A CONCEPTUAL DISCUSSION ON 'PATH DEPENDENCE' AND 'DEMAND FOR RETURNS' ARGUMENTS: PRIVATE ENTERPRISE VERSUS SOE PERFORMANCE

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Abstract

Enterprise historicity has always been a precursor to how it is run in contemporary times. While it is common knowledge that enterprises brace up to the challenges of paradigmatic shifts in business, what is commonly overlooked both in research literature and by business practitioners is the subtle influence that the ex ante firm behavior exerts on any ex post decision. Some researchers have liberally drawn from scientific literature to explain this phenomenon as that of path dependence.
In this paper, an attempt is made to discuss the relevance of path dependence in enterprise behavior and supplement it with the 'demand for returns' argument which posits that private enterprises stand to perform better as against state-owned enterprises as a result of the stakeholders' demand for their rightful share of value.

Key Words: Risk Management, Regulation, Corporate Governance, Germany, US, Legal Area

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Introduction

Today businesses are increasingly operating in boundary-less markets. There is a market for every product and product for every market. The globe seems to have shrunk to one common market place. While it appears that product markets are moving in tandem towards a convergence, what belies the 'one market' paradigm is the divergence in economic behavior exhibited by different countries. Scholars have for long contended that nations practice economic systems with which they have begun. However, beginning 1990s, most countries including the newly independent states (break away countries of erstwhile USSR), East European countries and even emerging economies like India have under near similar circumstances tried to adopt market-oriented capitalistic model. Two decades down, history is witness to the fact that most of the so-called transition economies are yet to fully transition to the Anglo-Saxonic model. And even countries like Germany, Japan, and Russia that were at different periods of history coerced to adopt Anglo-Saxonic paradigm, have done so only to revert to their original economic model, once the pressure was withdrawn.

Post years of economic mismanagement and its manifestation in the form a colossal balance of payments crisis in the early 1990s, when India was asked to actively adopt a liberalization programme if she had wanted any bailout package from the International Monetary Fund, the Government of the day urgently put together its LPG (liberalization, privatization, globalization) policy and had declared its intentions of opening up its economy and practicing the Anglo-Saxonic model of governance. While it frenetically accelerated its pace of liberalization and privatization, it failed to match the speed in setting up the much needed legal infrastructure to protect an ever growing set of stakeholders. Two decades on, we realize that India has not moved much from its pre-1990 position except that it has now more rents to extract from a divergent set of stakeholders.

So what is it that holds back some economies, in the face of rapid changes, from accepting systems that are likely to yield conducive results? Roe (2000) has suggested that it is political preconditions that determine the way a certain economy behaves. Governments, irrespective of their forms – be they democracies, autarchies or dictatorships – are mired with vested interests. We feel that democracies though offer the comfort of government by representation, yet contain in them the seeds of expropriation by the powerful of the powerless, much like the other forms of Government. And with current day democracies that have multiple political constituents and their concomitant vested interests, economy trudges two steps forward and four steps backward. The forward movement is especially to keep foisting its internationalization plaque and the backward movement is to accommodate future political combinations that would keep the incumbent government in power for a longer period.

Private sector players have been the biggest beneficiaries of the flux that has come to characterize both the emerging and transition economies. They

have adopted the market-oriented governance model and have unshackled themselves from excessive state controls. Other than statutory support, they rarely depend on the Government for their survival. They are quick to adapt themselves to the ever changing business paradigms and exhibit amazing agility in reacting to external environmental changes. While they are bound to their enterprise historicity to a certain extent, unlike the public sector corporations they are not bound by the Government's or economy's historicity.

Public sector corporations, irrespective of the size and sector that they operate in, are locked in to 'policy' historicity and despite the management's capability to counter external challenges head on, are dependent on the historic moves that their political masters have made. This brings in an element of tardiness in the way corporations are run.

