Institutional Change in Varieties of Capitalism

Peter A. Hall and Kathleen Thelen

Minda de Gunzburg Center for European Studies
Harvard University
27 Kirkland Street
Cambridge MA 02138
phall@fas.harvard.edu

Department of Political Science,
Northwestern University
601 University Place,
Evanston, IL 60208
thelen@northwestern.edu

Paper prepared for presentation to the Europeanists Conference, Chicago, March 2006

For purposes of discussion. Draft to be revised further. Comments welcome.

Comparative political economists have become deeply interested in processes of institutional change, and especially in those taking place in response to the opening of world markets associated with 'globalization' (Schmidt 2002; Djelic and Quack 2003; Rieger and Leibfried 2003; Campbell 2004). They are asking a number of questions. When do the institutions of the political economy change? What factors drive change? Are changes in the international economy enforcing institutional convergence on the developed economies?

We take up these issues with reference to one of the more influential frameworks devised to explain national differences in economic performance and policy, namely the 'varieties of capitalism' perspective now employed by a substantial number of scholars (see Hall and Soskice 2001). Building on the literatures of neo-corporatism and the 'regulation school', this approach applies the new economics of organization to the macroeconomy. It focuses on firms, as actors central to the process of economic adjustment with core competencies that depend on the quality of the relations they develop with other actors, including producer groups, employees and other firms. Those relationships depend, in turn, on the institutional support provided for them in the political economy as a whole. Although the perspective acknowledges that these relationships can take on a wide range of forms, it emphasizes the distinction between liberal market economies, where firms rely heavily on competitive markets to coordinate their endeavors, and coordinated market economies, where more endeavors are coordinated strategically. These different modes of coordination are said to confer comparative institutional advantages that mediate national responses to globalization. They rest on institutional complementarities that allow arrangements in one sphere of the

political economy to enhance the results secured in others. The framework provides distinctive perspectives on many of the issues raised by globalization.

However, questions have been raised about the adequacy of the varieties-of-capitalism perspective for understanding institutional change. Some argue that this approach is overly static and its distinction between liberal and coordinated market economies outmoded by the liberalization of the world's economies. Others read into it an overweening functionalism that explains institutional change by reference to its macroeconomic effects and suggest the approach neglects the social or political dimensions of institutional change.[1] These critiques raise important issues that go well beyond the Hall and Soskice (2001) volume. The varieties-of-capitalism approach offers fresh and intriguing insights into differences among the developed economies, but it can hardly be considered viable if it cannot also comprehend processes of institutional change. Many of the criticisms suggest that the equilibrium elements of the new economics of organization analysis are inimical to dynamic analysis and that rationalist approaches understate the chaotic quality of institutional change or the contribution unintended consequences make to it. These concerns have significance for the analysis of institutional change more generally.

The object of this paper is to address these issues by elaborating an account of institutional change more extended than the one provided in Hall and Soskice (2001) but congruent with its varieties-of-capitalism perspective. Our claim is that this perspective embodies a sophisticated understanding of institutional change that is eminently political and useful for analyzing contemporary developments in the developed political economies. We show that the equilibrium aspects of this approach are not incompatible

with dynamic views of the political economy and why broadly rationalist approaches to the political economy need not imply a barren functionalism.

We proceed by developing a series of propositions about the nature of institutions and the sources of institutional stability that we then use to develop contentions about institutional change. Our focus is on the institutions of the political economy in the realms of industrial relations, corporate governance, vocational training and technology transfer. Although our principal objective is to outline a theoretical perspective, we provide some preliminary substantiation for its propositions with reference to recent developments in Europe and Germany, a key case for analysts of change in the political economy. We conclude by drawing some general conclusions about the trajectory of the European economies today.

1. The Institutional Terrain

In this paper, we conceptualize institutions as a set of regularized practices with a rule-like quality in the sense that the actors expect the practices to be observed, and which in some but not all cases are supported by formal sanctions. They can range from regulations backed by the force of law or organizational procedure, such as the rules that apply when a worker is laid off, to more informal practices that have a conventional character, such as the expectation that firms will offer a certain number of apprenticeships.[2] In some cases, macro-institutions, such as the 'vocational training system' are composed of many component rules and practices that are themselves institutions.

Compared to alternative perspectives, several features of the varieties-of-capitalism approach to institutions are distinctive. As an actor-centered and broadly-rationalist approach, it conceptualizes the political economy as a terrain peopled with entrepreneurial actors seeking to advance their interests as they construe them, constrained in this by existing rules and institutions but also looking for ways to make institutions work for them.[3] The political economy is said to be replete with a multiplicity of institutions, many nested inside others. Some can serve as functional substitutes for other institutions, at least for some purposes.[4] Several important implications follow.

First, this perspective suggests that institutions are best seen, not as a rigid matrix of sanctions and incentives to which actors respond in relatively mechanical fashion, but as resources that actors use to attain their ends, in some cases switching from one institution to another when it seems more likely to serve their purposes. Although some institutions rely on sanctions for their operation, the varieties-of-capitalism approach moves away from a view of institutions purely as factors that constrain action toward one that sees them also as resources, providing opportunities for particular types of action, and especially collective action (see Hall 1998).

Second, this perspective implies that institutions are not simply the embodiment of strategic action, as some would have it, but can be the target or objects of such action (cf. Calvert 1995a). Because they face a multiplicity of institutions, actors often have a choice about which institutions to operate within. Any given strategy adopted by a firm or other actor is also likely to be conditioned, not by one, but by a number of institutions. Because the varieties-of-capitalism approach emphasizes institutional interaction effects,

it argues that firm strategies are conditioned simultaneously by multiple institutions, often in different spheres of the political economy (Hall and Soskice 2001: 21-36).

There are important points of tangency between this perspective and some other well-known approaches to institutions. From the 'logic of appropriateness' approach favored by some new institutionalists, this perspective accepts the point that institutions may sometimes influence action because they are seen as appropriate to the endeavor at hand from the perspective of a particular cultural worldview (March and Olsen 1989; Dobbin 2000). From the 'institutions as equilibrium' approach advanced by Calvert (1995a, b) and others, it accepts the observation that the stability of a particular pattern of strategic interaction often rests on the absence of Pareto-improving alternatives apparent to the actors under current conditions. Although often presented as polar opposites, we do not regard these perspectives to be mutually exclusive in a real world that contains many motives for and patterns of behavior.

However, neither of these approaches fully conveys the 'institutions as resources' element of our perspective and, if carried to extremes, both of these alternatives overstate the degree to which any one institution determines action. To say that an institution specifies patterns of behavior seen as appropriate to the culture should not be taken to imply that all or even most in that culture adhere slavishly to it. There is always room, and often reason, to be critical of what is deemed 'appropriate'. Similarly, although the mutual benefits of strategic interaction may render an institution more stable, that observation says only a little about how institutions are sustained, because it ignores the omnipresent processes of search and negotiation whereby entrepreneurial actors look for and attempt to agree on alternative ways in which to advance their interests (Knight

1995). There is more intrinsic openness to the institutional arena than these two perspectives imply.

