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Degrees of Freedom: Rethinking the Institutional Analysis of Economic Change

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No self-respecting economist, political scientist, or sociologist today ignores the importance of institutions. In standard economics, institutional analysis has found a central place: endogenous growth theory, transaction costs economics, as well as the new economics of organization imply an active incorporation of institutions into theory; and since the seminal article by March and Olsen (1984), even hard core behavioural political science has been forced to come to terms with the structuring effect of institutions, while game-theoretic approaches in political science underscore the role of institutions in shaping outcome sets.

This chapter builds on and acknowledges these contributions of institutionalism, but is critical of some of its implications for the analysis of economic change. We agree with the (often unspoken) claim that institutional frameworks preclude certain trajectories of change: particular adjustment paths are highly unlikely, and probably impossible, because of how they rely on the presence of other elements in an institutional framework. What we take issue with is a tendency in this literature to reify institutional frameworks, which runs the risk of leading to an institutionally determined teleology. Institutional frameworks, we will argue, have the capacity to offer alternative adjustment paths that cannot simply be 'read off': how actors operate in particular institutional frameworks, and how they 'learn' to operate within it, matters for their effects. Similar institutions can therefore lead to

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different outcomes, and institutional frameworks can offer actors new adjustment paths beyond the immediately visible ones.

Our critique addresses both actual and potential problems that we see with the literature. While many authors are sensitive to the points we raise, too often the implications of these points seem to be ignored. Our aim with this chapter is to take stock of this implicit debate within institutionalism and use it as a means to improve institutional theory.

The chapter starts by reviewing the standard arguments on institutions and economic change, and then present our alternative view. Section 3.2 presents empirical material on economic adjustment from France and Germany. This suggests that the creative use of elements of the institutional frameworks by critical actors, and the re-articulation of existing elements, allowed them to adopt paths that were probably impossible to predict with the use of the conventional views on economic adjustment in these countries. Section 3.3 concludes.

3.1. **The Contributions and Limits of Institutional Theory**

From two decades of research within the 'new institutionalism' in political economy, economic sociology, and comparative business studies a broad consensus is emerging on the relation between institutions, economic action, and economic change. According to this view, institutional frameworks powerfully shape the reaction space of actors in a two-step process. The first step is related to the role of institutions in defining the scope and nature of new problems. Since institutional frameworks operate as filters for environmental stimuli, actors perceive similar challenges very differently in differently organized societies (Hall and Soskice 2001; Locke and Thelen 1995). The second step deals with the set of possible solutions that actors may perceive for the problems they identified. Since institutions are logically prior to interests in this view, the formation of preferences by economic actors is an endogenous result of the existing institutional structure (Berger 1982; Hall 1986; Steinmo et al. 1992), and in this process, institutions are not neutral (Zysman 1994: 244). In sum, actors pursue their strategies in accordance with the definition of both the problems and their interests as they have been shaped by the institutional structure.

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A classic example of this line of argument is Streeck's study (1989) on how German and US car producers both faced a crisis in the early 1980s, but responded very differently. The German manufacturers, eager to capitalize on the 'Made in Germany' label, went up-market, while the US producers primarily saw their crisis as a cost crisis, and thus started searching for cost reductions. The German strategy directly resulted from the constraints imposed by (among other things) the system of labour relations with strong unions at their core, which precluded a cost-based strategy, and the ability of these very institutions to constructively offer alternative paths; the effect was a move up the quality scale into less price-sensitive market segments. In contrast, labour law has allowed US producers to de-unionize large parts of their production system, and impose a series of cost savings which often took the form of massive workforce reductions in order to compete with Japanese producers on price.

Two related but analytically distinct implications for the analysis of economic action are associated with this view: one is that different institutional frameworks lead to divergence across market economies; the second is that they contribute significantly to maintaining differences across, and continuities within, nations. Both of these outcomes are related to the notion of path dependency, which itself emphasizes three issues: the importance of starting points, the role of (institutional) inefficiencies, and the importance of critical junctures (Deeg, Chapter 2, this volume; Herrigel and Wittke, Chapter 11, this volume). Early events, often of a formative nature, thus have a great influence on the sequence and character of future events (Pierson 2000: 252). The importance of being first is a direct function of the presence of increasing returns to scale, the importance of switching costs, and the way early events set limits on the range of possible future developments (Arthur 1994; Crouch and Farrell 2002; Pierson 2000). The institutional structure of a system of corporate governance, for example, depends on the initial structure in which domestic firms were first embedded (Bebchuk and Roe 1999).

