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Strategic Rigidity: The interplay of organizational levels in self-reinforcing processes

Abstract: This paper deals with a paradox in strategic decision-making of organizations: The persistence of inefficient strategies although alternatives are feasible that would lead to a better result. To examine this phenomena first concepts of strategy formation are analyzed. It will be shown that strategies and its (partial) results can be seen as the outcome of sequential decision-processes. For this reason the theory of path dependency is chosen as an appropriate approach to explain the rigidity of inefficient strategies. The theory of path dependency has become a popular approach to explain rigidities in economic processes and the persistence of inefficient outcomes. It stresses the importance of self-reinforcing mechanisms that lead to temporal interdependencies. However, most of the time only one single mechanism on one organizational level is applied to explain path dependency of organizations. Because of the complexity of organizations and the numerous interdependencies between different organizational levels, in two embedded single case studies – the development of the Bertelsmann book club and the Bankgesellschaft Berlin AG – the interplay of processes and mechanisms on different organizational levels is analyzed.

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1 Introduction

Why do organizations hold on to inefficient strategies? This question has been addressed by several researchers within the last years. While ecology populists stress out the relevance of ‘structural inertia’, and a resource based view refers to ‘organizational capabilities’ turning into rigidities, recently the theory of ‘path dependency’ has become a popular notion to explain resistance to change. Beside the claim of historicity, the central element of path dependencies is the mechanism of positive reinforcement finally leading to a lock-in.

In the literature, there exists a wide variety of different types of self-reinforcing mechanisms, stemming from various scientific disciplines. Anyhow, first of all, none of these reinforcing types has ever been applied and tested by studying a process of strategic decision-making in an organizational context. Secondly, to date every mechanism has been examined by its own, lacking research on the interplay of several mechanisms on different organizational levels as the central driver of strategic inertia. Hence, this paper contributes to fill these gaps by presenting two empirical cases of path dependent processes with reference to strategic decision-making within organizations. These cases have been chosen to show how different mechanisms on different levels within an organization work together, finally leading to strategic path dependency. Results reflect that especially the interrelationships between different types of mechanisms are causal for a form of path dependency that is both hard to detect and break away from. After this introduction, in the theoretical part we begin by giving a brief overview of the concepts dealing with strategic decision-making of organizations, covering the basic epistemological assumptions underlying this paper. This leads to the theory of path dependence, focussing on a concept to be applied on empirical phenomena of strategic decision-making in particular. The theoretical part finishes by giving a detailed conceptual model that represents the understanding of strategic path dependency on an organizational level. The empirical part is introduced by the methodological approach that has been followed during research, leading to the presentation of the two case studies on strategic path dependency. A conclusion in the last paragraph sums up the central empirical findings, reveals alternative and complementary explanations and outlines interesting fields for further research.

2 Theoretical framework: Strategic decision-making and path dependency

2.1 Strategic Decisions

Strategy derives from term “stratēgos” (ancient Greek for leading) and defined originally in a military sense the "draft[ing] the plan of war (...) shap[ing] the individual campaigns and within these, decid[ing] on the individual engagements“ (von Clausewitz 1976). The idea of defining long-term goals and the means to achieve them was first established in economic theory by von Neumann and Morgen and their theory of games in the late 1940s. Chandler (1962) and Ansoff (1965) refined the concept for an organizational context. But despite 40 years of research in strategic management, no consensus on its definition exists: “(...) Strategic Management (...) may ha[ve] many definitions as there are experts, and writers have discussed the lack of consensus over what a strategy is.” (Gore et al. 1992). However, the heterogeneous concepts dealing with strategic decision-making of organizations can be generally divided into two distinct schools of thought that are going to be presented in the following sections (Mintzberg 1990 and Ansoff 1991).

2.1.1 Prescriptive Concepts

Prescriptive Concepts focus on the question of *how organizations should decide* (Ansoff 1979). They try provide a basis for making viable and economic efficient decisions. Two basic assumptions are fundamental for the understanding of prescriptive concepts.[1]

First, prescriptive concepts of strategy formation assume that strategic decisions are high-level decisions. Strategic decisions are made at the top of the organization: “(...) the chief executive officer (...) is THE strategist“ (Mintzberg 1990). The Strategic decision-making of organizations is therefore seen as derivate of individual choices (March/ Olsen 1994). Because strategic decisions at the top of an organization determine lower-level decisions of an organization in the future, prescriptive concepts separate the strategic decision process from the implementation of the chosen strategy. A dichotomy between strategy formation and strategy implementation in prescriptive concepts can therefore be stated: “It (...) emphasizes the distinction between the few people on top who are allowed to think

[1] The reader is asked to bear in mind that although the other prescriptive schools of planning and positioning have broken with certain of the premises of the design school (...) they have accepted the most basic ones. Mintzberg 181

and the many below who are supposed to act.“ (Mintzberg (1990), 185) Hence, the dichotomy between formation and implementation in the prescriptive concepts corresponds to organizational hierarchy (Mintzberg 1990).

The second fundamental assumption underlying prescriptive concepts is that strategic formation is a controlled and deliberate process of planning. Based on the assumptions of neoclassical theory, strategic decisions of organizations are deliberate, rational and orientated to a clearly formulated and consistent set of goals. Organizations always – in subject to the available information and the information processing capacity – choose the best of all feasible means to achieve these goals (Parson (1947). These basic assumptions of the prescriptive concepts are criticized by descriptive concepts of strategic management.

2.1.2 Descriptive Concepts

The descriptive concepts have their origin in empirical studies of strategic decision-making. Unlike prescriptive concepts suggest, a deliberate and intended process of planning and implementation could not be observed in many cases. With regard to these empirical findings, descriptive concepts of strategic management do not try to answer the question how organizations should decide, but rather *how organizations decide in reality* (Mintzberg 1977). The theoretical findings of the descriptive concepts can be summarized as followed.