2. Institutional Stability as a Political Problem

Why do actors adhere to the regularized practices that constitute an institution? Any analysis of how institutions change should begin from a conception of how institutions are sustained during periods when they remain stable.

The account we have just given of the institutional terrain generates answers to this question of a specific kind. Institutionalized behavior may resemble the following of rules but the principal motivation of actors for adhering to regularized practices lies in efforts to advance their self-interest as they construe it. Thus, most institutions in the political economy rest, not on practices of passive rule-following, but on a more active process in which entrepreneurial actors seek to advance their interests, especially in contexts of strategic interaction where appropriate institutions can improve the well-being of those who participate in them by resolving the collective action dilemmas they face. Such a view belies any simple notions of 'institutional inertia'.

Moreover, it calls for some revision in the way in which 'coordination' is construed. In game-theoretic analyses, 'coordination' is seen all too often as a pattern of behavior that arises relatively spontaneously, when the opportunity for it appears among actors who are seen as contractors.[5] Coordination is said to follow directly from the presence of supportive institutions. By contrast, from the perspective we are elaborating here, the achievement of coordination appears as a political problem. Coordination is not easily secured and rarely follows automatically from the presence of certain institutions.

Instead, active support for coordination must be mobilized on a relatively continuous basis from actors who are conscious of its limitations as well as its advantages.[6]

A good deal of the politics surrounding institutional stability flows from the loose coupling between self-interest and institutions. From the broadly rationalist perspective we adopt here, the durability of an institution can rest substantially, if rarely wholly, on how well it serves the interests of the relevant actors. Where an institution fails to serve those interests, it becomes more fragile and susceptible to defection. But the calculation about whether an institutional practice serves the actors' interests is a complex one, dependent on a range of considerations. They include, for instance, a balancing of the perceived short- and long-term interests of the actors, where time discounts and estimates about the effects of one's actions on others matter.

The varieties-of-capitalism perspective draws attention to a number of factors that militate in favor of the stability of institutions. One of the most important of these is the presence of institutional interaction. As we have noted, the strategies an actor such as a firm follows and the benefits it can expect from them are usually conditional on the presence, not of one, but of a number of institutions. Many German firms might be more willing to withdraw from the institutions that coordinate wage bargaining if they did not also face powerful German unions or operate particular types of production regimes.[7] Where the benefits of changing one institution are likely to be realized only when a substantial number of other institutions are also changed that institution should be more stable. Conversely, where there are alternative institutional means available for accomplishing a task, a firm's interests may bind it less tightly to one institution.

Thus, considerations about how readily alternative institutions can be constructed also condition the judgments actors make about whether to adhere to an existing institution. Because institutions are collective constructs that exist only when the behaviors of many actors converge, it can be exceptionally difficult to replace one institution with another. In a few cases, an alternative can be secured by fiat: the Swedish government shifted drivers from the left to the right-hand side of the road in one fell swoop. But, in many instances, as Culpepper (2003) shows, it can be difficult to persuade actors to coordinate on new ways of doing things, even when there are reasons to think they might be Pareto-improving. Before a new institution is established, one cannot prove it will deliver benefits and the relevant actors cannot be sure of the behavior of others on whom its efficacy may depend. The presence of such uncertainties is a crucial factor underpinning institutional stability. As Shepsle (1986) has noted, even where some of the relevant actors are anxious to secure greater benefits, a 'wedge of uncertainty' lying between the known outcomes of existing institutions and those potentially available from new ones can prevent actors from defecting from existing arrangements or agreeing to new ones.

For these reasons, the availability of meta-institutions for rule-making and deliberation can be crucial to the stability of existing institutions and the prospects for reform (Hall and Soskice 2001: 10-12). Since the world frequently throws up shocks that unsettle the benefits actors are securing from existing institutions, deliberative forums and other procedures for agreeing on a common diagnosis of the situation and possible responses to it can make it easier to sustain institutions whose benefits flow from the cooperative behavior they engender. Those forums speak to two types of problems. The

first is one of 'diagnosis', where the problem is to agree on the cause-and-effect relations associated with the situation and the impact of institutions on it. The second is one of securing 'distributive justice', a problem that arises because the relative size of the benefits going to each actor and the risks each bears from the establishment of an institution frequently vary even when the institution is Pareto-improving. As a result, for actors to accept an institution, they have to agree not only that it provide benefits but on the acceptability of how it distributes those benefits.

Considerations such as these also draw our attention to the importance of the 'common knowledge' underpinning the operation of most institutions. As Hall and Soskice (2001: 12-14) note, although it is often construed in relatively-thin terms that reflect a basic capacity to communicate and agreement on a few assumptions about the behavior of others, the common knowledge required to operate a complex institution must often be considerably thicker. To cooperate well, actors must feel reasonably confident about how others will behave in the face of many contingencies. That demands a set of shared understandings based on experience of interaction with each other, and the more extensive that experience, the more stable an institution is likely to be. The stability of institutions does not rest on instantaneous calculations about self-interest but on a body of experience from which important reservoirs of common knowledge are filled.

In short, many of the institutions in the political economy normally rest to some degree on how well they serve the interests of the actors who participate in them.[8] But institutions and interests are more loosely coupled than many theoretical approaches acknowledge. Much of this looseness flows from the informational problems associated with securing coordination. Actors continually reassess the intentions of those with

whom they are interacting and their own scope for action. They need to be reassured that existing institutions continue to serve their interests and that better alternatives are not available. In our view, the actors are daunted, but not altogether deterred, by uncertainty. Instead, some engage in a continuous search for better ways of serving their interests, while others try to defend existing institutions by assuring others that they continue to serve their interests.

The result is a politics of institutional stability, one of whose features is continuous experimentation, as the relevant actors test the limits of what others will deem acceptable behavior, seek new information about their partners, assess the effects of alternative courses of action, and consider how severely defection from institutionally-sanctioned patterns of behavior will be punished. For some actors at some times, of course, institutional stability might depend on habit. But, in the political economy, it more often depends on a stream of action that is relatively political in the sense that it entails conflict designed to test the limits of cooperative arrangements and mobilization to bring other actors in line with those arrangements (Thelen 2001: 73 ff.).

The history of industrial relations in Germany provides excellent examples (Thelen 1991; Streeck 1994; Hall 1994;). For many decades, Germany has had a set of institutionalized practices for wage bargaining that are highly coordinated, capable of delivering wage restraint, and relatively stable. There is no doubt that the resilience of the system depends partly on the satisfaction of employers and employees with the results it has generated, and a standard institutional logic can be adduced to explain why the system generates such returns (Soskice 1990). Some see this as a 'consensual' system of industrial relations, but on closer inspection it is clear that industrial relations in Germany

have been anything but smooth or consensual. Behind its wage settlements lies a politics marked by periodic conflict between employers and employees, including lockouts and strikes. Why should a conflictual politics be necessary to sustain a system that most participants have seen, over the long run, as one that serves their interests? The answer is revealing about the politics of coordination.

