Policy Reforms and Adaptation of State-Owned Enterprises in Developing Economies: A Resource-Based Perspective

Anjula Gurtoo
anjula@mgmt.iisc.ernet.in
Department of Management Studies. Indian Institute of Science
Bangalore – 560012 INDIA
Phone: +91-80-22922471
Fax: +91-80-23604534

Abstract

Adaptation of state-owned enterprises to policy reforms specific to developing economies has not been widely studied. Drawing from the resource-based perspective, this paper identifies pre-reform capabilities of state-owned enterprises in developing economies that can be relevant even in post-reform context. The paper proposes a framework to explain the competitive advantages that can be derived from these capabilities in the post-reform context and discusses the role that governments can play in enabling adaptation of state-owned enterprises.

KEYWORDS: State owned enterprises; capabilities; adaptation; resource based perspective

Introduction

Economic policy reforms, characterized by market driven, competitive and privatized policy regime, are being adopted as a strategy by developing economies as part of ongoing global economic change, with the purpose of promoting national economic development (Zahra, Ireland, Gutierrez, and Hitt, 2000). In the late 1980s and early 1990s, countries in Asia, Africa and Latin America initiated move toward a free market system and underwent rapid changes in government policy regulations favoring economic liberalization. These policy reforms include slashing of sectors reserved for government ownership, privatization of state owned enterprises, reduced quantitative restrictions on imports and import duties on capital goods, cuts in subsidies, liberalized interest rates, abolition of licenses for most industries, tax reforms and change in informal social contract of long-termism between employees and government (Ramamurti, 1999). The International Finance Corporation identifies 51 countries in Asia, Africa and Latin America that are going through such rapid economic development and liberalization (Hoskisson, Eden, Lau and Wright, 2000).

However, developing economies (DEs) are characterized by greater instability in their economic and political systems and institutions as compared to developed economies. They differ significantly on various social, economic, political, institutional, and infrastructure aspects. For example, in developing and emerging economies market-supporting institutions, such as property rights, capital markets, labor markets, and regulatory institutions, are not as developed as they are in industrialized economies (United Nations, 2000; Shleifer, 1997). Under these circumstances, one of the DE institutions facing acute difficulties in adapting to policy reforms is State Owned Enterprises (SOEs). Despite a decade of privatization, the vast majority of SOE assets in DEs continue to be in government hands (Ramamurti, 1999, Burton et al., 1993; Nunberg, 1997; McCourt, 2001), unlike in former socialist economies and some middle-income countries where

SOE assets have reduced significantly (Prud'homme, 1995). The deregulation experiment in DEs has so far been a painful, unsuccessful, and chaotic experience for SOEs. Studies like Uhlenbruck and Castro (2000) and Newman and Nollen (1998) address issue of adaptation of SOEs to radical policy and institutional changes in emerging economies. However their main focus has been middle-income economies or economies where the state and its institutions are not as unstable as in DEs. Literature gap underscores the need for developing frameworks to understand issues in adaptation of SOEs in the rapidly changing policy context of DEs; how SOEs in DEs can use their past capabilities to adapt in the post-reform context; and how governments in DEs can design processes of policy reforms that are can aid SOE adaptation.

This paper proposes a framework to understand pre-reform capabilities of SOEs in developing economies (DEs) that can be leveraged to facilitate effective adaptation to post-reform, liberalized- economy policy context. It draws from the resource-based perspective to identify the pre-reform capabilities of SOEs. Further it suggests some new capability can be required for SOEs post-reform, and explore the role of government policies in enabling effective adaptation to the post-reform context.