Divergence across nations is a result of institutionally determined differences in power relations among actors, privileging some while demobilizing others (Hall 1986: 19; Pierson 2000; Steinmo et al. 1992). Institutional frameworks affect the power of actors in several different ways: their ability to overcome collective action dilemmas, their access to the decision-making process, and the resources at hand. By structuring both preferences and power, the institutional framework faced by domestic companies and other actors constitute a 'matrix of incentives and constraints that militates toward some kinds of firm behaviour and away from others' (Hall 1997: 181).

Finally, the process of institutional formation is critical and infrequent. There are critical junctures characterized by institutional change that send countries, firms, and other actors along different developmental paths that are then extremely difficult to reverse (Hall and Taylor 1996: 942; Thelen 1999: 387). The metaphor of the branches on a tree is insightful. Once you start going down on a particular branch, other branches down the tree are precluded. Any evaluation of this debate has to start by acknowledging how much this view of institutions and institutional change has helped us in understanding economic adjustment. In most general terms, it has made us aware of the role of history in defining the range of possible adjustment paths (see, for example, Hall 1986; Hall and Soskice 2001; Pierson 1994). It has also allowed us to capture better why some experiments in institutional reform fail (Levy 1999; Wood 1997), why economic adjustment, including workplace restructuring, took different forms in different countries (Streeck 1989, 1996; Turner 1991), and why competitive pressures in international markets have not led to a single sustainable model of capitalism (Hall and Soskice 2001). In all these cases, existing institutional frameworks limited the range of options for economic actors, structured their incentives to favour the initial path, and this was reflected in the differences in the outcomes.

Yet this position may overstate the power of institutional frameworks—and therefore of the nature of the constraints that actors may perceive. One part of this objection is empirical. Multiple adjustment paths and patterns of business organization often coexist within the same institutional framework: even among the small group of OECD countries, there are differences between companies, sectors, and regions within each of the countries. Within German capitalism, for example, there are many instances of weakly regulated labour markets, where the hard codetermination laws that govern the economy in the ideal–typical version found in textbooks do not hold sway, and where primary and secondary working conditions are set unilaterally (within a minimum legal framework) instead of negotiated between strong actors (Hassel 1999; Herrigel and Wittke, Chapter 11, this volume). Conversely, some companies in the United States have, against the odds, been able to successfully rely on cooperative labour relations, shop-floor workers' participation in self-steered teams, and strategic comanagement (Rubinstein and Kochan 2001). And the German political economy increasingly accommodates very different models of regional economic development, ranging from the symmetric model associated with the south-west of the country (Herrigel 1996), to a considerably more hierarchical model of relations between large firms and their suppliers as in the east of the country (Casper 1997).

Are these internal variations just noise, as highly ideal–typical treatments of (frequently national) institutional frameworks assume, or is there a logic to and perhaps a hierarchy among these multiple patterns (Crouch and Farrell 2002)? Rather than treating this as just random variation and thus defined away, the first question should be how these different patterns coexist. Since institutional adaptation often involves the resuscitation of existing but ignored elements of the dominant framework (as in institutional 'bricolage' or in the generalization of what was initially a niche strategy to the rest of the economy—the case of 'diversified quality production' in Germany, as Piore and Sabel (1984) have argued), understanding how these different elements are mutually articulated becomes a necessity for understanding change.

Our final objection to some of the applications of institutional theories deals with the question of what to make of paths that were ultimately not chosen. First of all, there is a basic methodological issue: how do we know they were not chosen? If choice entails an active option for one of at least two alternatives, we have to be able to demonstrate that these alternatives were actually there, if only in the sense that they were debated as a possibility. Failure to do so has vast methodological implications, since it implies that we are unable to distinguish between a lack of (awareness of) alternatives—the operational opposite of 'choice'—and choosing a particular option. But even if we assume the existence of alternative paths, the question that needs to be answered is why these were not chosen when the chance was offered. Is this 'choice' (or rather 'non-choice') explained by the mechanisms at the heart of the path-dependency argument (positive feedback and switching costs), or by other, perhaps very different mechanisms such as sudden exogenously determined reversals in the economic or political fortunes of some of the actors? Correlation is not causation, as we never cease to tell our students; yet, when it comes to the institutional analysis of economic adjustment, we all too often accept lower standards of proof.[1]

[1] Wood (1997) offers a good example of how this should be done. After demonstrating that the first Kohl government had a very ambitious agenda in economic policy, which included tax cuts, a restructuring of key labour market institutions (works councils and training system), privatizations, and deregulation, his analysis shows how and why German employers were very reluctant to go along with this programme. Their interest was to avoid a complete overhaul of the system, especially in labour relations, because it might endanger their product market strategies, which had been highly successful until then. Thus, a coalition emerged, which included the workers' wing of the ruling party, employers, and unions, against the (for German standards

The reaction against these deterministic views of institutions has appeared in two forms of constructivism. The first is the 'soft' constructivist position that institutions do not solely regulate economic action, but are elements of a quasi-constitutional order that 'produces' as much as regulates actors and their outcomes; rather than seeing both as independent, this view stresses their mutual construction. The best examples of this position are found in the literature on comparative capitalism, which often started from the deterministic views and then reintroduced actors in a more dynamic conception. Both Hall and Soskice (2001) and Whitley (1999), for example, demonstrate how the capabilities and resources that economic actors have at their disposal are a function of the institutional frameworks they find themselves in.