In brief, the participants could never be certain that the system was serving their interests well. From time to time, unanticipated economic events led to wage settlements more rigorous than intended, and the unions struck to recover some of the gains they had expected and to remind employers they could be punished if they bargained in bad faith (Kreile 1978). This case thus demonstrates how important relations of power are to the stability of institutions in the political economy. Whether Pareto-improving or not, institutions generally distribute benefits unevenly and the relevant actors are interested in improving their share of them (Scharpf 1997). Employers' federations and unions mounted periodic strikes or lockouts to test the power or resolve of the other side and to reassure their own rank and file that they were doing their utmost on their behalf. Thus, one of the factors drawing German unions and employers back toward the institutions developed for wage coordination has been a lively perception on each side, periodically tested, that they have much to lose from failing to coordinate.

Moreover, if power relations in a cooperative context are based on the relative opportunity costs to each side of failing to cooperate, as Knight (1992) has argued, those costs usually depend heavily on the other institutional practices in which the actors are imbricated. When deciding whether to bargain cooperative with the unions, employers were influenced by other institutions impinging on their interests, such as the works

councils they faced, the work practices and production regimes they had evolved, and a range of other institutions affecting the costs a prolonged strike or lock-out would impose on them. The general point is that institutions do not simply resolve collective action dilemmas: they also reflect and contribute to the balance of power found in many parts of the political economy (see also Moe 2005).

An elaboration of the politics underpinning stability is important in addressing a frequently raised criticism of the varieties-of-capitalism perspective, namely its allegedly functionalist overtones. As the foregoing discussion makes clear, our perspective shares with functionalist accounts the premise that the support groups provide for an institution is motivated, to some extent, by the benefits it provides, something closely linked to the functions it performs. However, it differs from many kinds of functionalist accounts in two respects.

First, we do not assume that support for an institution derives primarily from the contribution it makes to national or aggregate economic welfare. Varieties-of-capitalism analysts devote a good deal of attention to explaining how the institutions of the political economy can contribute to national well-being. But they do not generally claim that the existence of an institution or changes in it depend on that contribution. We are sometimes interested in particular institutions because of the aggregate welfare they deliver, but institutional politics as we understand it is driven by self-interested actors seeking better outcomes for themselves or the groups they represent (Hall and Soskice 2001: 57-8).[9]

Second, in contrast to some types of functionalist analysis, we also think it dangerous to assume that the institutions of the political economy were originally created

to serve the interests they now do. For instance, although German employers now have substantial interests in the co-determination system, they vociferously opposed the legislation of the 1950s that enhanced labor's rights on the shop floor (Höpner 2003). Once these institutions were in place, however, employers organized their production strategies and a range of ancillary institutional practices around them, aiming at high-priced, high quality production (Streeck 1992). These same employers now overwhelmingly support codetermination, both because their market strategies now rely on them, but also because they face significant uncertainties about the kind of politics and conflicts on the shop-floor that would result if these arrangements were dismantled. In this as in many other cases, the institutions of the political economy are instruments that actors gradually adapt to their purposes and in which they become invested only after they have accommodated themselves and other practices to their presence (Thelen 2004).[10] One cannot explain the origins of an institution by reference to its current effects; at best, they may help to explain current levels of support for it.

In sum, although some see the varieties-of-capitalism approach as insufficiently political because it focuses on the ways firms coordinate their endeavors and construes coordination in equilibrium terms, it deploys an understanding of institutions that anticipates a lively politics, marked by experimentation, negotiation and conflict, even in cases of institutional stability. As Thelen (2001) argued, this approach rejects the notion that institutions are automatically stable, even when they are Pareto-improving, and sees important political dynamics behind equilibrium outcomes.

3. Institutional Change in the Political Economy

Our understanding of institutional change follows from the perspective on institutional stability we have just outlined. Because political economies are full of entrepreneurial actors interested in improving their position, existing institutions are bound to come under pressure. Institutional equilibria can change, as developments shift the material situation, power and self-understandings of the actors. Thus, Hall and Soskice (2001: 54) argued that institutional change will be a regular feature of both liberal and coordinated market economies. The key issues are: when can we expect change, how will it occur, and with what kinds of results?

Multiple Agents of Adjustment

One of the notable features of this approach is its insistence that there are multiple agents of adjustment in the political economy. Globalization is often presented as a contest between states and market forces (cf. Cable 1995), and there is no denying that the decisions governments take in response to international challenges play a key role in the institutional development of the political economy. In such contexts, as Streeck (2004) has observed, governments come closest to being architectonic actors. On the regulations they promulgate, many other institutions depend. However, the varieties-of-capitalism perspective insists that firms can be equally important agents of national adjustment. They cannot always construct new collective institutions without help from governments, but shifts in firm strategy can erode the viability of some institutions and make others more important. Moreover, firms are more sensitive than governments to shifts in the economy, because their survival is at stake. A good deal of the process of institutional adjustment in the developed economies can be understood as a *pas de deux* between firms

and governments, in which each responds to different pressures but has to cope with the moves made by the other side.

Recent analyses by Culpepper (forthcoming) and O'Sullivan (2005) of changes in the structure of French financial markets are revealing. Although those shifts began with government initiatives to privatize national enterprise and expand the ambit of French equity markets, the traditional networks binding French business to the state were unwound only when key firms took the initiative to dissolve their core shareholdings in the newly-privatized enterprises and to seek foreign acquisitions and investors. Much of the impetus for their strategies derived from the opening of international markets made possible by international agreements the French governments signed, but those strategies were driven by new market pressures and opportunities. Many large French firms realized they would prosper only if they secured global market share, and higher stock prices became a major asset in the stock swaps used to secure new acquisitions. Thus, French firms undertook a series of measures to solidify their market position, and the government obliged with congenial regulatory reforms in the sphere of corporate governance (Tiberghien 2002).

Something similar can be observed in the German political economy, where more open global markets put pressure on large German firms, especially in the financial, pharmaceutical and automotive sectors, to internationalize their operations and to seek a favorable regulatory environment in which to do so. Shifts in firm strategy lay behind government initiatives that made it easier for large firms to wind down their domestic shareholdings in order to amass capital for foreign expansion. In short, governments do not have the luxury of responding to international economic developments on a *tabula*

rasa. In many cases, they have to react to corporate strategies that are shifting even more rapidly in response to those developments. Sometimes, therefore, changes in rules may follow the accumulation of "deviant" behavior in breach of a formal legal regime, in effect to bring the rules and behaviors back in alignment (Streeck and Thelen 2005, 15-16).

As Evans (2005) reminds us, organized producer groups also have a role to play in this dynamic, especially where they are important vehicles for inter-firm coordination. Typically, their institutional practices come under pressure as firms shift strategies in response to new domestic or international opportunities. Those shifts can open up new cleavages between firms of different types – often between large firms with an international orientation and smaller companies oriented to domestic markets – forcing producer groups to devise new means to retain the loyalty of their members and new modes of coordinating the endeavors for which they were once responsible – a task at which they may or may not succeed, as recent developments in Germany and elsewhere suggest.