Resource Based View and Competitiveness of Firms

Resource based view (RBV) of the firm builds itself around internal competencies of firms. It believes that competitive advantage is rooted inside a firm, in assets that are valuable and inimitable. Resources that are scarce with little substitutes, or difficult to imitate, and enable organizations to exploit opportunities, provide sustained competitive advantage to firms (Barney, 1991; Russo and Fouts, 1997). Explicit barriers – introduced either by a firm's internal strategy or by governmental intervention – may facilitate rareness and inimitability of certain resources. Time lags, size advantages, superior foresight and preferential access to superior information and resources are examples of possible barriers to imitation by competitors (Barney, 1991). By nurturing internal competencies and applying them to appropriate external environment, firms can develop viable strategies to "exploit opportunities or neutralize threats in the firm's environment" (Barney, 1986; Russo and Fouts, 1997). Hence the RBV addresses the fit between a firm's ability to do and the opportunity available for it to do.

Within RBV, two mechanisms – resource picking and capability building – by which firms create economic rents (Makadok, 2001), need to be distinguished before attempting to understand the implication of RBV for adapting strategies of SOEs. Under resource-picking mechanism, firms gather information and analysis to outsmart the resource market in selecting resources that have high future expected value (Makadok, 2001). Barney (1986) highlights the importance of firm's access to superior information in utilizing this mechanism. Capabilities, on the other hand, refer to a firm's capacity to effectively deploy resources to meet desired ends. Capabilities are information-based, tangible or intangible, firm-specific processes that are developed over time (Amit and Schoemaker, 1993). Capability building consists of knowledge accumulation as a consequence of learning within the organization (Teece, Pisano, and Shuen, 1997; Ulrich and Lake, 1990). A firm's capabilities, by definition, are valuable and difficult to imitate by other firms. They aid in coordinating among various resources effectively (Prahalad and Hamel, 1990). Hence they increase the value of existing resources and new resources that the firm acquires. Learning is an integral element of capability-building process and involves conscious improvement efforts by people. Learning has also been emphasized by Wernerfelt (1984) and Teece, Pisano, and Shuen (1997) who argue that difference in knowledge-based resources can explain difference in firms' sustained performance. Capabilities can be classified as either functional or integrative (Verona, 1999). While functional capabilities enable accumulation of technical knowledge, integrative capabilities act as adhesive by absorbing critical knowledge from external sources and by integrating different technical competencies inside the organization (Verona, 1999, Pisano, 1996).

RBV and SOE Capabilities

Successful SOEs in DEs have built distinct capabilities during their experience of doing business in pre-reform periods. SOE pre-reform capability exploration by Pandey and Gurtoo (2001), Ramamurti (1997), and Dubash and Ranjan (2002) reveals distinct external and internal capabilities. Among SOEs' functional capabilities are operational & technological capabilities (e.g., operating under socio-economic conditions of supplies shortage; operating large-scale technologies; managing large-scale and logistically intensive systems of sourcing and distribution), and human resource capabilities (e.g., large size of experienced and cohesive workforce that exhibits family-type loyalty to the organization). SOEs' integrative capabilities include external integrative capabilities (e.g., experience of dealing with policy makers and with foreign partners for accessing financial assets and technological knowledge) and internal integrative capabilities (e.g., large-scale and integrated managerial processes and systems, and integrated structures). Relationship of these capabilities to aspects of social-economic-political context is explained in the paragraphs below.

Pre-reform, the SOEs were governed by direct state control on their financial, social and economic initiatives, and state monitoring of exchange relationships between economic actors (Hoskisson et al., 2000). The social-economic-political environment facing the nations governed their regulatory policies (Ariyo and Jerome, 1999). The political environment favored major role of state in national industrial and economic development. These factors reflected in centralized economic planning characterized by state ownership for many capital intensive industries, and protectionist environment for industrial enterprises through industrial licensing to control internal competition and prohibition of imports (Guillen, 2000). The social objective promoted equity among citizens as the majority population was unable to afford even minimum standard of living.