Strategies are often not the outcome of one big decision of a single strategist at the top of an organization, but rather emerge out of many small and disjoint decisions on lower-levels of the organization (Bresser 1998). In opposite to prescriptive concepts, in descriptive concepts the decisions of an organization gradually converge into the organization’s strategy. As a consequence, the descriptive concepts see the strategy of an organization as “a pattern in a stream of decisions” made by the organization (Mintzberg 1977). Henry Mintzberg (1977) therefore emphasizes that not all realized strategies of an organization were originally planned and deliberate: Strategies often emerge in an unintended way. The fact that a strategy is not (fully) deliberate or the consequences are not intended does not necessarily mean that this strategy cannot be successful: „It should be noted, however, that the degree of deliberateness is not a measure of the potential success of a strategy. In our research, we have come across rather emergent strategies as well as rather deliberate ones that have been highly successful (...)“ (Mintzberg/ Waters 1985).

The preceding analyses shows that despite the major differences in the way the prescriptive and descriptive concepts define the process of strategy formation, both concepts deem strategies as the outcome of – both deliberate rational high-level decisions and small condensing decision processes at the lower-levels of an organization – decision processes. Our paper follows this conclusion.

2.2 Path Dependency in strategic-decision processes

A process is defined as a sequence of actions and dynamic factors bringing about a result (Gore et al. (1992), 9). Regarding to processes, whose results are the long-term goals and objectives of an organization these actions are decisions in favor of a certain strategy and therefore strategic decisions. If the results of a pursued strategy are realized at one point in time, the process is called a one-level decision process. Sometimes however, the result of a process is realized in partial results in the course of time. In this case organizations have the chance to evaluate these partial results and to decide whether or not to continue the pursued strategy. It is just rational to hold to a specific decision of the past, if the strategy is efficient in the sense that there is no other feasible alternative that would lead to a better result. However, empirical examples show that organizations keep realizing an inefficient strategy. Numerous approaches such as the theory of commitment (see e.g. Staw and Ross 1987 or Brockner 1992) or concepts of organizational inertia (...) try to explain this ostensively unintelligible phenomena. However, these different approaches focus on the actuator' specific behavior to chose and its influencing factors; psychological as well as social factors in the theory of individual commitment to a falling course of action and political processes and structural inertia as explanations on the organizational level. Without doubt these concepts help to clarify in great parts why organizations stick to their established strategy. Anyhow, the explanations of persistent inefficient strategies are reduced to the action on the different bifurcation points. Because of this rather static approach, the underlying dynamics of the process are neglected. Here, the theory of path dependency and its idea of non ergodic processes appear to be an interesting approach to close this gap. In the following chapter the fundamental characteristics of path dependent processes will be shown.

2.2.1 The theory of path dependency

Although the theory of path dependency looks back to a long history in social science, the application of path dependence theory in an economic context can be traced back to David (1985) and Arthur (1989). Accordingly, path dependence theory challenges neoclassical assumptions by claiming three central features of any path dependent process: *Non-ergodicity, unpredictability,* and *irreversibility*. To start with, non-ergodicity implicates that during an emerging process several outcomes may be possible, as striking landmarks like sudden events, occurrences, or decisions may result in the redirection of a process. Accordingly, the result of an emerging process is hard to predict, as internal or external forces and events might form the process decisively. Anyhow, due to the path concept, the alternation of an emerging path gradually becomes impossible as special feedback loops inhibit the modification of the established pattern. Once a process has emerged, and decisions have been taken, the development is not reverseable.

Since the theory of path dependency has gained increasing popularity, it has been applied to various scientific disciplines. As a result its basic assumptions have been modified over time, to the effect that many phenomena related to inertia and rigidity are claimed to be path dependent. In order to prevent the explanatory power of the path dependence theory from an inflationary usage, this paper is founded on a narrow understanding of path dependent processes:

In this sense Sydow et al. (2005) designed a modified concept to be applied in organizational and interorganizational settings. Due to the dynamic character of path dependency, this concept includes a three-phased model in order to illustrate how path dependency emerges in the stream of time. Referring to processes of strategic decision-making, in the first phase at least two alternative strategies may be chosen. Although already coined by previous history, this early phase is seen as contingent, since each strategic option at least hypothetically has the chance to win over the rivalling one. Early events already influence the direction of decision-making, but still several outcomes seem possible. The occurrence of a critical juncture, triggered by small events, marks the turning point to phase two in the strategic development, as from this point in time positive feedback loops as a self-reinforcing mechanism come into play. Finally, as these increasing returns have generated sufficient momentum, the status of a lock-in in phase three has been reached. A particular strategy has established, locking-out any alternative solution.

In short, path dependent processes build on three main columns: Historicity in the sense that former events have an impact on following ones, the mechanism of self-reinforcement, and a lock-in in terms of rigidity. In opposition to the classical concept of path dependency, a strategic lock-in at the organizational level still implies a minimum of strategic contingency. Although the scope of action is highly limited, deviating choices may still be possible even though difficult and unlikely (Sydow et al. 2005).

Studying the underlying causes of strategic inertia from a path dependent perspective requires concentrating on the second phase coined by the mechanism of positive self-reinforcement. Here the central forces can be identified that influence the strategic direction of an organization towards rigidity.

2.2.2 Path dependency and mechanisms

By definition, a mechanism consists of "sequences of causally linked events that occur repeatedly in reality if certain conditions are given." (Mayntz 2004). This notion covers two central aspects: Firstly, mechanisms help to understand that bifurcation points in processes are intertemporally connected. In the face of strategic rigidity, the notion of mechanism reveals how the stream of decision-making has emerged in time. Secondly, statements about mechanisms can be generalized, and therefore – given specified initial conditions – potential outcomes may be anticipated. In order to study empirically strategic inertia from a retrospective point of view, this factor may not be central, as the status of rigidity already has occurred. Anyhow, the generalization of mechanisms becomes highly relevant, if the development towards inertia is still in progress, and an organization is in danger to become locked-in.