In short, although the role of states should not be underestimated, institutional change in the political economy is driven by the shifting strategies of several sets of important actors, each acting out of different sets of interests.[11]

The Impetus for Institutional Change

There is no doubt that developments in the international political economy are important stimuli for contemporary institutional change in the developed world. These developments include: the growing weight of the service sector in production and

employment and falling barriers to trade and communication that intensify international competition and open up opportunities for sales or production elsewhere in the world. The liberalizing initiatives of the European Union and the reunification of Germany have been of special importance to Europe. These developments have shifted the opportunity structures and returns to existing institutions facing many firms and workers. Much of the institutional ferment in Europe is inspired by these developments, and many analyses treat the problem of institutional change as if the impetus for it were invariably exogenous to the institutions themselves (cf. Frieden and Rogowski 1996).

However, as a number of scholars have begun to point out, the impetus for change can be endogenous to them, and many institutional changes in the political economies of Europe have been inspired by the unanticipated effects that flow from existing institutions (Thelen 2004, Thelen and van Wijnbergen 2004, Greif and Laitin 2005). The case of solidaristic wage bargaining in Sweden is a well-known example. In the 1930s, Swedish employers pressed for centralized bargaining arrangements in order to link wages in the sheltered sectors to those bargained for the export sectors. But they did not anticipate that centralized bargaining would also become a vehicle for compressing differentials between the wages of skilled and unskilled workers. Over time, however, centralized bargaining strengthened the position of unskilled workers, whose interests could be pooled across all industries in a way that had not been possible under sectoral bargaining, and became a vehicle for political exchange with a strong social democratic government. As Sweden's unskilled workers used their strength to narrow differentials with skilled workers, they undermined the capacity of employers to recruit and deploy skilled labor. By the 1980s, concerns about this issue were grave enough to lead the

export sectors to pull out of centralized bargaining arrangements, thereby modifying the institution they had originally created.

We see a similar dynamic in the German economy, where the development of a system of wage coordination in which the trade unions exercised considerable power, while effective at restraining wages in the short-term, led to substantial increases in real wages over the long-term. The response of employers was to increase labor-saving investment (Manow and Seils 2000). Although that preserved the wage bargaining system, it led to the development of production regimes that are not conducive to the creation of jobs. As a result, German firms and governments have come under increasing pressure to alter the institutions of the political economy.

In short, the impetus for institutional change does not always lie in socioeconomic developments exogenous to the institutions of the political economy themselves. The history of change in the European political economies should not be written as if it were entirely a series of responses to external shocks. The challenge facing analysts is to see it as a process partly endogenous to the character of the institutions developed in each nation and driven by the unintended consequences that flow from those institutions.

4. Three Routes to Institutional Change

Many analysts of institutional change focus their attention on major legislative initiatives, such as Thatcher's reforms to industrial relations or Schröder's reform of corporate taxation, marquee events of undeniable importance. However, the framework we have outlined suggests that there are at least three routes to institutional change in the political economy, each with a distinctive dynamic. Beyond explicit reform, which is widely

theorized in the literature, we find also significant change through what we call processes of defection and reinterpretation.[12]

Reform

Of course, the most visible route to institutional change is through processes of reform, which we define as institutional change mandated or endorsed by governments. We see institutional reform, first and foremost, as a process built on coalitional politics. The principal challenge facing analysts is to identify the coalitions of social or political actors that provide the support for a change in regulations or policy regimes and the factors motivating that support.

The implication of this analysis is that institutional reform often originates in political compromises among actors, whether producer groups or political parties, diversely motivated in contexts of distributive conflict. As a result, there are no guarantees that the process of institutional reform will advance national well-being. If firms decide to support the regulatory regimes that sustain the comparative institutional advantages of the nation, it is because they also underpin the competitive advantages of the firm; and behind many reform debates lie other conflicts of interest, such as those that habitually divide capital and labor, but also those that divide different types of firms and workers. Institutional change is a process of continuous mutual adjustment inflected by distributive concerns.

However, and as pointed out above, the varieties-of-capitalism perspective reminds us that these conflicts can be deeply influenced by the character of existing institutions. Firms and other actors do not judge proposals for reform as if the new

institutions will operate on a blank slate, but from the perspective of how they will interact with existing institutions. Here, interaction effects among institutions in different spheres of the political economy are important. Actors' assessments of whether a new set of institutions will benefit them often turn on how well those institutions fit with strategies into which those actors have been drawn by virtue of the presence of supportive institutions elsewhere in the economy. Once institutional arrangements in one sphere take shape, they can condition the arrangements actors will support in another sphere.

Swenson's (2001) comparison of pension reform in Sweden and the U.S. provides a nice example of this dynamic. He shows how institutions developed in the sphere of industrial relations during the 1930s conditioned the types of pension policies employers were willing to support in the 1950s. Sweden's centralized collective bargaining system kept wages in check but fuelled new forms of competition among firms based on the provision of company pensions. Under conditions of full employment, employers were willing to support a social democratic initiative to institute state pensions as a way to ameliorate and control such competition. By contrast, in the United States, the Wagner Act of 1935 left company-level wage bargaining intact, and no constituency emerged among business for state pensions, since low-skill firms valued the flexibility they enjoyed to suppress wage costs and high-skill firms were interested in using generous pensions to attract skilled labor.

Goyer's (2005, 2006) comparison of reforms to corporate governance recently adopted in France and Germany points to a similar dynamic. In response to international pressures for change, there were reforms in both nations. But the character of the reforms firms were willing to make in the sphere of corporate governance seems to have been

influenced by the character of the institutional arrangements they faced in the sphere of labor relations. In France, where most firms faced weak works councils and trade unions, many firms were willing to accept measures that made hostile takeovers more feasible, even if that forced them to restructure their operations to deliver higher share prices, but they resisted efforts to render their balance sheets more transparent or improve the protection offered minority shareholders. Goyer argues that the weakness of organized labor made this kind of institutional settlement attractive to firms because it left them with the maneuverability to restructure. In Germany, by contrast, where the power of works councils and trade unions was institutionally entrenched, firms were quicker to adopt international accounting standards and strengthen the position of minority shareholders but resisted measures that would have exposed them to hostile takeovers because the industrial relations institutions made it difficult for them to restructure. In short, the views management took toward reforms in corporate governance were conditioned by the character of industrial relations.

Defection

We borrow the term 'defection' from game theory, where it refers to strategies that deviate from the behaviors associated with a cooperative outcome, and use it for cases in which actors who have been following the practices prescribed by an institution stop doing so. Where the institution is associated with a formal organization, such as a trade union or employers association, the actors may also drop their membership in it. Although less eye-catching than legislative reform, this is an important avenue toward institutional change in the political economy.

Recent developments in the German metalworking sector provide a good example (see Kume and Thelen 1999; Thelen 2000). When communism collapsed providing firms with access to new markets and suppliers in the east, many large German firms in metalworking took advantage of those opportunities to extend their supply chains and revamp production processes. Those changes made them more efficient but more vulnerable to disruptions in production. Therefore, these firms developed strong interests in labor peace and were able to offer skilled workers higher wages in return for it. Lacking the scale to shift production in this way, however, many smaller firms, especially in East Germany, still had to restrain wages in order to remain competitive. As a result, a cleavage opened up between firms in the sector with respect to the appropriate strategy to take toward wage bargaining.