The Path Dependence Argument

Researchers have liberally drawn from the sciences, especially evolutionary biology to explain this phenomenon of "lock in" as that of path dependence. Arthur (1989) has indicated at non-ergodicity to explain the concept of path dependence. He contends that history is by and large related to the non-ergodic properties of economy, which means if outcomes are affected by the sequence of events then there is a strong possibility that there is a historical 'lock in' that shapes those current outcomes. In a way therefore, if a certain outcome is not affected by a sequence of events, then there is neither history nor lock in; it is random event. The readers will agree that no event is a random one, unless it is accidental. All events are rooted in some *ex-ante* decisions and most decisions are taken based on the fitness of things. If we interpolate this thought process a bit further, we realize that 'fitness of things' can be gauged only post an iterative effort, which further compels us to acknowledge that a 'sequence of events' or 'history' is what is referred to while making decisions. So while current actions or choices might not be similar to historical or past actions or choices, they are not far moved away from them either. This indicates that most choices that we make today are path dependent though they might not deliver optimal results.

The standardization of an inferior system like that of QWERTY keyboards is one such example that path dependent researchers have unfailingly drawn upon to explain how path dependent entrenchment might fail to lead to Pareto optimal outcomes. While the Dvorak keyboards were considered superior, it is QWERTY keyboards that held the edge in the market. As David (1994) suggests there could be multiple reasons for the acceptance and continued patronage of an inferior system, for e.g., *technical interrelatedness* as in the established relationship between the typists and the keyboards, *increasing returns* as a consequence of high market share for the product and *high switching costs* indicating the reluctance of users to switch over to a better product due to irreversibility of investments.

A question therefore arises if as economic agents are we prisoners of historicity and 'lock in' and despite having knowledge of the correct choices, do we bind ourselves to incorrect choices? Leibowitz and Margolis[1] (1995) have tried to discuss the possible path dependent behaviors by categorizing them into three different degrees. Instances that are sensitive to starting points but that have no implied inefficiency are supposed to be characterized by *first degree path dependence*. They put us on a path that attracts costs when left. *Second degree path dependence* occurs when, post adoption of a choice which looked appropriate when it was made, one realizes that efficient alternative choices are available that are likely to yield better results but the costs of switching become prohibitive. At this stage, the inferiority of the chosen path can be understood, but only in retrospect. *Third degree path dependence* is said to take place when there exist opportunities to remedy an inefficient outcome by adopting alternative paths, but persistence with inefficient choices leads to a dynamic market failure.

While it is difficult to perfectly predict future outcomes *ab initio* and hence we indeterminately fail to extricate ourselves from 'lock in' what certainly belies logic in contemporary economic governance is the stickiness that corporations to a certain extent and governments to a larger degree exhibit to path dependent rules. So, while at an individual level it is easier to shed path dependence and actively embrace disruption, enterprises and governments are caught in their own historicity that shape and determine their contemporary behaviors. And more often than not, history constrains choices (Gorringe, 1995).

In this paper, the focus is on understanding why Government organizations take the 'sticky' route and despite available opportunities to remedy their past choices exhibit characteristics of third degree path dependence as defined by Leibowitz and Margolis (1995). The author believes that product market competition will most likely correct the choices of private corporations over a period of time and those that refuse to shed their enterprise historicity in making economic decisions are likely to perish sooner than later.

Why then is the emphasis on Government organizations or public sector units? Almost all Government run organizations are an outcome of a deliberate policy path that the political establishment takes at the time of the country's initial stages. This sets the path for the future choices that the economic agents are likely to make. Even when the Government is replaced by opposition which advocates a

[1] Leibowitz and Margolis through their categorization have in a subtle way discussed the 'inefficiency theory' more than they have supported path dependence.

diametrically opposite economic viewpoint, it has been observed that change is not likely to come by rapidly. This is because economic policies go through the grind of a selection process and given the impetus of path dependence, change, if at all happens, happens incrementally. If incremental change is a continuous process, then a long lasting change becomes viable. For example, in the early 1990s in India, Bharatiya Janata Party (BJP) with its *swadeshi*[2] slogans opposed the liberalization policies adopted by the then Congress government. However, five years hence when it came to power, it could not take back the country to the pre-liberalization era. Instead, all its economic policies were entrenched in historicity and its economic actions were muscled by path dependent selection process.