Single events within a process may be temporally interrelated by different types of mechanisms. Anyhow, path dependence theory particularly draws on the mechanism of positive self-reinforcement. This mechanism stems from the idea of positive feedback-loops, meaning that the increase of a particular variable leads to a further increase of this very variable (Arthur 1989, 1994). Following Sydow et. al (2005), Koch (2006) has complemented a catalogue of several categories that contributes to give the broad variety of different self-reinforcing feedback-types a certain order.

	Type of mechanism	Main focus
1	Economies of scale and scope	Cost
2	Direct and indirect network externalities	Utility
3	Learning	Skills/ Capabilities
4	Adaptive expectations and expectations of expectations	Standardization
5	Coordination effects	Interaction
6	Complementary Effects	Connectivity

Tab. 1: Types of self-reinforcing mechanism (Koch 2006).

As indicated in *table 1* each positive feedback mechanism – although all of them are self-reinforcing – works on different levels: Whereas economies of scale refer to a monetary or cost-driven dimension, the mechanism of learning, for example has to be identified by looking at the development of skills, routines and capabilities. Besides the distinction between these different levels of analysis one has consider that feedback loops can work within an organization only, but also between the organization and environmental factors. Accordingly, in order to identify organizational path dependency, one has to consider interconnections and organizational relationships with market conditions like customers and competitors, either.

Different intra-organizational levels like costs and skills as well as relationships external to the organization already indicate the complexity of self-reinforcing mechanisms that may form and drive an organization towards path dependency. With reference to the dynamics of an emerging path dependency, one has to integrate the dimension of 'time', as well. As mentioned above, the starting point of positive feedback loops can be located after a critical juncture. According to the understanding of path theory, they end by initializing the status of a lock-in. Anyhow, their influence is highest before the status of a lock-in has been reached, but even if an organization is locked-in, self-reinforcement and feedback loops may still work on the organization. Different feedback loops may alternate within the stream of the emerging path as well, or – on the contrary – cannibalize and compete against each other.

The attempt to explain strategic inertia by a single mechanism only fails to provide a general allowance of the interdependency and the interaction of processes on different levels of an organization. Therefore, in this paper we shed light on the complex interplay of different levels, dimensions and phases self-reinforcing mechanisms may work on in an organization. This is done by conducting two striking case studies that are to be presented in the section subsequent to the methodological chapter.

3 Methodology

The methodological part outlines how the construct of path dependency is operationalized and which data has been generated. At first, the research setting of a case study-design is discussed, followed by the methodology of qualitative data analysis. Finally, it is exposed by which indicators strategic rigidity and self-reinforcement are measured.

3.1 Research setting

The research is based on two in-depth single-case studies of the German Bertelsmann Book Club and the Bankgesellschaft Berlin AG. In both cases the unit of analysis covers the process of strategic decision-making. The cases are conducted longitudinally and retrospectively.

A couple of arguments underline the benefits of the conducted research design in order to study the object of investigation at hand. Firstly, "case studies are the preferred strategy when '*how*' and '*why*' questions are being exposed." (Yin 1994). Since it is the purpose of this paper to analyse *how processes on different organizational levels can lead to a self-reinforcing process*, the case-study design is found to be most useful for research. In a second place, case research is able to closely spotlight mere theoretical constructs by illustrating causal relationships in detail. In addition to that, and underlining the longitudinal character in particular, actually case research is needed to closely study how processes and their underlying dynamics reveal over time (Siggelkow 2007).

3.2 Data sources

Data were collected from three main sources: Company archives, public data, and semi-structured interviews.

Company archives included historical strategic plans, organization charts, internal memos and minutes of business meetings. The selection of relevant documents was guided by a deductively designed catalogue of keywords that were looked for in the index book of the archive. The list was inductively complemented. Publicly available data supplemented company documents. Historical annual reports, business press and trade magazine articles on both the focal organizations and the relevant market helped to document the strategic development of the Bertelsmann book club and the Bankgesellschaft Berlin AG. In the case of the book club a journal on the book market was completely scanned from 1950 to 2006. In the case of the Bankgesellschaft Berlin AG the same was done with all relevant national daily newspaper and news magazines from 1990 to 2001.[2] Again, the search was guided by a range of keywords, originating from theoretical implications, that was successively enhanced during the process of empirical research. Finally, in the case of the book club, a sample of current and ex-Bertelsmann employees as well as experts of the book market was interviewed. The sample included individuals that either influenced the strategic direction of the book club by themselves or were highly involved in its observation. In some cases this process involved interviewing retired employees as well as employees who had moved to other companies.

3.3 Research process

The investigation mainly covered two blocks: It was looked for strategic rigidity and a mechanism of positive reinforcement. Due to the dynamic character of path dependence, the whole process from 1950 to 2007 was analysed. Central time sequences were focused in utmost detail. Starting with the construct of strategic rigidity, three indicators have been identified. Firstly, a strategic development must be continuous over time. Since strategic continuity can only be named rigid if resistance to change is at hand, dynamic market conditions and economic inefficiencies have been looked for in a second and third step.

Although a firm’s strategic continuity, dynamic market conditions, and inefficiency already hint at strong inertial forces that may be explained by path dependence, as a necessary condition the mechanism of self-reinforcement has to be identified, either. Based on the theoretical assumptions of path dependence theory, indicators for positive reinforcement have deductively been exposed and looked for during field research (according to Koch 2006). In an iterative research process these indicators have been specified and complemented. Due to the focus of this paper, research implied the interaction and

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2 The sample included Berliner Morgenpost, Der Tagespiegel, Berliner Zeitung, Süddeutsche Zeitung, Frankfurter Allgemeine, Der Spiegel amongst others.

interconnectivity of self-reinforcing mechanisms at a micro-level within the focal organizations as well as between the organizations and environmental factors on a macro-level.