Metalworking exemplifies the institutionalization of coordinated wage bargaining in Germany. Wage negotiations are conducted at the sectoral level between *IG Metall* and *Gesamtmetall*, two of the nation's most powerful producer groups, and they worked well because *Gesamtmetall* managed to retain the support of most firms in the sector. To do so, it bargained hard, seeking modest wage increases so as to hold down the wage bill for smaller firms, at the cost of mounting lockouts to remind *IG Metall* of its resolve. When the most advanced firms in the sector developed new supply chains whose effectiveness depended on uninterrupted production, however, they developed an aversion to lockouts, and *Gesamtmetall* began to agree to wage settlements higher than some firms could afford. As a result, the latter have begun to defect from *Gesamtmetall*, either dropping their membership or finding ways to avoid paying the wage rates it negotiated. Through a process of defection, the institutions governing wage coordination

in the metalworking sector are being transformed. Similar processes of defection are shifting institutional practices in many spheres of the German political economy and elsewhere in Europe as well.

Reinterpretation

A further route to institutional change from below lies in what we call 'reinterpretation'. In these instances, the actors associated with an institution leave its formal attributes intact but gradually change the content of the practices associated with it. In some cases, that entails reinterpreting a legal or regulatory regime. In others, it involves the gradual acceptance of practices that would not formerly have been seen as congruent with the continued existence of the institution. In comparison to 'reforms' discussed above that formally revise or abolish an institution, the process of reinterpretation shifts existing practices in piecemeal fashion from below (Streeck and Thelen 2005).

Recent developments in German collective bargaining display many examples of reinterpretation, as employers and workers attempt to bend existing practices to suit their interests better, without formally abolishing them. A good example lies in skirmishes over the meaning of a core provision in German labor law known as the *Günstigkeitsprinzip* (Rehder 2004). That principle stipulates that certain issues normally reserved for collective bargaining at the industry level can be decided at the local level, in bargaining between works councils and individual employers, provided that the outcome operates "to the advantage of the worker". Thus, firms can pay wages in excess of the industry rate, but they cannot demand concession bargaining. In recent years, however, employers began to take advantage of an ambiguity in the meaning of *Günstigkeit* to

justify local employment pacts that offer workers greater job security in return for lower wages. Their argument was that anything offering greater job security in a context of high unemployment operates "*zu Gunsten des Arbeitnehmers*".

Although that particular practice has so far been deemed illegal by the courts, these sorts of efforts to reinterpret the division of labor normally enshrined in the collective bargaining system have been a regular feature of German industrial relations. In 1984, for instance, new space was opened up for plant-level agreements on working time; and since that time other agreements have continued to expand the scope for work council bargaining on a range of other issues as well (Thelen 1991; Hassel and Williamson 2004). Overall, a very significant flexibilization of the German bargaining system has been accomplished without a noisy rewriting of the formal rules, but rather through successive (and successively expansive) interpretations of the scope for bargaining on the local level to respond to the specific market conditions faced by individual firms. These are cases in which the 'rules' conventionally associated with an institution are reinterpreted to accommodate new diversities in the interests of the actors associated with it.

Processes of reinterpretation, such as these, sometimes act as shock absorbers in the face of new economic developments. They reflect an elasticity in the institutions of the political economy that formal analyses sometimes miss. Faced with defection, an institution central to strategic coordination does not always break down completely. In many cases, cooperation can be secured again on a slightly different basis, through processes of reinterpretation. Thus, elasticity can be important to the survival of strategic coordination, but this should not obscure the indisputable changes that occur in the

institutions in the process (e.g., and perhaps above all in the functions these institutions perform and the substantive outcomes with which they are associated). The implications of this for understanding institutional change from a varieties-of-capitalism perspective are explored in the following section.

5. The Implications for Varieties of Capitalism

What are the implications of this analysis for the future of varieties of capitalism? The challenges facing the developed economies should not be minimized. Europe's largest economies suffer from low rates of growth and high levels of unemployment. Aging populations burden many welfare states, and the rise of the service sector has called into question economic models attuned to the demands of industrial capitalism (Iversen and Wren 1998). In such contexts, there is bound to be institutional change.

However, the terms of contemporary debates about institutional change are manifestly inadequate. Most analyses ask whether the developed economies are 'liberalizing' and subsume under that label most contemporary initiatives, ranging from efforts to privatize industry, cut back social benefits, reduce employment protection, promote equity investments, encourage part-time employment, and lower minimum wages. Most of these measures reinforce the role of markets in the allocation of resources. But, if we are interested in the impact of institutional reform, the crudeness of this category obscures more than it clarifies. It suffers from three prominent defects.

First, liberalization is a multidimensional process. The types of initiatives we have just listed need not accompany one another and often they do not. Denmark has reduced employment protection without making major cuts to unemployment benefits.

France has encouraged part-time work without cutting its minimum wage. To what extent these measures tend to occur together should be an object of inquiry but, for that kind of inquiry to be possible, we need to disaggregate the concept of 'liberalization' and explore each of its separate dimensions.

Second, even measures to 'liberalize' a single sphere of the political economy do not all have the same effects. Consider the reform of corporate governance. Steps to protect minority shareholders, to encourage international accounting standards, to promote independent directors, to unwind cross-shareholdings, and to allow hostile mergers and acquisitions, among others, are all often described as elements of a single 'liberalization' process. But the impact of each of these measures is quite different. Consider their impact on 'coordinated market economies' (Hall and Soskice 2001). Some analysts seem to assume that any step in this direction will substantially enhance the power of shareholders vis-à-vis stakeholders and corrode the potential for strategic coordination in such economies. However, we see few reasons why the adoption of international accounting standards, independent directors and better protection for minority shareholders should have a major impact on corporate strategies or damage the corporate networks that condition the provision of capital in such nations, let alone impose changes in labor relations. Conversely, we see good reasons to think that corporate strategies might change dramatically if hostile takeovers were to become a prominent feature of such economies. To treat all of these measures as part of a single process of 'liberalization' inadvertently disguises their differential impact.

Third, if our analysis is correct, the impact of any institutional reform on the operation of the political economy should be dependent on the structure of other

institutional arrangements in that economy. There is evidence, for instance, that the economic impact of reforms to corporate governance depend on the character of labor relations in the country at hand (Hall and Gingerich 2004). A number of studies have suggested that the economic impact of making the central bank more independent of political control will depend on the character of the nation's wage bargaining (Iversen 1999; Hall and Franzese 1998). Even when the analysis refers to identical institutional reforms, to speak as if they will have identical effects in all nations is misleading. Because of institutional interaction effects such as these, the impact of reform may vary dramatically across nations.

Without denying that the concept of 'liberalization' has an important political reality that derives from its association with the 'move to the market' begun in the era of Reagan and Thatcher, we question its value as an instrument for diagnosing the impact of institutional reform or for predicting the future direction of the developed political economies. Britain and Sweden both experienced what can be called significant "liberalization" in the area of industrial relations in the 1980s and 1990s (Wallerstein and Golden 1997). But in Britain this was associated with the demise of unions and employers associations (i.e., it involved a collapse in previous coordinating capacities). In Sweden, by contrast, liberalization involved a cross-class realignment and the sloughing off national-level coordination in favor of a new alignment associated with much closer coordination between blue and white collar bargaining within the export sector, while leaving the public sector to its own devices (Thelen and Kume 2005). Not all changes, that is to say, and not even all changes traveling under the banner of liberalization, bring CMEs closer to LMEs in any very meaningful way. To make sense

of these developments and their implications, "liberalization" is too blunt a tool; we need alternative categories with which to assess the impact of institutional change.