Readers may indicate that the 1990s witnessed a disruptive intervention in economic policies and that India could successfully shed the shadow of her 'over protective, government intervening' path dependent regime. The author agrees and points at the dichotomy that path dependence argument has to provide to explain the disruptive phenomenon. For example, India's stickiness to history has defined her economic actions for over four and half decades since her independence, which were at times progressive and most times regressive and that over a longer period of time turned to expropriate value from all economic actors and stakeholders. Her path dependent choices were proven wrong and in the year 1990 she was left to the mercy of external international agencies for a new lease of life. So the quick adoption of the LPG policy was not so much a proactive acceptance of disruption but a forcible and administered one --- more akin to a historical economic accident in which Governments are left with little choice than to accept the administered change and rebuild on it. What is a more worrying trend though is the initial acceptance to change and then a gradual movement towards past structures.

Bebchuk and Roe's (1999) seminal paper on path dependence has suggested that "a country's pattern of ownership structures at any point in time depends partly on the patterns it had earlier" and has gone on to cleverly break the notion of path dependence into that of structure-driven path dependence and rule-drive path dependence. By structure-driven path dependence they meant that subsequent ownership structures are largely impacted by the initial ownership structures; and rule-drive path dependence arises when the initial ownership structures impact the subsequent ownership structures through their effect on legal rules. This explains why India could not revert to its pre-liberalization period despite a main political party advocating a contrarian view. Decrying path dependence, Altman (2000) has claimed that "economic agents would eventually respond to better opportunities." He further suggests that 'lock in' occurs if inefficient outcomes are consistent with the economic agent's preferences. His contention is valid in so long as he talks of private enterprises that carry less amount of historic burden as compared to public enterprises that are riddled with historicity. The stakeholders to a private enterprise are a fraction of those that of a public sector enterprise. And the most dominant set of stakeholders in a private enterprise is the owners, who when change either through exit or because of market compulsions, leave room for shedding path dependent behaviors. On the other hand, public sector enterprises have many masters and are very volatile. Therefore, despite the economic agent's preferences to the contrary, 'lock in' is likely to dominate economic choices.

'Revealed Institutional Preference' as Manifestation of Path Dependence in Transition Economies

Privatization seemed to have offered a gold rush to most economies, globally, in the early 1990s. While the breakaway countries of erstwhile USSR were trying to shed their socialistic legacy, some Central and Eastern European countries attempted at adopting the attractive Anglo-Saxonic economic paradigm in the wake of miserable economic failures. Closer home, some Asian countries too actively tried to hop on to the liberalization and privatization bandwagon and with the East Asian financial crisis the need to adopt the market-centric model of governance seemed to be the only panacea for many an economic ills.

The question that the author tries to examine is whether the wide spread adoption of Anglo-Saxonic model of governance and the consequent transition of economic systems was devoid of path dependence. Researchers have evidenced that most transition efforts have been failures due to insider rent seeking and corruption that are a manifestation of path dependent behaviors.

While one can intuitively claim that profitability improves post privatization, what one needs to examine is whether the divestiture of the state-owned enterprises (SOEs) have been made cleanly, meaning that there are no further governmental shadows or linkages. Else, there could be a likely deterioration in performance post privatization which could be attributed to either lack of or bad restructuring of the SOEs before they were privatized (Dewenter and Malatesta, 2001). One may dismiss off the contention of bad restructuring as that of governmental inefficiency in the economic re-allocation process. Or one could attribute the inefficiency to the lack of

[2] Swadeshi means 'own country' in the literal sense. From a politico-economic perspective it relates to the advocacy of self-dependence, non-reliance on foreign goods and products. So the swadeshi movement of the early 1990s veered around the central idea of achieving self-sufficiency through the strengthening of domestic enterprise.

readiness in the economy of a political transformation process concomitantly with the economic transformation. And if both political and economic transformation do not happen concurrently, the economy is likely to evidence a lot of path dependent behaviors that scuttle the speed of economic transformation.