The second form of constructivism establishes a more radical break with the prevailing form of institutionalism. It emphasizes strategic action, and takes that to its logical conclusion: there are, in principle, no limits to the types of solutions that economic actors can bring to bear on problems they identify; indeed, since even the identification and conceptualization of a problem is socially constructed, institutions cannot be assumed to have any fixed quality whatsoever—neither for identifying problems, nor for finding solutions (Sabel and Zeitlin 1997). If institutional frameworks matter, it is because they offer elements to construct novel strategies—but these elements are always subject to a protracted process of redefinition and reconstruction, often up to the point that they may have little to do with what they were initially.

The problem with these constructivist views is that the soft view is not sufficiently distinct from the deterministic position, whereas the radical one has moved too far in the opposite direction. Regarding actors as constituted by institutions also imputes an institutionally determined rationality onto the situation: actors still pursue interests, but these interests are a direct function of the institutional framework they find themselves in. This implicit teleology evokes echoes of Wrong's critique of sociology's 'over-socialized conceptions' of actors (Wrong 1961): actors, either individually or collectively, do think, evaluate, develop strategies, and act upon these considerations. Treating each of these steps in the process as determined by the rules and norms that govern individuals, groups, and organizations, misses the point

radical) reform proposals, and the reforms died a silent death. Thelen (2000) takes the analysis further and demonstrates that parallel strategic considerations were at the basis of German employers' reluctance to adopt similar (but even more modest) reforms in the mid-1990s.

that actors can do unexpected things that do not necessarily follow directly from the institutional framework. Since actors are able to learn from the previous generation (of actors and of actions), they can quickly find themselves a step ahead of the institutional framework as they knew it. Institutional frameworks may constrain, in other words, but they may also offer new possibilities as a result of these constraints, because they allow for forms of learning that may extend beyond the possibilities recognized in the initial framework.

But the openness of institutional frameworks is, despite what radical constructivists seem to assert, not without limits. As Culpepper (2002) demonstrated, for example, without an adequate social and institutional infrastructure, it is impossible to construct high-skill training systems de novo. Attempts in the 1970s by successive Labour and Tory governments in the United Kingdom to forge a system of wage bargaining that helped check rampant inflation, failed largely because of the absence of underpinning institutions (Regini 1984). And as many countries in Eastern Europe are finding out today, building the institutions of capitalism involves more than simply importing them from abroad, especially if none of the necessary supporting institutions are present. As we will see in the case studies in the next section of this chapter, institutions do set limits on the direction of potential adjustment paths, even in extreme crisis situations. The initially healthy reaction by the radical constructivists to the single-scenario determinism of the dominant institutionalist theories may therefore have been an overreaction. Any notion of systemic institutional coherence (Aoki 2001; Hall and Soskice 2001) implies that particular paths are excluded or impossible: institutions do offer 'negative scenarios'.

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The position we defend here builds directly on these criticisms and has two components. The first is related to the underlying model of change. We think that the punctuated equilibrium metaphor which has invaded the analysis of change in political economy (and, to a lesser extent, economic sociology) over the last few decades (Krasner 1984) has led to a profound misunderstanding of processes of social, economic, and institutional change—a point noted early on, incidentally, in a famous essay by one of the 'fathers' of punctuated equilibrium theory in biology (Gould 1980). Human society does not evolve according to a slow-speed Darwinian model in which multiple generations are required to select small beneficial changes, and in which long periods of stasis are interrupted by sudden sharp crises and rapid changes. Instead it evolves according to a model that is closer to what Lamarck had in mind, in which traits acquired in one generation are transmitted to the next: human beings—and the social artefacts they construct, such as interest groups, companies, and other organizations—learn, both across and within generations.[2]

This argument has two immediate implications. First, change, rather than the stasis invoked by the punctuated equilibrium models, characterizes human societies, and organizations, as actors are permanently evaluating their position and the returns on that position. In addition, and in large part as a result, change can be extremely fast in principle, probably limited only by the speed with which actors recognize that a particular set-up does not serve their interests broadly defined. Institutional frameworks are therefore caught in an almost permanent process of redefinition, which allows actors operating within them to explore interpretations that can be very different from the ones that were initially intended.