These regulatory constraints reflected the organizational functioning of SOEs. Government control created mammoth organizations managing almost the entire supply chain in a sector. Moreover, these mammoth structures were ill conceived, directed according to changing political whims and climates. They grew haphazardly with a mix of disparate technologies and inefficient systems. Strategic decision making was highly centralized and dependent on short-term governmental priorities (Ramaswamy and Schiphorst, 2000). The top management reflected policy makers' attitude. Consequently, positional and role boundaries were thick with high vertical differentiation, particularly at higher levels of structural hierarchy. Static environment, with narrow horizontal operations (but high vertically integrated and centralized operations) demanded little innovation and hence perpetuated a change resistant culture (Ramaswamy and Schiphorst, 2000). Key technologies were bought from foreign companies with help of foreign financial support and governmental guarantees. Moreover, the socio-economic mandate of employment generation, aided by paternalistic employee orientation, added large workforce to SOEs which displayed unquestioning loyalty towards the government (Pandey and Gurtoo, 2001; Lee Hyo Soo, 2001). On the positive side, most successful SOEs had accumulated long years of experience in managing highly vertically integrated operations in capital intensive industries, witnessing scale as well as scope economies, controlling transaction costs, selecting international partners on financial assets and technological capability, and developing systems to manage large sized workforce (Lee Hyo Soo; 1996).

Policy Reforms and SOEs

Institutional and economic constraints of DEs reflected in weak governance institutions, poor infrastructure development, immature financial markets, low borrowing capacity of governments and SOEs, and low average consumption levels of population due to rampant poverty (Ariyo & Jerome, 1999). In view of greater enormity of weaknesses and imperfections in pre-reform period, policy reforms in DEs toward competition, privatization and market-driven economy represent a turbulent change. Newman and Nollen (1998) studied organizational transformation during institutional upheaval in transition economies. Drawing on organizational change theory,

organizational learning theory, and institutional theory, they explained organizational transformation in the institutional contexts of transition economies through a conceptual framework. Since concomitant upheaval in the institutional context is observed in both transition economies and DEs, and is different from institutional change context observed in the developed economies, Newman and Nollen's proposed conceptual framework also holds good for DEs. This framework is useful in understanding why upheaval-like institutional change inhibits second-order learning of SOEs required for adaptation to policy reforms in DEs. They outlined several reasons for unsuccessful learning and transformation of SOEs like lack of relevance of existing resources and capabilities; lack of legitimate organizing templates and schemas; ambiguous cause-effect relationships, and consequent adherence to old, inappropriate routines; strategic confusion; and mimetic changes in strategies, structures and systems based on irrelevant models. Further, they say that adverse effect of institutional upheaval on organizational learning and transformation is less pronounced for firms that were less embedded in pre-reform institutional framework, and whose pre-reform experiences and capabilities were relevant for future performance.

SOEs in DEs had a disadvantage of lack of exposure to diverse industries, products and markets, resulting in past capabilities that were less relevant for the changed policy and institutional context. Thus, as per Newman and Nollen's framework, they are ill-suited for adaptation to policy reforms on 'experience' account. However, we can argue that SOEs in DEs have an advantage as they are 'less' embedded in pre-reform institutional framework. Guillen (2000) provides an explanation for this. While explaining the success of business groups in emerging economies, he observed that greater market imperfections and greater autonomy and size of the state promoted the formation of business groups by encouraging organizations to diversify in a collection of unrelated activities and industries. He explained that economies with either high outward flow of foreign trade and investment and low inward flow of foreign trade and investment, or vice versa, are conducive to existence of business groups. The past few decades have witnessed most DEs moving from a policy regime with barriers to both inward and outward flows of foreign trade and investment to a regime with at least one of the barriers relaxed. A majority of DEs first opened barriers to outward flows, resulting in emergence of domestic business groups along with SOEs. Subsequent opening of barriers to inward flows (as part of policy reforms) has led to a scenario where three agents – domestic business groups, SOEs and MNCs – co-exist but are facing enormous problems in adapting to changing policy regimes. Although this trend has not been observed by Guillen, his framework does provide the explanation that SOEs, being vertically integrated and non-diversified, were more suited to post-reform policy and institutional context in emerging economies. This implies that SOEs in DEs have initial advantage on 'embeddedness' account in the reformed policy context.