In approaching this problem from a varieties-of-capitalism perspective, it is important to distinguish between the specific institutional arrangements and the type of coordination they induce through their impact on the incentives and strategies of the relevant actors. How coordination is sustained (or not) is a completely different issue, both analytically and empirically, from how specific institutional arrangements are maintained (or not). In some cases, significant shifts in specific institutional arrangements are entirely consistent with continuing coordination. For example, tracking the evolution of vocational training over a 100-year period, Thelen documents a series of significant changes in the institutional arrangements and practices underpinning the German skills system. These changes, far from undermining the kind of coordination on which the German high-skill equilibrium is based, were in fact critical to its survival – not least for the way they adapted that system to changes in the economic and political environment.

Conversely, however, sometimes a high degree of formal institutional stability can operate to mask important changes in the extent and type of coordination achieved under them. As noted above, many of the formal features of German industrial relations have demonstrated remarkable resiliency over the past decade, even as significant changes have occurred as a result of the exodus of many small firms from the system and as significant new powers have been delegated to local labor representatives. These changes do not signal a full scale breakdown of coordination (indeed, arguably, they have averted this by injecting new flexibilities into the system), but they do signal a rather

significant reconfiguration of coordination in Germany (more tightly organized now around the interests of large firms and their core workforces, among other things).

Our point, then, is not that coordinated market economies are not changing; clearly they are. One analytic problem is to distinguish the types of institutional reforms that damage the capacities for strategic coordination characteristic of 'coordinated market economies' from those that leave them intact. Coordinating capacities of the sort we find in countries such as Germany and Sweden originated and developed historically, they are sustained politically, and as such they can certainly be lost or squandered. However, because many of the changes we can observe in coordinated market economies take the form of a renegotiation rather than full breakdown of coordination, more nuanced categories and analysis are required to deal with what we think of as non-trivial movement within the broad category of "coordinated market economy" based on changes in the specific interests and political coalitions on which such coordination rests.

What such analysis looks like, concretely, is well illustrated by a thriving literature that has emerged in tandem and in fruitful dialogue with the literature on varieties of capitalism.[13] This literature tracks the construction and evolution of many of the key political economic institutions around which specific political economies, especially important coordinated market economies, are organized (e.g., Swenson 2002, Thelen 2004, Mares 2003). Much of this literature is devoted to an analysis of the cross-class political coalitions that presided over the genesis of important institutional configurations, and explains changes in their form and functions with reference to changes in the political foundations on which they rest (see also Iversen 1996 and Thelen and Kume 2005). While there is certainly nothing to guarantee that the capacities for

strategic coordination in CMEs will survive the current wave of liberalization broadly defined, one of the core findings of many of these more historically oriented analyses is the striking resiliency, in some recognizable form, of many of the key institutional supports for such coordination over long periods of time and through massive historical ruptures (on this, see especially, Thelen 2004).

On the whole, our analysis suggests that coordinated and liberal market economies are changing but in terms that are likely to leave them quite different from each other, despite the 'liberalizing' reforms of recent decades and despite significant changes in coordinated market economies. On the one hand, we anticipate more change in the developed economies than studies focused on public policy reveal. Because firms are themselves important agents of change, substantial shifts in institutional practices are taking place 'from below' via processes of defection and reinterpretation. On the other hand, precisely because it is rooted in processes of experimentation that are a regular feature of the political economy, most institutional change has an incremental character. It occurs via processes of mutual adjustment among the relevant actors that usually result in small alterations to existing practices.[14]

Central to our perspective is the observation that the political economy is an ecology of interacting institutions, in which an actor's major strategic moves are usually conditioned by a number of institutions. Thus, when one institution changes, firms are not always inclined to overhaul their strategies. Rather than adopt a completely new set of strategies, they often adjust to that change by seeking alternative sources of institutional support for the strategies on which they customarily rely; if necessary adapting other institutions to new purposes. When the large German banks shifted their

strategies to take advantage of new international opportunities, for instance, German firms that once relied on those banks for protection against predatory investors and for information about potential investments began to look to other partners for protective cross-shareholdings and to employer networks for inside information.

Accordingly, differences in the existing strategies of firms are salient to the ways in which they will adjust to new challenges, and the effects of any one institutional reform must be judged against the continuing impact of other institutions in the political economy. That is why the varieties-of-capitalism perspective expects the adjustment path of liberal market economies to be different from that of coordinated market economies, even if all 'liberalize' to some degree, as they are doing. In liberal market economies, liberal reforms should reinforce the strategies of companies that have long relied on arm's length market relationships to coordinate many of their endeavors. By contrast, market-oriented reforms and the intensification of competition that follows from more open global markets constitute more serious threats to established corporate strategies in coordinated market economies. Those strategies are shifting. But in many cases firms do not seem to be abandoning corporate strategies built on strategic coordination so much as reconfiguring the terms of that coordination to meet new challenges and opportunities.

In the sphere of labor relations, although there has been institutional change in liberal directions across Europe, reflected in increases in part-time or temporary employment and reduction in unemployment benefits, employment protection, and union membership, a substantial gap on such measures remains between the coordinated and liberal market economies (Hall and Gingerich 2004: Table 8). While hard won and much heralded, cutbacks in the policies providing social protection in these political economies

have been relatively small. They have not yet prevented most firms from hiring labor on the terms they have long used or deterred workers from seeking the relevant skills (Hassel and Williamson 2004; Campbell *et al*. 2006). Although wages are now rarely coordinated at the peak level of the economy and sectoral wage coordination is looser than it was twenty years ago, the institutional capacities for wage coordination in these nations have not yet disappeared (Iversen 1999). High levels of unemployment have reduced the importance of such coordination to firms in some countries, but it may well take on more importance when labor markets tighten. Low-wage labor markets are developing in nations that once avoided them such as Germany; but it is not yet clear whether this development will corrode employer-employee relations or firm strategies in the core economy. Japanese firms have sustained significant capacities for strategic coordination for many years with this type of dual labor market (Vogel 2004).

In the sphere of corporate governance too, the developed economies have seen many institutional reforms. But, as we have noted, the import of some of these changes for firm strategies is ambiguous, and where the proposed reforms strike at the heart of existing firm strategies, there has been substantial opposition to them. German delegates to the European Parliament blocked legislation that would have made hostile takeovers easier, and they are not yet common features of coordinated market economies (Callaghan 2004; Guillen 2000). International markets are now more important as a source of capital for large European firms than they once were, but they have not put as much pressure on firms to alter their corporate strategies as some analysts anticipated. As Höpner and Jackson (2001) have noted, although German firms have a larger labor force and higher wage bills than their British counterparts, their share prices assure a

return on equity roughly equivalent to the British firms. And, as Goyer (2004) notes, pension funds interested in investing for the long term have been drawn to German equities. From a varieties-of-capitalism perspective, it makes sense that international investors would tolerate divergences in firm strategy designed to exploit the comparative institutional advantages of each nation.