Second, while institutional frameworks may be considerably more malleable and open than the conventional views assume, systemic constraints of internal coherence impose limits on this openness. This appears to us as one of the most important lessons from the institutionalist analysis of comparative economic organization over the last two decades. We leave open for the time being whether these systemic constraints are best conceived of in terms of a tightly coupled system with a single-point equilibrium (Aoki 2001; Hall and Soskice 2001) or of a looser, Weberian-inspired 'elective affinity' model (Lane 1995; Whitley 1999). What matters in our view is the emerging consensus in political economy and economic sociology that institutional cherry-picking rarely works as planned, precisely because (to push that metaphor) the cherries are hanging on a tree that they need in order to grow.

In the next section we develop our argument through summary accounts of how large firms in France and Germany adjusted to different pressures for change. In this process, as we will show, the institutional framework that they found themselves in acted as a constraint by precluding particular options. At the same time, however, many of these firms managed to exploit endogenous but often hidden degrees of freedom that the institutional framework offered. In the first account, on industrial renewal in France since the early 1980s, we

[2] Note that we are not suggesting, as the literature on policy learning does, that this is an apolitical process. Learning can be of a purely didactic type, but almost certainly involves deeply political processes: the construction of a problem, the inventory and development of resources (including power) at the disposal of protagonists, and the actual negotiations are an integral part of what we call 'learning' in the Lamarckian sense. Jacoby (2000) develops some of these arguments when discussing institutional transfer.

will show not only that French policy-makers were unable to emulate the German model which was the main signpost for their attempts to rejuvenate French industry, but also that the 'orphaned' institutions that emerged as a result of these attempts, became the object of a process of active reinterpretation by large firms—the leaders, by default, in French industrial adjustment during that period.

The second summary discusses the introduction of shareholder value in Germany. Despite the very similar pressures to those that occurred in other countries, most notably in the Anglo-Saxon economies in the 1980s, and which could have forced the corporate governance system in Germany down a similar path of rapidly expanding equity markets and outsider models of corporate governance, large firms in Germany adopted a model which carefully balanced workers' and shareholders' interests.

3.2. **Surprising Reorganizations of Large Firms in France and Germany**

Methodologically, both of these accounts can be read as critical cases for the view that institutional framework constrain actors in their search for solutions to new problems. The study of large firm adjustment in France has to be considered against the background of the conventional images of the French business system, often dating back to Crozier's seminal studies in the 1960s, which still inform much of today's economic sociology and political–economic analysis of the French economy. According to that view, French business is caught in a vicious circle of low trust and therefore hierarchical workplaces, high state involvement to overcome the problems that result from this workplace set-up, and therefore an endemic incapacity of economic actors—firms, associations, and trade unions—to change without central state intervention. Imagine now that such a centralized state-centred framework is facing an increasingly competitive international economy and that protectionism no longer is a viable political option because of European integration. The outcome is, or ought to be, a profound crisis without an endogenous solution, precisely because the central state seems to be the last actor to be able to provide that. Yet large firms in France not only managed to adjust quite successfully; they did so without relying on the state for guidance by exploiting the (perhaps limited but real) existing degrees of freedom they discovered in their institutional environment.

The second case study is constructed in a parallel way. Germany's institutional framework is considered to be highly restrictive in ways that often remind us of the 'stalemate society' that France was supposed to be. As a result, when large firms became exposed to pressures from international capital markets, large publicly quoted firms in Germany were facing several problems: the need to become more transparent, construct compatible incentive structures throughout the company, and more attention to the demands of institutional investors. At the same time, however, the system of codetermination, which gives workers and their representatives hard and soft participation rights in the companies, imposed hard constraints on how management could implement reforms that addressed their needs. Yet, the German codetermination system turned into an asset for corporate governance reform, and the reforms themselves strengthened the codetermination system because they imposed additional transparency on the companies. The apparently overwhelming constraint in this case study is the presence of several institutional constraints on the ability of managers to conduct the business strategy of the firm.

Note, first of all, that the institutional frameworks for economic action in these two cases have always been considered to be very different in comparative analyses (Levy 1999: 23–56; Maurice et al. 1986; Ziegler 1997; Zysman 1977, 1983). Then consider the outcomes: in both cases, the initial limits on the system imposed by the institutional frameworks restricted the nature of the options that large firms were able to engage. In both cases, adjustment followed a path that reflected the preexisting institutional framework. At the same time, however, the limits imposed by the institutional framework tell us little about the path actually adopted by the large firms in their adjustment, since in both cases the large firms reconfigured important elements in their environment so that they became compatible with the types of strategic solutions they were searching for. Institutional frameworks may have constrained the firms in their adjustment path, but they did not condemn them to a particular form of adjustment.