Newman and Nollen's framework, despite explaining how institutional upheaval affects organizational response of firms in emerging economies (including DEs), does not explain how some firms (including SOEs) can leverage past capabilities to effectively respond and adapt to reformed institutional context. They assumed that lack of prior experience in new institutional context implied complete absence of appropriate organizing templates and schemas, and consequent complete absence of relevant capabilities. I argue that this may not necessarily be the case, because despite radically changed policy regime, certain aspects of social-economic-political context continue unchanged in DEs, implying continued relevance of some organizing templates and schemas. Certain capabilities of SOEs in DEs, which were developed mainly in the process of adapting to the social-economic-political context rather than to the specificities of policy regime, are likely to be useful even in the changed policy context.

There are examples of a few SOEs that have been partly successful in adapting to reformed policy context in DEs where reform process is over a decade old. These include many SOEs in China, some SOEs in India like National Thermal Power Corporation and Oil & Natural Gas Corporation, and some SOEs in other DEs like Brazil and Sub-Saharan African countries (White, 2001; Burton et al., 1993; Dunsire and Hood, 1989; McCourt, 2001). The RBV can explain how SOEs can adapt to reformed policy and institutional context in DEs. The RBV effectively identifies

those accumulated capabilities from the past that SOEs can leverage for reorienting their strategies, structures and systems in reformed scenario. This also facilitates understanding why many SOEs in DEs find it difficult to adapt to reformed policy context. This learning will be useful for governments and policy makers in DEs to design reforms process that enables effective adaptation of SOEs

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Policy Reforms and SOE Capabilities

Figure 1 outlines our proposed framework for explaining effects of pre-reform policy scenario on those capabilities of SOEs that can be potentially leveraged to gain competitive advantage even in post-reform policy scenario, and new capabilities that need to be additionally acquired by SOEs to effectively adapt to post-reform**.**

Despite progress of economic reforms, social-economic conditions of weak infrastructure and surplus demand (or supply shortfall) in most industries are likely to prevail in DEs for many years to come. This is because most DEs still have a majority of population living and transacting mostly outside of modern markets due to existence of multiple social, economic, infrastructure and institutional barriers to diffusion of modern technologies, products and services (Pandey & Gurtoo, 2001). Some of these barriers, including poorly developed infrastructure, low consumption levels of significant portion of population living in rural and semi-urban areas, weak governmental support institutions for promoting social-economic development, are likely to continue in foreseeable future. Operating under combined pressures of excessive supply-demand gap and poor transport and communication infrastructure requires a different orientation for management of technological, production, and logistical systems. For example, informal and innovative methods of communication, coordination and transport are often employed by successful firms to source inputs and reach their products or services to consumers in DEs. Similarly, innovative methods of pricing and advertising are used for expanding customer-base to low-income and remote regions. Such methods can be designed and implemented more successfully by large state-owned firms who have both sufficient resource-cushion and privileged access to state's infrastructure and resources. SOEs in DEs, by virtue of their long experience in surviving under excessive demand and poor infrastructure conditions, and their past relations with governments, are better placed in competing under similar conditions even in post-reform policy context.

Proposition 1: In developing economies, the continuance of surplus-demand and poor infrastructure situation in post-reform scenario is likely to offer certain competitive advantage to state-owned enterprises.