The scope for change at a political level is more uncertain, however, and as important to institutional change as the shifts in firm strategy inspired from below. Many of the large European economies suffer from high levels of unemployment and a fiscal crisis engendered by generous welfare states and aging populations. As a result, many governments have been encouraging the growth of temporary or part-time employment and reducing the generosity of some of their social benefits. On the whole, the changes made to social benefits in the coordinated market economies have been small, and their benefit systems remain markedly different from those found in liberal market economies. Levels of income inequality have risen more dramatically in liberal than in coordinated, market economies.

Coupled to high levels of unemployment, however, these reforms have provoked levels of discontent that are ultimately also consequential for coordination. As we have noted, strategic coordination depends, not only on the presence of supportive institutions, but on the 'common knowledge' embodied in a set of shared understandings about how each actor will behave. Although often modeled as a set of expectations, these understandings include conceptions of social justice that are crucial to resolving the distributive conflicts that arise when actors try to coordinate with one another. In that respect, there is a sociological underlay at the heart of successful strategic coordination

(Rothstein 2005; Streeck 1997), and that underlay is being eroded by pervasive feelings of discontent about distributive issues in many parts of Europe today. If workers no longer believe that the institutions within which they work will deliver a just set of rewards, their willingness to support those institutions may decline, threatening the nation's institutional capacities for securing cooperation in both the political and industrial spheres. It is here that many of the most serious question marks hanging over the coordinated market economies lie.

Since the scope for institutional change depends on the character of the existing 'institutional ecology', one of the implications of our analysis is that the prospects for institutional change may be greatest in a third set of economies of the sort found in southern Europe and sometimes labeled 'mixed market economies'. Here, the room for market competition has traditionally been limited by a range of regulations and there has long been a substantial amount of strategic coordination in the spheres of labor relations and corporate governance. However, the distinctive feature of these political economies has been the role played by the state in strategic coordination. Faced with confessional divisions among competing union confederations, their governments often stepped in to regulate wage rates, typically by translating the terms of a settlement across an entire sector or by legislating minimum wages to which other wages are tied. Similarly, through public enterprises and influence over flows of funds in the banking system, the governments of these political economies typically intervened heavily in markets for corporate governance and matters of corporate finance.

The prominent role the state played in strategic coordination left these political economies peculiarly vulnerable to the 'move to the market' of the 1980s, which saw the

decline of state intervention across Europe. Where governments became more reluctant to intervene, as they did in France and Spain, firms and workers found themselves without the support for strategic coordination on which they once counted. As a result, institutional change has been more dramatic in these nations than in the liberal or coordinated market economies of northern Europe. The retreat of the state left the trade unions of Spain and France in a weak position, and firms have taken advantage of the opportunity to move wage bargaining toward the firm level, reduce job security, and render work relations more competitive. Large firms have rebuilt some forms of strategic coordination, notably with suppliers, but the markets for corporate governance in these political economies have become substantially more competitive than they once were (Hancké 2001, 2002; Culpepper *et al*. 2006).

Of course, there are significant differences among the mixed market economies of southern Europe, and the institutional response to the retreat of the state is not yet complete. But it is here that the most pronounced movement away from strategic coordination toward the market modes characteristic of liberal market economies has taken place, as firms with limited capacities for strategic coordination of their own, have turned to market modes of coordination to replace the efforts of once-activist states. These cases suggest that, where it is not deeply-rooted in social institutions, strategic coordination can be fragile and difficult to reassemble once dissolved.

Conclusion

The object of this paper has been to elaborate the theory of institutional change we associate with a varieties-of-capitalism perspective on the political economy. We have

tried to show that its broadly rationalist approach has much to contribute to the understanding of social change and that an approach which understands institutions in part in equilibrium terms can accommodate an analysis of institutional change. We have emphasized that, even when institutions are Pareto-improving in the context of strategic interaction, their stability cannot be taken for granted but rests on a highly-political process of mobilization marked by conflict and experimentation through which informational issues are resolved and distributional issues are contested.

We have argued that institutional change in the political economy is as likely to occur 'from below' as 'from above' and identify three routes toward such change, based on defection, reinterpretation and reform. We associate 'reform' with a coalitional politics in which distributive issues loom large and the interests of actors are conditioned by institutional arrangements elsewhere in the political economy. Because we see the political economy as an institutional ecology in which the strategies of the actors are simultaneously conditioned by multiple institutions, we see the process of institutional change as one of mutual adjustment, inflected by distributive concerns, with incremental impacts on the strategies of firms and other actors. As a result, cataclysmic institutional change in the political economy is likely to be rare, even though the long-term effects of incremental change can be profound. Underlining a distinction between institutions and the modes of coordination they support, we suggest that the capacities of firms for coordination are sometimes though by no means always resilient in the face of institutional change.

Of course, many other observations could be made about the process of institutional change taking place in the developed economies (see Aoki 2001; Campbell

2003; Streeck and Thelen 2005). The point of this paper is simply to outline the insights a varieties-of-capitalism approach offers. That approach ultimately calls attention to the problem of establishing when institutional reforms threaten existing modes of coordination, when they stabilize existing modes, and when they are irrelevant to them – a problem most pressing in the case of coordinated market economies where 'liberal' reforms are often said to erode the capacities of firms for strategic coordination. Although we do not answer that question here, we suggest the answer must depend on moving beyond conventional conceptions of 'liberalization' toward analyses of the impact of specific types of reforms that recognize the complex interaction effects common among the institutions of the political economy.

References

Amable, Bruno. 2003. *The Diversity of Modern Capitalism*. Oxford: Oxford University Press.

Aoki, M. 2001. *Toward a Comparative Institutional Analysis*. Cambridge: MIT Press.

Bates, Robert. 1988. "Contra Contractarianism: Some Reflections on the New Institutionalism," *Politics and Society* 16 (2): 387-401.

Blyth, Mark. 2003. "Same as It Never Was: Temporality and Typology in the Varieties of Capitalism," *Comparative European Politics*, 1 (2): 215-25.

Boyer, Robert. 1990. *The Regulation School: A Critical Introduction*. New York: Columbia University Press.

Cable, Vincent. 1995. "The Diminished Nation-State: A Study in the Loss of Economic Power," *Daedalus* 124,2 (Spring): 23-54.

Callaghan, Helen. 2004. "The Domestic Politics of EU Legislation: British, French and German Attitudes towards Takeover Regulation, 1985-2003." Paper presented to the Conference of Europeanists, March.

Calvert, Randall. 1995a. "Rational Actors, Equilibrium and Institutions." In Jack Knight and Iai Sened, eds., *Explaining Social Institutions*. Ann Arbor: University of Michigan Press: 57-94.

Calvert, Randall. 1995b. "The Rational Choice Theory of Institutions: Cooperation, Coordination and Communication." In Jeffrey S. Banks and Eric A. Hanuschek, eds., *Modern Political Economy*. New York: Cambridge University Press: 216-68.

Campbell, John A. 2004. *Institutional Change and Globalization*. Princeton: Princeton University Press.

Campbell, John. A., John A. Hall and Ove K. Pedersen. 2006. *The State of Denmark*. Montreal: McGill University Press.