3.2.1. *The surprising modernization of French industry*

By the early 1980s, the French economic development model, which had served the country well up until then (see Boyer 1997; Levy 1999 for succinct accounts of the post-war French model), had ground to a halt. Economic growth slumped, inflation soared, productivity fell sharply, and corporate profitability followed suit. While it might be tempting to attribute this crisis to growing international competition which created competitiveness problems for the large firms, a closer look reveals that the difficulties of the French model were the result of an internal crisis of the French production regime, and exacerbated by the macroeconomic policies of the government between 1976 and 1983. Large firms faced a dramatic productivity and profitability crisis, and the macroeconomic stabilization policies pursued by the Left government after the U-turn in 1983 had two direct consequences for them. It made the 'traditional' French solution, which consisted of the state subsidizing the companies out of the crisis, impossible because of budget constraints and European competition policy. Additionally, the tight monetary policies, which led to high interest rates in support of the franc, aggravated the financial problems of the highly indebted large firms.

Between 1981 and 1984, French governments developed initiatives in three fields that were designed to support a forced reorganization of French industry while allowing the broad macroeconomic policy to pay off in the areas of labour relations, regional development, and finance. Policy-makers were actively looking for inspiration in Germany, and attempted to copy what they considered as mature institutions that critically contributed to German economic success onto French soil. The Auroux laws, the largest package of labour reforms in French history, were meant to create an industrial relations system that would simultaneously defuse the perennial workplace conflict and modernize the decision-making structures inside French companies. The Defferre reform package involved a series of measures that decentralized decision-making in many areas, one of which was economic development, towards the regions. The underlying aim was, with the strength of local economies in Germany in mind, to build the conditions for similar dynamic local industrial tissues in different regions in France. Finally, the financial system was reorganized to make banks more responsive to the needs of industry. Again, the German housebank system, which involved close ties between banks and companies, served as an example.

This German-inspired road turned out to be impossible to adopt, and as a result the well-intended reforms ultimately failed to produce the results they envisioned. The Auroux reforms ended up weakening instead of strengthening the unions, and the workplace reforms that did come about were not only very modest judged by their initial goals, but became building blocks in a management strategy to increase labour productivity. The decentralization of economic policy-making created a host of regional institutions for economic development, but with very little effect on how local industrial structures were organized. Finally, by rapidly introducing competition for both deposits and credits, the financial reform not only weakened the (previously highly protected) French banking sector, it also failed to live up to its goal of bringing the worlds of finance and industry closer to one another. As Levy (1999) convincingly argues in a review of these different policy initiatives, the reforms faced two types of problems: the first was that the actors that were supposed to be empowered by the new initiatives were too weak to carry them through on their own; the second was, ironically, that without the state, the actors that were supposed to be empowered—the trade unions, the banks, and regional economic actors—were unable to use the decentralization policies. Since none of the supporting institutions were in place, the policies fell on very dry soil, and ultimately failed.

However, while the policies may have failed because they targeted the wrong actors, large firms, through a process of trial and error, ended up deploying them as tools for their own restructuring—thereby radically altering the meaning and impact of the policies and institutions in the process. In many cases, management in the large firms had—or at least might have had—a reasonably clear idea about where to go, but was incapable of envisioning ways to get there because the French institutional framework constrained most of their steps: in 1984–85, at the apex of the crisis, the state was the outright owner of a large part of the economy, indirectly controlled the bulk of industrial credit as a result of the nationalized banking sector, indirectly set wage rates for the economy through the minimum wage, and induced strategies of economic development through indicative planning.

Large firms in France therefore had to reorganize their ties with the state, first and foremost the ownership patterns that linked them directly to the state—a process for which they relied on the new instruments that were born out of the financial deregulation cum privatization policies of the 1980s. In the nationalized companies management used the privatization policies to construct a corporate governance system that acted as a protective shield against both a potentially intrusive state and potentially highly nervous short-term capital markets. In the state-owned public services, the same was achieved through permanent renegotiation of the relationship between management and the state: stemming the losses of these companies required a profound internal reorganization which emphasized profitability, and these (internal and external) goals were written into the planning contracts between state and management, leading to increased operational autonomy of the latter. And in the private companies, management autonomy either never posed a problem, because the ownership and control structures provided management with the autonomy for restructuring it needed; or structures that secured autonomy had to be created.[3]