Many SOEs in DEs operated in potentially large markets domestically due to both having monopoly status and being in capital intensive industries. Thus, they have decades of experience in operating and managing large-scale technologies and systems for production, maintenance, quality control, project management, sourcing, costing and financing. All this offers enormous accrual of economy of scale effects. Experience in owning and managing large-scale and logistically intensive systems of sourcing and distribution offers SOEs significant multiplier cost and response time advantages for accessing new markets, besides benefits of economy of logistics. This is likely to be useful for exploring opportunities and entering into new products and markets to survive in post-reform scenario. Further, since most SOEs were vertically integrated in operations and assets, they had experience also in accruing economy of scope benefits. Part of the systems for delivering economies of scale and scope are likely to be useful even in post-reform scenario where SOEs are expected to compete on cost in addition to other dimensions, albeit with increased competition, increased customer awareness and modern technologies. Along with new competitive dimensions of flexibility, customization, delivery and quality, old dimension of cost is also likely to play important role in competition, particularly for large low-income consumer segments in DEs.

Proposition 2: In developing economies, the capability of state-owned enterprises in delivering economies of scale and scope are likely to be useful in post-reform scenario.

Guarantee of economic stability and the prevalent social culture of family oriented values in DEs (Kher, 1997) evolved a workforce in SOEs largely loyal to the organization. Reforms have introduced an unstable business environment, leading to unpredictability in economic security for its employees. Thus, in post-reform scenario, the human resource has a significant stake in survival of the enterprise. The systems of SOEs need to be overhauled and their workforce need to be retrained for performing new roles, meeting new and more stringent requirements of performance, and working with new technologies, structures and systems of management. Strong and effective leadership can play a critical role in enabling and motivating the employees for developing equal partnership in effecting these changes (Quinn, 1985).

Proposition 3: *Under effective leadership, loyalty of large size workforce may give an advantage to state-owned enterprises in developing economies in post-reform scenario.*

Decades of interacting with policy makers in pre-reform scenario has given enormous experience to senior managers of SOEs in DEs in exploring innovative ways of accessing superior information about various resources and upcoming policy and institutional changes. This was critical because the state had significant control over most industries in pre-reform period. This is likely to be important, although not as critical, even in post-reform scenario because the state in DEs is playing an important role as designer, implementer and regulator of reforms process. Further, SOEs in DEs often selected foreign partners for accessing financial assets and technological capability (Hitt et al., 2000). This was done through government support. Successful SOEs have thus built certain congenial and professional relationships with foreign partners. Access to financial assets and technological capability is likely to continue to play important role for enabling future investments and acquiring modern technologies in post-reform scenario. This is because, while SOEs, unlike big MNCs, lack capabilities in self-mobilizing finance and technologies, these capabilities will matter in competitive, market-driven business environments for enabling firms' strategies to grow, acquire new technologies, access superior product and process development infrastructure, and invest in complementary assets necessary to introduce new products and enter new markets. Internal capability of Chinese pharmaceutical SOEs to produce complementary assets necessary to introduce new products was critical to their success (White, 2000). Good relationships with foreign partners may allow SOEs easier access to both finance and superior technologies as compared to other domestic firms. Their past experience in interacting with governments is also likely to benefit them in rapidly accessing such sources. Thus, SOEs in DEs may have superior resource-picking capacity compared to other firms, resulting in effective creation of economic rent as explained by Amit & Schoemaker (1993).

Proposition 4: *SOEs in DEs are likely to have superior resource-picking capacity for government regulated resources, international financial assets and modern technologies, as compared to other domestic firms.*

SOEs in DEs developed integrated managerial process and systems, and integrated structures, in order to manage information flow and coordination within a large-scale organization. Effective coordination and information flow was critical for managing large-scale of operations, bulky organization structures, and large size of workforce. It helped SOEs in controlling overhead costs while delivering economies of scale and scope. Most such coordination and information flow systems were informally and innovatively designed in order to manage large-scale production and intensive logistics operation in adverse social-economic-political environments characterized by uncertain material supplies, poor infrastructure of communication, transport and energy supply, and inability to design formal systems in rural and remote markets. Effective coordination and

information flow systems are useful also for enabling superior performance on flexibility and response time. Therefore, innovative internal integrative capabilities of SOEs are likely to be useful even in post-reform, competitive scenario that is expected to witness continuance of uncertainties and imperfections mentioned earlier. Together with overhauling human resource systems and complementing with information technology systems, past coordination and information flow systems of SOEs can be leveraged to meet the demands of new competitive environment.