Even in countries where political and economic transformations happened simultaneously, privatization programs were mired in past historicity. Czech Republic, which had lesser economic and political constraints owing to its new found freedom, took mass voucherization as the route to privatization. While the idea was novel in that it allowed the citizens of the country to participate in the equity shareholding of the privatized firms, it could not stop ownership concentration as over 70% of these vouchers were amassed by the Investment Privatization Funds (IPFs) (Vinscensini, 2001 and Harper, 2002). So, in a way, ownership concentration exhibited path dependence behavior – in the pre-privatization period, the government was the majority shareholder and in the post-privatization period, IPFs started by Czech banks became the majority shareholders. So while the Government was trying to diversify shareholding, its inertia has allowed the concentration of ownership in a single set of owners.

Poland took the divestment route through two methods – ‘capital privatization’ that attempted to sell large firms to foreign and domestic investors through the capital market; and ‘leasing method’ – where insiders were allowed to lease the assets of the SOE and create a new company. Unwittingly it got trapped in the leasing method as the internal pressures were far too many and the government of the day could not shed its inertia and its historical behavior. Changes were effected at a snail’s pace and were at best incremental thereby taking away from the rigorous pace of the privatization process (Vincensini, 2001).

Hungary too was caught in the web of insiders appropriating the privatization process. It took the country over a decade to change its privatization trajectory and open up to foreign investors. So while countries, in the wake of economic despondency, are coerced to adopt newer economic models, the political will to speed up path shaping trajectories is lost in the unwillingness and sheer helplessness in abandoning path dependence. In some cases, scholars have evidenced that despite accepting contemporary economic models, some countries have time and again sprung back to their old systems which the path dependence theorists term as *revealed institutional preference* (see Hedlund, 2000).

Hedlund’s (2000) study of Russia in the post Gorbachev era also indicates that Boris Yeltsin engaged in a huge charade of mass privatization by issuing worthless shares of companies, that had little or no future, to millions of workers, even while ensuring that prime government positions were awarded to his ‘yes men’ such that power is not devolved too far away from him. So while on the one hand, under international pressure, Russia was trying to get out of the prevalent bad economic equilibrium, on the other hand it time reverted to its original institutional choices that let it slush itself in the bad equilibrium. This leads one to believe Pierson’s (2000) contention that “entrenchments of institutional arrangements obstruct easy reversal of the initial choice.” This is in line with North’s (1990) argument that the overall institutional trajectory is difficult to predict and alter in the long run, though in the short run some events could sway institutional choices to contemporary demands.

Citing interesting examples of ‘choice reversal’ in Japan, Germany and Russia, Buck and Shahrim (2005) strengthen the *revealed institutional preference* hypothesis and thereby bolster our path dependence argument. In the pre-World War II period, Japanese corporate ownership was characterized by *zaibatsus* (largely family owned and controlled with pyramidic stock holdings). During the period of 1946-1952 when US assumed direct control of Japan, it attempted at liquidating *zaibatsus* and doing away with the culture of interlocking shareholding and master-servant kind of feudalism. As soon was power handed back to the Japanese in 1952, *zaibatsus* came back as *keiretsus* with the past institutional structures of cross shareholding, cross directorships and interlocking directorates.

Germany too exhibited similar governance traits in the pre and post World War II period. Military governments (especially those practicing Anglo-Saxonic economic model) took control of Germany and immediately called for a change in the way corporations in the country operated. Ownership concentration was coerced towards dispersion and attempts were made to break the state-industry nexus. Once the US left Germany, ownership concentration manifested itself in the form of large block holders and institutional preferences were reverted to the old times. For Germany, US’ exit based governance system seemed destructive in the long run as it thrived on warnings, threats and outrageous shareholder demands.

Thus, the author conjectures that political structures that existed at the time a country started are likely to dictate future choices. Initial political structures possess with them the scope to define institutional structures and as first agents or occupants of such structures they entrench themselves to an extent where reversal becomes an impossible task (Robinson 2001). However, contingent behaviors bring about incremental changes that are indicative of adaptation to the challenges posed by the external environment and it is through a series of incremental changes that good contemporary economic equilibriums can be achieved.

