firms.

The second suggested research direction emerging from this paper is an examination of the institutionalization of growth within education, particularly business education. Proposition 5 (preferred strategy) and Proposition 6 (organizational evaluation) each suggest that business educated students will more frequently endorse growth orientation. Both of these propositions lend themselves to experimental analysis using various groups of students and practitioners (Priem & Rosen-
stein, 2000). Broad support manifests if business educated students routinely prefer growth oriented solutions regardless of economic performance. Partial support suggests that students prefer high-growth, low-profitability scenarios over low-growth, high-profitability scenarios.

The general depictions of the institutional propositions lend themselves to examination of U.S. educated practitioners. However, promising research options involving analysis of practitioners and students outside the United States also exists. Particularly given findings that Japanese managers utilize a different preference sequencing in regards to strategy selection than do U.S. and European managers (Song et al., 2002), it is possible that the general perception of growth strategies may differ contextually between cultural groups. Given the general success of foreign firms, such distinctions may shed some light on the boundaries between rational and irrational growth.

The final research direction suggested by this paper does not evolve from the propositions as much as from the evidence examined. Table 1 details a panel of studies each using some measure of growth or size with correlations to a performance measure. Given the data provided and pulling in additional studies, the relationship between growth and performance is fruitful grounds for meta-analysis. This recommendation echoes the charge from Combs et al. (2005) to explore the boundaries of performance dimensions. Following the advice of Combs et al. (2005), researchers should explore which combinations of operational performance indicators correspond to firms with rational growth agendas as well as which combinations align with irrational growth agendas. This paper only drew observational inferences from the table, for example self-reporting evidenced highly positive correlations – even so, the observational inferences presented here are similar to the analysis of performance dimensionality presented by Combs et al. (2005). It was not the purpose of this paper to determine which types of growth more likely produced profits, but rather to offer an explanation for the ready acceptance of growth as a positive function despite theoretical and empirical evidence to the contrary. While the earlier research directions offer insight into studying institutionalized growth, a meta-analysis is a recommended direction for addressing decades old questions regarding the multi-dimensionality (Venkatraman & Ramanujam, 1986) and environmental impacts of performance (Dess et al., 1990).

**Discussion**

This paper has introduced the topic of irrational growth as an area for research inquiry. Irrational growth occurs when a growth strategy on the part of a firm
fails to achieve profitability. Using current business research, various measures of growth function as measures of firm performance. We treat growth as a positive outcome despite indications that increased size may decrease profitability and lacking clear-cut indication, that growth regularly translates to profitability.

An institutional theory perspective offers the explanation for such favorable treatment of growth in the literature. Institutional theory provides an understanding of why practices and structures which may only be useful in specific instances become imbued with meaning and value beyond their objective benefits and become standard prescriptions for valued behavior. Using an institutional theoretical base, several empirically testable propositions have been advanced that would provide evidence of the existence and the extent of an institutional bias in favor of growth.

For academics, the primary implication arising from this paper is the extended development of a common research area, firm performance (Steers, 1975; Weinzimmer et al., 1998). Taking guidance from Poole and Van de Ven (1989), research should examine the paradoxical nature of growth in greater detail. Further, using Kimberly (1976) as a guideline, research may find value in a deeper investigation of a commonly utilized performance indicator. For practitioners and for students of business, the end result of such a research agenda involves a better series of prescriptions for the planning and implementation of rational growth strategies. From an educational standpoint, to the extent that academics influence the practices of future business leaders (Ghoshal & Moran, 1996), such research should be beneficial to the development of our field.

Growth is a commonly used performance indicator in business research. However, the relationship between growth and profitability is far from clear-cut. Using the concepts of rational and irrational growth, a research agenda emerges which, ideally, shall prove informative within the business literature. It appears that a deeper understanding of the relationship between growth and profitability is crucial for increasing the quality of practitioner strategic formulation and implementation.

References


---

**Biographical Sketch of Author**

**Troy A. Voelker** is an Assistant Professor in the School of Business at the University of Houston – Clear Lake. He earned his doctorate at the University of North Texas. His research interests are in the areas of strategy, inter-firm alliances, inter-firm networks and firm capabilities.