Proposition 5: *Internal integrative managerial systems and structures of SOEs in DEs are likely to offer them an advantage in meeting competitive demands of post-reform context.*

Implications for Governments of Developing Economics

The experience of SOEs and policy reforms in many DEs shows that SOEs find it extremely difficult to adapt to post-reform scenario (Newman & Nollen, 1998). Instances of failures (Ramamurti, 1999; Ariyo & Jerome, 1999) and successes (Ramamurti, 1999; Nolan, 2001) of SOE adaptation to post-reform context in DEs suggests that policy and institutional reforms process carried out in a sequence of less radical multiple steps enable SOEs to adapt better. Effectiveness of design of specific steps for a DE depends on the domestic social, economic and institutional context of that DE.

Ariyo & Jerome (1999), in their analysis of reasons for possible failure of SOE reforms in Africa, highlight the need to first focus on determinants of reform outcomes before designing a reform policy. They demonstrate the importance of partial divestiture, attention to absorptive capacity of the country while designing sequencing and mix of SOEs slated for privatization, and consideration of non-economic aspects that affect reaction of local citizens (for example, assistance to the poor, and apprehensions about foreign control on critical indigenous resources). The failure of electricity industry policy reforms in India (Mehta, 1999; Gurtoo & Pandey, 2001) highlights the disastrous effect of lack of policy makers' experience with competitive market dynamics and with handling negotiations between SOEs and MNCs.

Existence of limits or barriers to competition over certain period of time is imperative for enabling organizations to accumulate and sustain capabilities that are rare, valuable, and inimitable (Peteraf, 1993). Guillen (2000) supports this claim by observing that business groups could sustain in emerging economies by accumulating capability to combine domestic and foreign resources to enter diverse industries quickly and cost effectively. This capability was inimitable due to preferential access to resources ensured by asymmetric foreign trade and investment flows. In order to effectively adapt in post-reform scenario, SOEs in DEs are required to build many new capabilities in addition to capabilities of the past. Therefore, government's role is important for both designing reforms process in less radical steps and retaining or introducing limits to competition in critical areas to allow SOEs to build required capabilities.

Proposition 6: *A policy reforms process carried out in a sequence of less radical steps, and retaining limits to competition in initial period of reforms, is more likely to enable SOEs to adapt effectively to its changes.*

Conclusions and Limitations

In this article I have drawn from the resource-based literature, from the literature on SOEs and DEs, and from my own experience of studying organizational change processes in SOEs in India. Main contributions of this article are two-fold. First, it covers SOE adaptation issues in relatively less studied economies. Second, rather than focusing on how policy changes affect SOEs in DEs, it focuses on how to identify the pre-reform capabilities that can be leveraged by SOEs for effective adaptation even in post-reform context. The latter theme is less studied even for emerging economies in general.

Despite its contribution, there are several limitations of our article. These limitations also highlight the need for further research. First, the claims about specific characteristics of DEs and pre-reform capabilities of SOEs in DEs need to be further validated by a more comprehensive study of a number of DEs. This will help in a more rigorous classification of characteristics of DEs and distinct capabilities of SOEs in DEs. Second, the discussion on government's role in enabling effective adaptation of SOEs needs further expansion. This requires an identification of elements of reforms process design that are directly controlled by governments, and a study of how specific alternate steps of reforms process influence SOE adaptation capacity.

Third, although this paper has used the RBV in developing its central arguments, other theories like institution theory, organizational change and learning theories can also be used extensively to explore related aspects. Questions like 'How SOEs can effectively adapt to policy reforms in DEs?' and 'How do institutional changes effected by policy reforms lead to changed organizational requirements of SOEs in DEs?' can have a more comprehensive review with including the above-mentioned theories.

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FIGURE 1: THE PROPOSED FRAMEWORK