After this redefinition of the relative position of management *vis-à-vis* company owners, the second step was very similar in the different large companies: they set goals for their internal reorganization, and attempted to adjust their workforce and supplier system by introducing new organizational models that were slowly becoming standard organizational models in many other countries as well. Here, however, the old problems of the French model resurfaced under a new guise. Neither workers nor suppliers had the capacity to follow the companies in that new strategy. Many workers were low-skilled, which endangered a productivity drive, the labour relations system was conflictual rather than cooperative, and suppliers were technologically underdeveloped, organizationally weak, and underfinanced. The large firms squared the circle by relying heavily on a wide collection of state policies that dealt with a reorganization of the labour market to restructure their workforce. At the same time, they used the new institutions for local economic development to reorganize their supplier base: they enlisted municipal and regional development agencies, technology centres, training institutes, and employment offices to support their suppliers in the forced upgrade.

Thus, while the 'German' option of decentralized production that relied on workers' skills, cooperative labour relations, deep competencies of suppliers, and an active involvement of banks in corporate governance turned out to be unfeasible because the underlying centralized and adversarial institutional framework was unable to accommodate such a shift, French industry adjusted by finding its own route. The large firms adjusted, not as a result of trajectories imposed by the state, but by actively constructing a new institutional environment that fitted with what they perceived as their new needs, using these new tools to further their internal adjustment, and explore new markets. In order to accomplish this, they borrowed elements from failed government

[3] In some cases, this could take a long time and be subject to significant internal tensions which for a long time blocked any attempt at organizational restructuring and heavily burdened the future adjustment of the company, as in Moulinex (see Hancké 2002: Chapter 6).

policies in the areas of corporate governance (to secure independence from the state and capital markets), and from decentralizing policies in labour relations and economic planning (to support their productivity drives). The French institutional framework of the 1980s may have precluded the preferred up-market option, but it also offered creative large firms instruments for their adjustment.

3.2.2. *Corporate governance reform and codetermination in Germany*

The German system of corporate governance has been described as the paradigm case of coordinated market economies in advanced capitalism. The central institutions governing the German system, themselves tightly linked in a wider framework, included a concentrated ownership structure with friendly domestic banks and firms at its core, a reliance on bank loans and retained earnings as a source of finance, accounting and disclosure standards that favour the accumulation of hidden reserves, and therefore do not accurately reflect market value, and a system of industrial relations characterized by the participation of employees at the firm level through codetermination rights at the plant and board levels (Hall and Soskice 2001; Thelen 1991; Zysman 1983).

The cosy world of German corporate governance was rocked by developments in the 1990s, both at the domestic and international level, that significantly contributed to the rise of shareholder value as a key reference point for companies (compare Deeg, Chapter 2; Lane, Chapter 4, this volume). One critical driver was probably financial liberalization, which had two important consequences. On the one hand, it pushed up interest rates as banks were forced to compete for deposits with new competitors; on the other, the use of derivatives and other exotic financial instruments exploded. The high cost of capital and the availability of alternatives encouraged large German companies to tap into international financial markets (Deeg 1999). In addition to financial liberalization, an increasing percentage of takeovers in the United States and in other advanced industrialized countries have been financed by equity swaps (Rappaport and Sirower 1999: 147–51), which implies that firms with a higher market capitalization possess a substantial advantage in the global M&A marketplace (Coffee 1999: 649). At the same time, the ownership structure of German companies evolved from one centered upon domestic banks and non-financial enterprises to one in which financially committed institutional investors became more important, which has increased substantial pressures for greater financial returns, and therefore put pressure on its system of corporate governance—and of the position of employees within it (Hoepner 2001: 6).

The institutional framework that prevailed in Germany in the 1980s and 1990s, and the rights and position of works councils in the firm in particular, foreclosed the option of rapid and deep restructuring of large firms. While legal participation rights of works councils are strong in social matters, weaker over personal issues, and modest in economic and financial matters (Müller-Jentsch 1995), they have been able to use their veto power strategically in some areas through linking outcomes there to other issues where they have weaker rights. The works council at the Volkswagen's Braunschweig plant, for example, used its codetermination rights on working times and wage grades to demand an expansion of the skills and training funds for affected workers in the 1980s (Thelen 1991: 213). In addition, the position of organized labour and the works councils in the training system has enabled them to impose significant constraints on hiring new personnel when a company scaled back its activities to a few core competencies: since new training programmes have to be approved by an expert body in which organized labour holds half the seats, they have de facto veto power over these programmes.