'Demand for Returns' Argument and Performance in Private vs. SOEs

In the wake of Berle and Means' (1932) seminal study on 'separation of ownership and control' and the concomitant 'creation of information asymmetries' hypothesis that emerged as a consequence, governance researchers have been studying firm performance for over eight decades now. Information asymmetries could be created by one firm actor against other firm actors to deprive them of their rightful optimal value. For example, majority shareholders could expropriate value from minority shareholders by creating information asymmetries. Likewise, firm managers can expropriate value from owners who do not play an active role in governance; or say managers and owners could collude to expropriate value from other stakeholders. The information asymmetries hypothesis is further fuelled by the dominant paradigm of 'conflicts of interest' and is also endogenously related to it.

Different stakeholders have different motives for remaining vested in the firms. And these motives could work at cross purposes that could be detrimental to the firm's value maximization efforts. The market-centric model of governance takes cognizance of the 'conflicts of interest' problem and provisions for stakeholder activism that keeps it in check. Likewise, a variety of institutional arrangements like strong regulatory bodies, active and vibrant capital markets and excellent legal protection to investors coupled with some strong governance instruments like markets for corporate control, markets for managerial labor and board composition have to a great extent ensured that corporations perform better. It may however be noted that despite the availability of strong governance mechanisms, value leakages do happen.

A private firm's performance is monitored by the minute by various stakeholders and while this may build in managerial myopia, it is also helpful in keeping a tight leash on any performance digressions. A firm that fails to deliver makes itself a target for takeover thereby diminishing not only its own value but also that of the managers running it. Such managers are not attractive enough in the managerial labor markets.

The active role that capital markets play through their 'voice' or 'exit' strategy robustly signals the direction that the private firms are taking. Given that there is a possibility of shrinkage in capital if the signals are that of 'alarm,' private firms cannot afford to jeopardize their own existence. Markets therefore play an important role in driving in a sense of urgency to value maximization.

The stakes for a private firm are far higher given the dispersion in ownership and a multitude of actively participating stakeholders. Each actor in the private firm is therefore coerced to play a constructive and collaborative role that helps the firm improve its efficiency gains and therefore perform better.

Demand for returns is therefore a strong predictor of firm performance. It takes an opposite view to that of the free rider theory. As long as there are stakeholders who are either unwilling or lackadaisical in their approach to initiate action against value expropriation and hoping to piggyback on the efforts of other vocal stakeholding groups, free rider problem is likely to exist and is more importantly likely to erode stakeholder value. Finance researchers have done innumerable empirical studies and have concurred that organizations that have active stakeholders demanding for their rightful returns have performed better than those that are riddled with free riding stakeholders.

Private firms, though exhibit a sense of enterprise historicity in their decision making, have been able to circumnavigate the challenges offered by modern day business environment, solely because of the demands made by the stakeholders for prudent and quick response times. This requirement to practice agility in countering external challenges coupled with stakeholder demands leaves little scope to exhibit path dependent behaviors. Despite, the incumbent pressures of being monitored so extensively, private firms are able to deliver value, mostly because of the emergent tensions that each stakeholding group builds in its bid to maximize its own value.

However, one cannot deny the existence of path dependence in private firms. The author's only contention is that by and large private firms do not have the luxury to engage in path dependent behaviors what with a multitude of stakeholders breathing down their necks for their rightful value gains.

The same *demand for returns* argument is extended to SOEs to articulate the contention on why they do not shed their historicity despite business exigencies. SOEs struggle with a huge dichotomous ownership structure --- they are both highly concentrated and yet at the same time highly diffused. Ownership concentration lies with the government and diffusion is in as far as all the citizens being owners. Citizens capitalize these enterprises in indirect ways and yet have absolutely no control on the way they are run. As SOEs, in a majority cases, do not have to depend on external sources for their funding needs, they are run as personal fiefdoms of their parent ministries.