4 The case of the German Bertelsmann book club

The following findings are generated from an in-depth case study of the German Bertelsmann book club. After an outline of central strategic milestones in history, all three conditions for strategic rigidity are analysed chronologically: Strategic continuity, market dynamics, and economic inefficiencies. Finally, according to the theory of path dependence, it is looked for self-reinforcing mechanisms.

4.1 Historical development

Outlining the historical development of the Bertelsmann book club in Germany, one has to start right after the end of the Second World War in 1945. The production facilities of the publishing house ‘C. Bertelsmann’, originally founded in 1845 by the bookbinder Carl Bertelsmann, were almost completely destroyed during the war. Directly after the war, the reconstruction was started, and work was resumed in the very year 1945. According to its tradition, the publishing house focused on its classical portfolio, the production of theological, scientific, and ‘aesthetic’ – later called fictional – literature. Meeting the demand of the market, Bertelsmann had the idea to cooperate with book agents as sales representatives. Hence, it was possible to hit the rural areas and deliver large numbers of books to the customer directly. (Gööck 1968).
As the idea to sell its books in cooperation with travel agents turned out to quickly increase the sales, in 1950 Bertelsmann decided to found a book-club. The ‘Lesering’ was a membership-based club that offered and delivered an exclusive selection of books to its customers. The underlying idea of the book club was the large scale production of a highly selective range of books that already had been commercialized by the steady book-trade. Hence, in great parts, the business of the book club covered the trade with book licences. Due to the law of fixed book prices in Germany these book licences permitted the book club to print its own editions and offer them to its members at reduced prices. By contract, the members had to pay a certain fee and therefore were obliged to buy a number of books regularly. If a member did not order any book in time, a popular bestseller – the so

called ‘Hauptvorschlagsband’ – was sent automatically (Bramann et al. 1993).

The mail-order system by catalogues as the traditional distribution channel of the book club was successively expanded by chain stores in 1964 and online-demand in 2001. Beginning in 1962, Bertelsmann entered the foreign market and founded book-clubs in Spain, France, Great Britain and the Netherlands in analogy to the traditional German business model (Lehning 2003). The expansion is ongoing up to today, recently the idea of membership-based book clubs has been transferred to the Asian market (Handelsblatt 2005, 30.05.). In addition to the market segment of book clubs, Bertelsmann actively entered further domains of the media market. Up to 2007 Bertelsmann has become a multinational media corporation dealing in various segments of the media market.

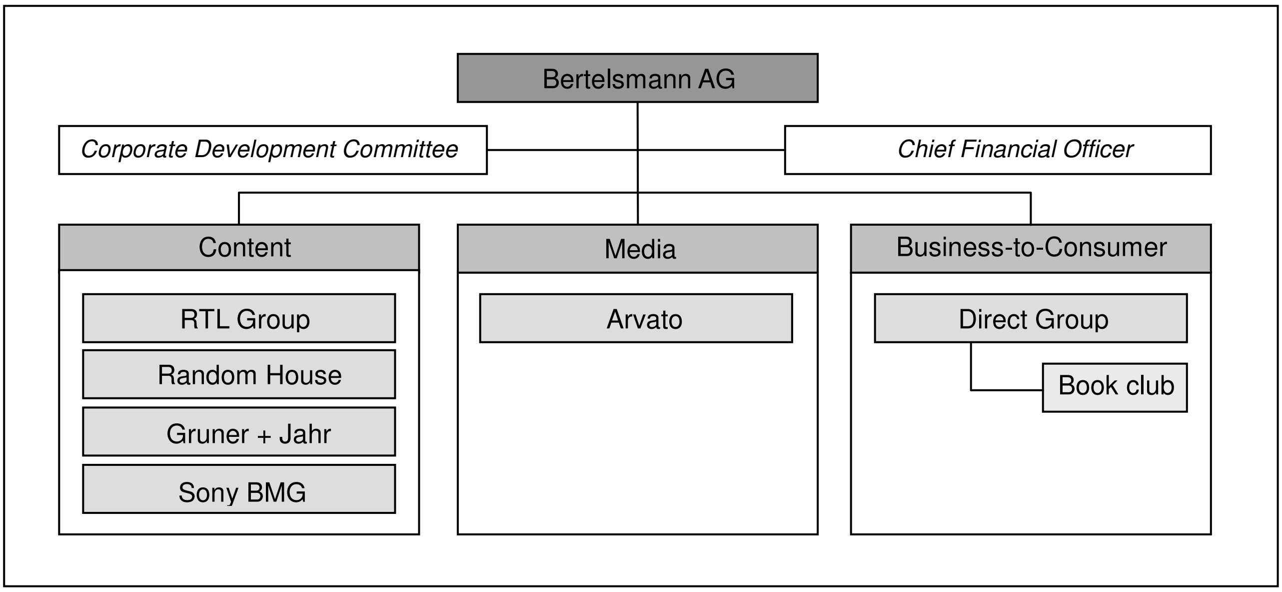

Fig. 1: Organizational structure of Bertelsmann AG (Schulze et al. 2005).

Due to the fact that the book club is embedded in a complex corporate structure, in this paper interconnections between other divisions are taken into account, too. Although the strategic path dependency is supposed to be found in the organization of the book club in particular, self-reinforcing mechanisms may develop between different sections within the whole corporation.

4.2 Strategic rigidity

As presented in the methodological part, strategic rigidity is based on three columns: Strategic continuity, dynamic environments, and economic inefficiencies. In order to detect strategic continuity, the development of both the business model and the product range have been analysed from 1950 up to today. According to the business model, in 1950 the book club was founded to directly distribute a limited range of books to its customers as members. In turn, the members benefited from lower prices compared to traditional bookshops. Empirical results revealed that these central features of the business model are kept stable in business history up to today (Bertelsmann 2006a, Bertelsmann 2006b).