While the existing institutional framework of German corporate governance significantly limited the availability of options, and of a trajectory based on deregulation in particular, it also offered a series of possible adjustment paths. One possible outcome—often lamented in the German and international business press—was immobilism as a result of the mutual veto positions of all the actors; a creative reconfiguration of the institutions of the other. However, the German system of corporate governance has been characterized by considerable change. Some large companies have adopted elements of shareholder value priorities in their strategy (Goyer 2003; Hoepner 2001). Of all the changes in the German system of corporate governance over the last decade, the adoption of financial transparency was perhaps the most important one (see Goyer 2003: 191–8). In 1996, only nine firms of Germany's largest 120 were using an international accounting standard. By 2001 that figure had risen to ninety-six, and this figure included all the members of the DAX 30 stock market index. In contrast, other measures usually associated with shareholder value, such as a focus on core business activities, have not become a new model for German firms.

The adoption of financial transparency as a strategy of shareholder value demonstrates the flexibility of the German institutional framework. At their core, international accounting standards make it close to impossible to accumulate hidden reserves, and as a result reflect the market value of the firm better than the conventional German standards. Moreover, quarterly reports force firms to provide plenty of additional information on a continual basis while making cross-subsidies between units more visible. These effects protect the interests of outside shareholders in the firm. But financial transparency also has the effect of increasing the information available to employees, especially in a 'thick information' setting like the German one—thus increasing their ability to monitor management. It should therefore not come as a surprise that employees have generally supported the introduction of greater financial transparency (Hoepner 2001: 27).

This suggests that the institutions of corporate governance can complement each other in different ways under different conditions. The firm-level codetermination scheme found in Germany is perfectly compatible with financial transparency under a shareholder value-oriented system—as it was under the previous bank-based financial system in which German accounting standards protected firms against short-term financial demands. Since the adoption of greater financial transparency was a negotiated process with employee representatives (Hoepner 2001: 27–8), employees can act as informed and credible participants in the process of firm adjustment, thereby reducing managerial incentives to act in a unilateral manner. The active participation of employees in firm restructuring has allowed the institutions of codetermination to both resist the deregulatory consequences associated with the advent of flexibility and of shareholder value strategies, and to turn them into instruments that reinforce existing employee representation models.

Moreover, the negotiated adoption of some shareholder value strategies in Germany took place in an overall context in which employees have been able to shape the patterns of adjustment to changes on world markets. In particular, the use of firm-level agreements has been a new element of the interaction between works councils and management in Germany. Works councils have also used their position to negotiate comprehensive restructuring packages designed to allow for the introduction of shareholder value measures without relying on wage cuts, dismissals, and external labour flexibility (Streeck 2001: 26). Over half of the 100 largest German companies have negotiated 'location agreement' and 'employment pacts', trading wages for job security, in the latter half of the 1990s. And slightly fewer than twenty of these have also included specific investment plans for the next 2–4 years in exchange for more flexible work shifts and a reduction in company bonuses and wages. The aim of these plant agreements was to improve the competitiveness of firms in a context of global competition, and they therefore make portfolio restructuring through dismissals of workers in peripheral units a less attractive option.

What lesson does the transformation of German corporate governance entail for the study of institutions? The German political economy—and its system of corporate governance in particular—has often been analysed as a mixture of constraints and incentives (Streeck 1992). The ability of management to implement strategies of adjustment in a unilateral manner is constrained by several factors, most notably the legal rights of works councils and trade unions. On the other hand, and in contrast to the arrangements found elsewhere, the institutional arrangements of German companies provide management with opportunities to include employees in the development and conduct of the business strategy of the firm (Thelen 1991).

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While we agree with this view, we would emphasize that some of the enabling features of the German model are not related to the institutions per se, but result from experimenting and learning by actors. The various constraining elements of the German institutional framework—barriers on dismissals, legal rights of works councils, training requirements, and others—could be introduced by legislation in other countries. By contrast, only some of the enabling arrangements of the German system—such as associational governance of training or the inability of firms to poach skilled workers—could be copied via legislation.

For example, in many large firms works councils have used their legal rights to become de facto comanagers of the firm, and thereby have often been key actors in the introduction of competitiveness-enhancing rationalization schemes (Herrigel and Wittke, Chapter 11, this volume; Müller-Jentsch 1995). The willingness of works councils to become positively involved in the business strategy of the firm reflects the choices and strategies of actors in light of two key developments. The first is the decentralization of wage bargaining in Germany—and the rise in importance of several new firm-level issues—has increased the importance of works councils at the expense of national unions. However, the decentralization of wage bargaining is not unique to Germany, and its consequences on the behaviour of works councils differ across nations as the French and Swedish cases demonstrate (Howell 1992; Thelen 1993). In these two countries, the weakness of firm-level works councils entailed that the decentralization of wage bargaining meant that either trade unions faced a major identity crisis that required fundamental institutional changes (Sweden) or that firm-level flexibility came to be associated with straightforward deregulation of the labour market (France). The decentralization of wage bargaining and the rise of importance of firm-level issues, however, cannot by themselves account for the strategy and actions of works councils in Germany.