Political ministers who are in direct charge of these enterprises have a lot lesser stake in their performance. With just one election away, or, at the longest five years away, from likely being ousted out of power, politicians are rather less worried about the performance of the enterprises in their charge. It serves them well to engage in rent-seeking from the charges in their hold and engross themselves in the

pursuit of satisfying relevant political constituents (Kruger, 1982).

As there are very few institutional arrangements that impose (ineffectively) checks and controls on non-performing SOEs, performance is largely left to the interplay of market forces and not on governance competence. Managements of SOEs though competent, could demonstrate ineptitude in a bid to appease their political masters.

Even if a bugle of alarm is sounded by vigilant constituents, given that governments have the power to decide their fiscal policies, they are in a far better position to re-capitalize firms should such a need arise. In the Indian context, two examples drive home the point – (i) the current non-performing assets (NPAs) scenario in the public banking sector is testimony to the fact that SOEs are made to serve the interests of their political masters (see Bardhan, 1984 to understand how the seeds to this modern day debacle have been sown). Today's malady of NPAs is a direct outcome of mindless lending by the banks to debtors of dubious character (more appropriately termed as willful defaulters), especially at the behest of politicians, in the form of loan melas[3] or discounted loans schemes; (ii) Air India, a huge state owned airlines behemoth, is bleeding the taxpayers for years on end and the ministers responsible for managing this entity are inadvertently funding its failure through funds collected from the taxpayers.

The biggest advantage of the SOEs (as in the Indian context) is also its biggest disadvantage. As mentioned earlier, ownership is concentrated with the government and the SOEs are capitalized by the funds collected from the taxpayers of the entire nation. So ownership is in a way far too diffused for any one shareholder to raise her *demand for return* voice. Every shareholder (or every taxpayer as in this case) is a free rider. Unlike the 'market for managerial labor' applicable for private enterprises, there exists a *replacement market* for the 'governance team' of the SOEs and eventually the new team that replaces the old one is equally motivated to extract private rents from the public organizations. This to the author's belief constitutes an act of path dependence.

Political history of most countries has witnessed that succeeding governments have not departed far away from their predecessor governments in so far as impacting economic equilibriums is concerned (Bhasa, 2010). Policy departures have ensured fresh policies are rolled out keeping in mind the paths set by the predecessor governments, and rightly so. Economic policies made by the predecessor government cannot be turned upside down as soon as the new government comes into power, as the previous policies are likely to touch and impact a lot of constituents and a sudden reversal would not only jeopardize the existing equilibrium but also be difficult to implement.

Therefore it can be loosely (sic) conjectured that unless 'demand for returns' becomes a prominent governance mechanism to pull up SOE performance, governments will exhibit tardy path dependent behaviors. We have seen how even transition economies, that under duress adopted disruptive economic models, have reverted to their original path dependent behaviors once the pressure was eased.

Conclusion

Path dependence offers robust explanations to the way governments and through them SOEs behave. For the governments, it bodes well not to disturb existing equilibriums as long as power can be enjoyed minus the trappings of change. Drawing from the Indian context, we can reasonably argue that path dependence is deeply entrenched in government behavior. How otherwise does one explain the fact that it has taken the country over three decades and seven governments to bring about an incremental change in the administered prices mechanism (APM) regime in the petroleum sector? And still we witness, that successive governments are unable to shed the path dependence of not being able to raise the prices of some petroleum products like domestic liquefied petroleum gas and kerosene oil. *Why?* Because there is no *demand for returns* from the diffused shareholders (taxpayers) and this gives the government enough scope to (a) exhibit path dependent behavior; and (b) recapitalize the loss making SOEs at the expense of the taxpayer.

Literature on path dependence is yet to mature. The extant literature is more of an attempt to skillfully adopt the relevance of an important evolutionary concept within the *historical context* narrative of firm behavior. Research studies that weave political history with governmental response to economic management within the path dependent context are few and far between. Through this paper, an attempt is made to arouse the interest of the reader in the concept of path dependence and by establishing a conceptual linkage with the *demand for returns* argument the author leaves the topic for a further exhaustive debate.

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[3] Mela means a 'fair' and loan melas mean loan fairs.

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