Considering the development of the product range shows slightly different results, anyhow. Whereas for the first five years, exclusively books have been sold, since 1956 the product portfolio has been enlarged. Nowadays, in 2007, the club offers CDs, and DVDs, leisure articles like games and furniture. At first sight, the traditional book club has turned into a leisure club with a product range that widely surmounts books and media articles. Anyhow, continuous in time, the club always regarded its core business as a book trading one. In this sense, the enlargement of the club's portfolio is interpreted as supplementary – not to cannibalize but to support the selling of the books (Preußner 1989, Börsenblatt 1983, 31.03.). To conclude, both the business model and the book club's product range have been found to be continuous over time.

Besides continuity, market dynamics have been analysed to state strategic rigidity, either.

With reference to Porter's five forces (Porter 1980) results showed that from 1950 to today the conditions of the book market have become highly dynamic. Whereas in the first years after the foundation in 1950 a high demand for books could not be satisfied by the existing net of book stores (Gööck 1968) nowadays the German book market has become highly competitive and is lead by big chains like 'Hugendubel' or 'Thalia'. Additionally, online-trading companies like 'amazon.de' entered the German market, and competitors like 'Weltbild' established in the mail-order sector (Dörrich 1991; Börsenblatt online 2007, 08.05.). To summarize, the book market from 1950 up to today is found to be highly dynamic with reference to the market forces. Given the continuous strategic development of the book club in addition to these dynamic environmental conditions finally leads to the analysis of the club's economic situation over time. It was looked for both the development of the turnover rate and the membership base. Results proposed to subdivide the time-frame of analysis from 1950 to 2007 into three phases: The years from 1950 to 1970 were coined by exponential growth and tremendous success, whereas in the following phase from 1970 to 1990 commercial rates stagnated, resulting in the book club's reaction to consolidate and expand into foreign countries (Lehning 2003). A short-termed increase of the club's turnover-rate due to special effects in 1990 (buchreport.express, 22.09.1999) was followed by a phase of regression that is still ongoing. The headcount of members – about six million people in 1990 – decreased to three million people in 2007. In this very period from 1990 up to today, turnover steadily has shrunk, resulting in cumulated losses of 100 mio. euro within the last nine years (Handelsblatt 2006, 26.09.).

In short, strategic continuity, dynamic market conditions and economic inefficiency have been shown. These results imply that the strategic development of the Bertelsmann book club has lead to inertia.

Due to the theory of path dependency, the process having resulted in rigidity is to be analysed in terms of self-reinforcing mechanisms. This is done in the following paragraph.

4.3 Mechanisms of self-reinforcement

In order to understand the underlying logic of the book-club, the cost structure of book publishing has to be considered in detail. Book publication is characterized by substantial fixed costs (Shapiro/ Varian 1999). Submitted manuscripts have to be reviewed, accepted manuscripts have to be edited and proofread, typesetting may involve not just simple text but also formulae, charts and tables, and artwork and cover design have to be paid for. Consequently, there are largely fixed costs with respect to any title before the first copy is printed (Kandel 1996).

Bearing this cost structure in mind, during the growth from 1950 to 1960 the business model of the book club was highly beneficial due to large economies of scale (Roszinsky-Terjung 1981). With reference to its high membership base and the limited product range, the book club was able to market much higher circulation numbers than the traditional book-trade. Whereas on average a fictional book gained a number of 4.000 paid copies in the conventional market, the book club distributed about 100.000 copies at an average to its members (Schönstedt 1991). Taking into account that the bestselling 'Hauptvorschlagsband' in 1954 quarterly was sold with an edition of 400.000 copies illustrates the mass production of single titles (Gööck 1968). Given the high fixed costs of book-publishing in combination with this large scale production clearly reveals fundamental economies of scale with respect to the book club's business model.

In addition to that, the members' commitment by contract helped the book club to estimate its number of paid circulation quite exactly. One of the main economic shortcomings in the traditional book publishing sector is the high forecast-uncertainty. Publishing houses traditionally take high risks in estimating the possible scale of distribution, as they often cannot rely on assured data. Contrarily, the book club is able to anticipate its sales with high probability (Ludwig 1997).

Hence, various arguments counted for the replication of the established business model. In the face of an exponentially growing membership base and highly increasing returns from 1950-1960, the decision to keep on running the established business model was permanently reinforced. Continuous investments into recruiting new members by a complex system of advertising techniques further increased returns due to economies of scale. In turn, these benefits were invested to gain new members resulting in higher returns and so forth.

On the basis of this tremendous success successively a complementing infrastructure was built up to support the book club-business. Accordingly, existing publishing houses expanded, others were taken over or founded. In 1954 ‘Mohn & Co. GmbH’ as a printing house was founded in order to produce the books that were sold in the club (Gööck 1968). Finally, a logistic system was implemented which served to deliver and distribute the book club’s products. Hence, over time Bertelsmann established facilities over large parts of the supply chain in order to fully serve its book club business (Roszinksy-Terjung 1981).

In the light of the complex infrastructure of ‘Bertelsmann AG’ today (*see Fig. 1*) several business segments still originate from their interconnection with the book club.

These very interconnections have lead to complementary effects that firstly resulted in beneficial synergies, but turned to be constraining when market conditions changed and the economic success transformed into failure. A closer look at these connections reveals that still today mainly two complementing business units are highly interwoven with the book club.