The second development is the negotiated introduction of shareholder value strategies in Germany—but which is not unique to the field of corporate governance. Economic adjustment over the last fifteen years has often been framed by negotiations between employees and management at the national level. One can point to the tripartite committee on the Alliance for Jobs and the process of social concertation as embodied in social pacts as prime examples of the negotiated adjustment of the German political economy (Regini 2000). Package deals linking issues across several policy fields—employment and social policies, wage bargaining, welfare reform—have been the main outcome of these negotiations.[4]

The negotiated character of changes in German corporate governance and other policy areas accounts for the willingness of works councils to become active participants in the strategy of the firm, since it has provided employees with the ability to act as informed and credible participants in the process of firm adjustment, thereby reducing managerial incentives to act in a unilateral manner. The active participation of employees in firm restructuring has led to a situation without the potentially deregulatory consequences associated with the advent of flexibility and of shareholder value strategies. Codetermination therefore seems to have evolved from a set of institutions designed to reconcile class conflict into a framework in which the competitiveness requirements are internalized in part by the ability of works councils to act as a strategic partner for management (Hoepner 2001).

[4] See also the above discussion on the introduction of firm-level agreements on location and employment in Germany.

3.3. Conclusion

This chapter has argued that the dominant view of institutions in contemporary political economy increasingly seems to miss important dynamic elements of economic change. Most importantly the view of change associated with this approach—path dependency—is unable to make proper sense of two disturbing elements. The first is how to analyse the coexistence of different organizational patterns within one national economy. In essence, the dominant views define those away as statistical noise. The second was how to make sense of possible adjustment paths that were 'not chosen'—were they the result of the feedback mechanisms at the basis of the path-dependency view? Both problems follow from an inadequate conceptualization of the interaction between institutional frameworks and actors that underlies the dominant view.

The two summaries of corporate adjustment in France and Germany over the last two decades demonstrated the need for a view that treated institutions not simply as constraints under which actors optimize adjustment paths. Rather than simply imposing constraints, as we demonstrated, institutional frameworks also provide elements that actors can creatively use to build responses to new challenges. In the case of large firm adjustment in France, the initial road, inspired by the institutions that were associated with German economic success, was impossible because many of the underlying arrangements found in Germany were simply not present in France. But, instead of being trapped in this situation, firms then began to actively construct a new institutional framework, with elements of existing old and new policies and institutions that met their needs. Similarly, instead of being caught in the maelstrom of shareholder value, which supposedly pits managers and owners against workers, the codetermination system in Germany became a crucial institutional vehicle for managing external pressures.

This suggests that institutions embody multiple potential scripts. Historical institutionalism seems to (and, in all fairness, often does) give convincing ex post explanations for why one of these scripts prevailed. However, it is frequently unclear if two conditions held: were there real alternatives that were actively debated, and did the ultimate choice follow from the rational calculus of actors? Explaining why some options were not chosen is therefore equally important as why some were chosen; the burden of proof is—especially in the case of historical continuity—as much on 'why not?' as on 'why'.

This is not a call for establishing counterfactual histories, or for disappearing down a methodological black hole in trying to answer the usually overdetermined question of why something did not happen (Emigh 1997). What we suggest is that explaining institutional continuity—perhaps especially continuity—resulting from path dependency requires more careful research designs, often of a comparative nature, to demonstrate how choices were made, and that these choices reflected the rational calculus mechanisms at the basis of path-dependency arguments.

But the path-dependency arguments have made a few important methodological and theoretical contributions, to which we should remain attentive. The chances for success of institutional change or reform are not distributed symmetrically. It is, for example, much easier to actively deregulate a labour market (as Thatcher and Reagan demonstrated in the 1980s), than to build a new, non-market based, institutional framework (as the French discovered—see Culpepper 2002). Similarly, some piecemeal reforms of elements in institutional frameworks might be simply impossible because they are inconsistent with other elements in the framework. Even in its weakest version, institutional complementarities impose a degree of institutional congruence that cannot simply be ignored.[5]

As a result, some adjustment paths may be impossible—the French political economy, for example, may have had many options open, but the German road that policy-makers aspired to was definitely not one of them (Culpepper 2001; Hancké 2002; Levy 1999). However, identifying what is impossible says little about what is possible. This is where the limits of the historical–institutionalist approach, as exemplified in the path-dependency argument, become apparent.

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[5] Amable (2000) suggests to think in terms of 'hierarchies' of institutions: some institutions within a framework set parameters for the development and operation of other institutions.

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