Firstly, a wide range of publishing houses owned by ‘Bertelsmann AG’ deals with the book club. Data reveal that between 1960 and 1970 about 15% of the book-club’s licences stemmed from publishing houses owned by Bertelsmann. From 1970 to 1980, the rate increased to 25%. (Schönstedt 1991). Due to the definition of complementarities, these findings implicate that over time the decisions of the strategic development both of the publishing houses and the book club mutually reinforced each other. The increasing demand for licences by the book club successively increased the benefits of the publishing houses. Accordingly, both business units continuously got interconnected and directed their business strategy towards each other.

Similar results have been found between the division of ‘Arvato’ and the book club. ‘Arvato’ as a media service provider is specialized in printing, information technology, and services like logistics and database management (Bertelsmann 2007). Although ‘Arvato’ internationally has established as a profitable business unit on its own, still large scale business stems from its relation to the book club. Almost all books of the German book club are printed and delivered by ‘Arvato’ (FAZ 2006, 23.08.). Again, studying the past development of these two units exposes their mutual interference. Due to the exponential growth of the book club in the early years, ‘Mohn & Co. GmbH’ was founded as a supplementary firm in order to do the printings for the book club. Over time, additional services like logistics were included, and successively ‘Mohn & Co. GmbH’ – later called ‘Arvato’ – became in charge of most services for the book club. Both business units strategically got highly interwoven to the effect that nowadays the complementary business relations to ‘Arvato’ in part are causal for the continuation of the book club’s business (FAZ 2006, 23.08.).

Hence, although the book club itself generates losses for nearly ten years now, the establishment of strategic complementarities during the phase of high returns has lead to a highly restricted scope of action on a corporate level. Due to its coevolutionary development the book club has become indispensable for other units.

The interplay of the effects of economies of scale and complementarities is illustrated in *Figure 2*.

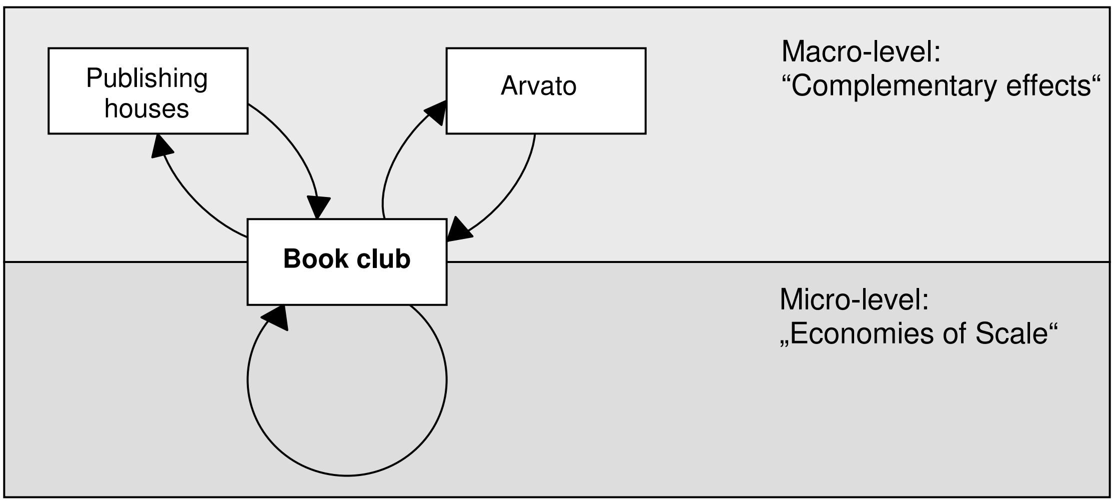

Fig. 2: Interplay of self-reinforcing mechanisms

5 The case of the Bankgesellschaft Berlin AG

Only seven years after the founding in 1994, the Bankgesellschaft Berlin AG faced a financial crisis that threatened the existence of the banking group. Because of a high increase of risk provisioning, the equity ratio dropped under the statutory quota of 8 percent. Bankruptcy of the Bankgesellschaft Berlin AG could only be averted because of large scale recapitalization at the amount of 2 billion euro: The crisis of the Bankgesellschaft Berlin AG in 2001 was therewith the biggest imbalance of a banking group in German post-war history. Investigations of a committee of inquiry from the State of Berlin revealed that this crisis was not the outcome of an unforeseeable and short-dated development, but rather the consequence of a questionable long-term strategy of the Bankgesellschaft Berlin AG in the business of closed property funds. Although the inefficiency of this strategy and its potential ruinous outcome were already known in 1997, the Bankgesellschaft Berlin AG held on to it. To identify the reasons for this strategic rigidity, at first the development of the Bankgesellschaft Berlin AG from 1994 to 2001 will be studied. Following, the importance of the closed property funds for the whole bank group will be outlined. In the subsequent paragraph the dynamics underlying this development will be shown.

5.1 Historical Development

The Bankgesellschaft Berlin AG[3] was a universal bank operating mainly in its core region Berlin and Brandenburg but also nationally and internationally. The Bankgesellschaft Berlin AG was founded in 1994 as a merger of Berliner Bank AG, Landesbank Berlin – Girozentrale – and Berlin Hyp AG together with all other subsidiary companies (Annual Report of the Bankgesellschaft Berlin AG 1994, 28). Main shareholder with 56.6 percent was the State of Berlin (Land Berlin), 15 percent were held by the Norddeutsche Landesbank – Girozentrale – (Nord/LB), 10 percent by the Gothaer and 18 percent by minority shareholders (see *figure 3*).

[3] The Bankgesellschaft Berlin AG changed its name to Landesbank Berlin AG in August 2006.

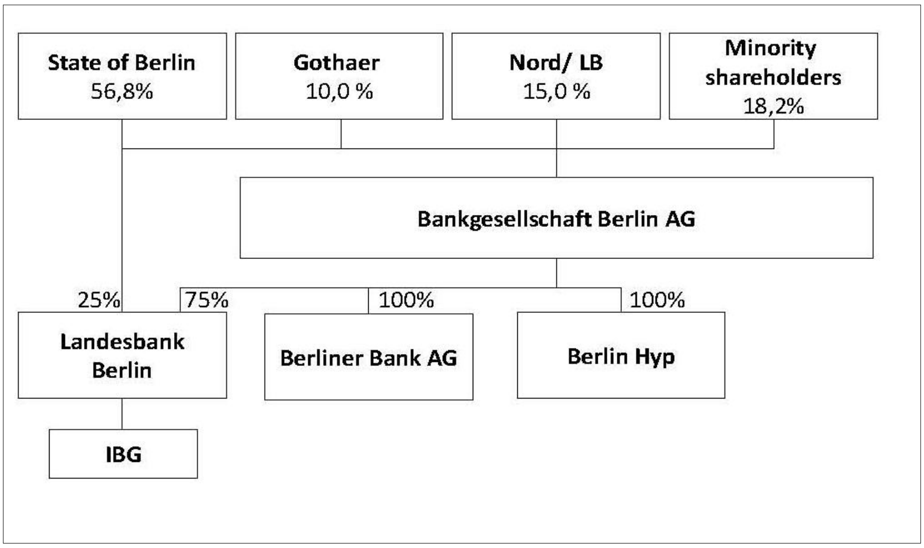

Fig. 3: Organizational structure of the Bankgesellschaft Berlin AG in 1994

With a balance sheet total of over 190 billion DM and 14.000 employees, the Bankgesellschaft Berlin AG immediately became the sixth largest banking group in Germany. The State of Berlin, as the majority shareholder of all three banks, pursued with the founding of the Bankgesellschaft Berlin AG definite financial goals. The primary financial objective was to disencumber the highly unbalenced budget of the State of Berlin. On the one hand, the State of Berlin did not need to finance necessary recapitalizations of the corporate affiliates anymore, because of the high equity ratio and endowment with capital of the Bankgesellschaft Berlin AG. On the other hand and even more important, the State of Berlin expected high revenues because of increasing commercial taxes and in particular because of dividend payouts. These expectations decisively influenced the further development of the Bankgesellschaft Berlin AG in the following years.

The development of the Bankgesellschaft Berlin AG in the first years was affected by its expansive strategy in profitable but risky businesses. The strategy was based on optimistic expectations of the economic development of Berlin and Brandenburg and necessary to obtain the strategic goal to pay out an annual dividend. But the expectations underlying the pursued strategy were belied. As a consequence the Bankgesellschaft Berlin AG had to announce an allowance for doubtful accounts at the amount of 2.5 billion DM in 1996 (Annual report of the Bankgesellschaft Berlin AG 1996, 10). Despite this enormous financial strain, the Bankgesellschaft Berlin AG declared a dividend on previous year's level. In order to fulfill this declaration hidden assets had to be released. However, the crisis led to a personnel turnover at the board of directors. At the turn of the year Wolfgang Rupf, who was appointed to the board of directors only months before, became chief executive officer. He was expected to reorganize the Bankgesellschaft Berlin AG, to cut costs of administration and, as a consequence of the high allowance, to expand the risk management and risk controlling within the banking group. But efforts of consolidation and the realization of synergy effects did not meet these expectations. Thus, annual returns of the corporate affiliates underperformed. As the Berliner Bank AG had to announce another value adjustment in 1998, the Berliner Bank AG slipped into a second serious crisis. That 1998 was at the same time the best business year for the Bankgesellschaft Berlin AG since its founding in 1994, could be traced back to the huge success of the closed property funds of the IBG.

5.2 Strategic rigidity

When the Bankgesellschaft Berlin AG was founded in 1994 the closed property funds were irrelevant regarding to strategic considerations. Within four years, however, the IBG became market leader in the German market of closed property funds; the annual asset of the closed property funds increased from 194.94 million euro in 1994 to almost two billion euros in 1997. With the increasing funds assets, the financial importance of the closed property funds increased contemporaneously. However, the issue of closed property funds also involved high financial risks that stemmed from unusually extensive guarantees. These guarantees included for example guaranteed rental incomes over a period of 25 years, a guaranteed withdrawal of the investors shares at 100 percent after 25 years or 115 percent after 30 years; therewith, the IBG assumed practically all potential risks from the investors. In the beginning of 2001, the publication of an internal minute of a board meeting of the Bankgesellschaft Berlin AG revealed that these risks summed up to over one billion euro. Thus, the equity ratio dropped under the statutory quota of 8 percent. The proscription of the extension of credits and therewith the inevitably resulting bankruptcy of the Bankgesellschaft Berlin AG could only be averted by a recapitalization by the State of Berlin in an amount of over 2 billion euro. Soon it became obvious, that the risks, associated with the closed property funds, were already known within the Bankgesellschaft Berlin AG since 1997.[4] However, the inefficient strategy was not only continued, but

4 See for example „Walther Report“ (June 1997), „Fides Report“ (November 1997) and “Report of the C&L

actually expanded: The Bankgesellschaft Berlin AG profited from the closed property because of *direct and indirect returns*.

5.3 Positive Feedback loops

The IBG obtained high earnings for the granted guarantees. These earnings allowed the IBG to make an annual net profit, which rose from 10 million DM in 1994 and 80 million DM in 1999. Because of a controlling and profit transfer agreement between the IBG and the Bankgesellschaft Berlin AG, the Bankgesellschaft Berlin AG *profited directly* from these surpluses. For the Bankgesellschaft Berlin AG the *indirect returns* of the closed property funds were of even greater importance. One quarter of the cost were cost for invisibles, like fees for the distribution of the shares of the funds and for the assumption of the external financing. These costs incurred primarily within the banking group, so that the affiliated banks of the Bankgesellschaft Berlin AG benefited from the closed property funds. The total utility for the Bankgesellschaft Berlin AG of direct and indirect returns summed up to 500 to 600 million DM per annum. Closed property funds therefore gained more and more importance for the Bankgesellschaft Berlin AG to obtain an annual net profit and to achieve the objective of paying an annual dividend (P_1): Without the earnings from the closed property funds, the annual returns of the Bankgesellschaft Berlin AG would had been negative from 1996 to 1999, and a dividend payout in 1996, 1997 and 1999 not be possible (Drucksache 15/4900).

However, these guarantees were seen as necessary for marketing policy and fundamental for the success of the closed property funds. Since the guarantees were based on optimistic expectations about the economic development of Berlin and Brandenburg and these expectations fell short, the closed property funds caused great expenditures about two to three years after their issue (P_{1+n}). To balance these expenditures out and to obtain a constant annual return, the IBG had to issue further closed property funds with a gradually increasing fund assets: Thus, a vicious circle of increasing expenditures and increasing risk developed (see *figure 4).*

Deutsche Revision"

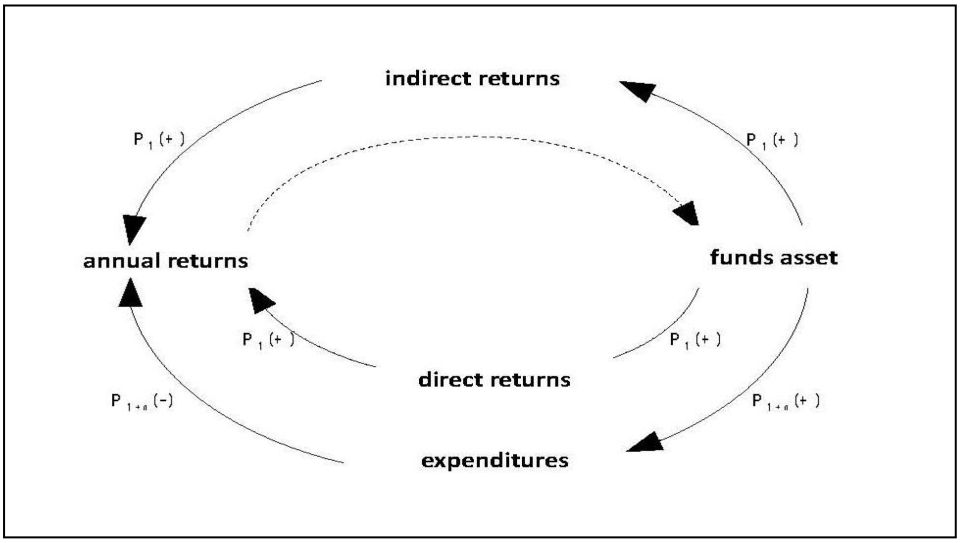

Fig. 4: Self-reinforcing processes

The self-reinforcing process thereby started on a lower organizational level and gradually grasped the whole organization. In the beginning the closed property funds were only of financial importance for the IBG. Without closed property funds in 1996 for example the IBG would had had to announce an annual shortfall of 44.3 million DM instead of an annual net profit of over 41 million DM. To outbalance the deficit the IBG had to increase annual funds asset. However, with an increasing funds asset, the closed property funds became more and more important for the whole banking group, because of indirect returns. This self reinforcing and escalating process was additionally enforced by the fact that the risk provisioning for expenditures caused by the closed property funds in the future was not sufficient. The combination of annual expenditures and the necessity of an appropriate risk provisioning led the Bankgesellschaft Berlin AG gradually to a strategic lock-in, where leaving the pursued strategy was not a possible any more. At the point where no further closed property funds would had been issued, the expenditures, the missing direct and indirect returns and the necessary risk provisioning would had debit the annual returns. A report of the audit firm Fasselt-Mette & Partner in March 2000 examined that the lack of risk provisioning had already summed up to over 1 billion dollar. The Bankgesellschaft Berlin AG had to announce an annual shortfall for 2000 in the amount of 1.684 billion euro (Annual report of the Bankgesellschaft Berlin AG 2000). The collapse of the Bankgesellschaft Berlin AG could only be averted through an external recapitalization by the State of Berlin.

6 Resume

This paper started with the question why organizations hold on to inefficient strategies. To answer this question, in a first step the two major concepts of strategic decision-making in organizations – the prescriptive and the descriptive concepts – were outlined. It became obvious that both see strategies as the outcome of decision processes, even though this decision processes are seen as deliberate and rational in the prescriptive concepts and rather as emerging and often unintended lower-level processes in the descriptive concepts. Hence, an approach was chosen to explain strategic rigidity that emphasizes the importance of temporally interdependencies of bifurcation points in processes: The theory of path dependency.

The theory of path dependency has been a popular concept to explain the inception and persistence of inefficient outcomes of economic processes. To be called path dependent, a process has to be a historical sequence of events, starting with contingency, followed by self-reinforcement, gradually leading to a lock-in. This idea had been transferred to strategic decision-processes, in which sequenced decisions in favor or against a pursued strategy mark the bifurcation points. To understand how self-reinforcing processes emerge, the development of the Bertelsmann book club between 1950 and 2007 and of the Bankgesellschaft Berlin AG between 1994 and 2001 were studied in two in-depth case studies. In both cases, the organizations held on to economically inefficient strategies. The empirical findings showed that in both cases this strategic rigidity can be traced back to underlying self-reinforcing processes. As traditionally assumed in the literature of path dependency these positive feedback processes were not caused by one single mechanism but rather the result of the interplay of different mechanisms on different organizational levels. In line with the complexity of organizations and its interactions with environmental factors several implications may be drawn from our results: Even though rigidity and inertia happen to occur within a single organization their emergence should be traced back by conducting a multi-level analysis. Moreover, in order to break an existing path, a detailed understanding of the interplay of mechanisms on different intra- and inter-organizational levels is found to be highly important.

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