Coates, David. Ed. 2005. *Varieties of Capitalism, Varieties of Approaches*. Houndmills: Palgrave Macmillan.

Culpepper, Pepper D. 2003. *Creating Cooperation: How States Develop Human Capital in Europe*. Ithaca: Cornell University Press.

Culpepper, Pepper (forthcoming) "Institutional Change in Contemporary Capitalism: Politics and Finance in the 1990s" *World Politics*

Culpepper, Pepper, Peter A. Hall, and Bruno Palier. Eds. 2006. *Changing France: The Politics that Markets Make*. London: Palgrave-Macmillan:

Djelic, Marie-Laure and Sigrid Quack. 2003. *Globalization and Institutions: Redefining the Rules of the Economic Game*. Cheltenham: Edward Elgar.

Dobbin, Frank. 1994. "Cultural Models of Organization: The Social Construction of Rational Organizing Principles." In Diana Crane, ed., *The Sociology of Culture*. Oxford: Blackwell: 117-91.

Dore, Ronald et al. 2003. "Varièta e dinamiche del capitalismo," *Stato e Mercato* 69 (December) 363-83.

Evans, Ana 2005. "Preemptive Modernisation and the Politics of Sectoral Defense: Adjustment to Globalisation in the Portuguese Pharmacy Sector."

Frieden, Jeffry and Ronald Rogowski. 1996. "The Impact of the International Economy on National Policies: An Analytical Overview." In Robert O. Keohane and Helen V. Milner, eds., *Internationalization and Domestic Politics*. New York: Cambridge University Press: 108-136.

Goldthorpe, John A. ed.. 1984. *Order and Conflict in Contemporary Capitalism.* New York: Oxford University Press.

Goodin, Robert. 2003. "Choose Your Capitalism?" *Comparative European Politics* 1 (2): 203-13.

Goyer, Michel. 2005. "Institutional Complementarity and Change: Assessing the Impact of the Transformation of Corporate Governance in France and Germany." Paper presented to a Workshop on Institutional Change in Contemporary Capitalism, London School of Economics, June.

Goyer, Michel. 2006 "The Transformation of Corporate Governance in France." In Pepper Culpepper, Peter A. Hall, and Bruno Palier. Eds. *Changing France: The Politics that Markets Make*. London: Palgrave-Macmillan:

Greif, Avner and David Laitin. 2004. "A Theory of Endogenous Institutional Change," *American Political Science Review*, 98: 622-562.

Guillen, Mauro. 2000. "Corporate Governance and Globalization: Is There Convergence Across Countries?" *Advances in International Comparative Management* 13: 175-204.

Hall, Peter A.. 1994. "Central Bank Independence and Coordinated Wage Bargaining: Their Interaction in Germany and Europe," *German Politics and Society* (Winter): 1-23.

Hall, Peter A. 1998. "Institutions and Economic Performance: The Evolution of the Field from the Perspective of Political Science." Lecture to the GAAC Workshop on Institutions and Economic Performance in Advanced Economies since 1945. Wissenschaftszentrum, Berlin July.

Hall, Peter A.. 2000. "Organized Market Economies and Unemployment in Europe: Is it Finally Time to Accept Liberal Orthodoxy" in Nancy Bermeo, ed. *Context and Consequence: The Effects of Unemployment in the New Europe*. New York: Cambridge University Press.

Hall, Peter A. 2005. "Preference Formation as a Political Process: The Case of Monetary Union in Europe." In Ira Katznelson and Barry Weingast, eds., *Preferences over Time*. New York: Russell Sage Foundation.

Hall, Peter A. and Robert Franzese, Jr.. 1998. "Mixed Signals: Central Bank Independence, Coordinated Wage Bargaining, and European Monetary Union," *International Organisation* (Summer): 502-36.

Hall, Peter A. and Daniel Gingerich 2004. "Varieties of Capitalism and Institutional Complementarities in the Macro-Economy." Discussion Paper of the Max-Planck Institute for the Study of Societies.

Hall, Peter A. and David Soskice. 2001. eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press.

Hancké, Bob. 2001. "Revisiting the French Model: Coordination and Restructuring in French Industry" in Hall and Soskice, eds., *Varieties of Capitalism*.

Hancké, Bob. 2002. *Large Firms and Institutional Change: Industrial Renewal and Economic Restructuring in France*. Oxford: Oxford University Press.

Hassel, Anke and Hugh Williamson. 2004. "The Evolution of the German Model: How to Judge the Reforms in Europe's Largest Economy. Paper prepared for the Anglo-German Foundation for the Study of Industrial Society.

Hoepner, Martin. 2001. "Corporate Governance in Transition: Ten Empirical Findings on Shareholder Value and Industrial Relations in Germany,. Max Planck Institute for the Study of Societies, Discussion Paper, No. 5.

Hoepner, Martin. 2003. "The German Party Paradox". Max Planck Institute for the Study of Societies, Discussion Paper

Hoepner, Martin and Gregory Jackson. 2001. "An Emerging Market of Corporate Control? The Case of Mannesmann and German Corporate Governance." Max Planck Discussion Paper ¼. Max Planck Institüt für Gesellschaftsforschung, Cologne.

Howell, Chris. 2003. “Varieties of Capitalism: And Then There Was One?,” *Comparative Politics* (October): 102-124.

Iversen, Torben. 1999. *Contested Institutions*. New York: Cambridge University Press.

Iversen, Torben and Thomas Cusak. 2000. “The Causes of Welfare State Expansion: Deindustrialization or Globalization,” World Politics, 52: 313-49.

Iversen, Torben and Anne Wren. 1998. "Equality, Employment and Budgetary Restraint," *World Politics* 50 (July): 507-46.

Jackson, Gregory. 2004. “Contested Boundaries: Ambiguity and Creativity in the Evolution of German Co-Determination.” In Wolfgang Streeck and Kathleen Thelen, eds. *Beyond Continuity: Institutional Change in Advanced Political Economies*. Oxford: Oxford University Press: 229-254.

Knight, Jack. 1992. *Institutions and Social Conflict*. New York: Cambridge University Press.

Knight, Jack. 1995. “Models, Interpretation and Theories: Constructing Explanations of Institutional Emergence and Change.” In Jack Knight and Iai Sened, eds., *Explaining Social Institutions*. Ann Arbor: University of Michigan Press: 95-120.

Kreile, Michael. 1978. “West Germany: Dynamics of Change.” In Peter Katzenstein, ed., *Between Power and Plenty*. Madison: University of Wisconsin Press: 191-224.

Manow, Philip and Eric Seils. 2000. “Adjusting Badly: The German Welfare State, Structural Change and the Open Economy. In Fritz Scharpf and Vivien Schmidt, eds., *Welfare and Work in the Open Economy*. Oxford: Oxford University Press: 264-307.

March, James G. and Johan P. Olsen. 1989. *Rediscovering Institutions: The Organizational Basis of Politics*. New York: Free Press.

Mares, Isabela. 2001. "Firms and the Welfare State: When and How does Social Policy Matter to Employers" in Hall and Soskice, *Varieties of Capitalism*.

Mares, Isabela. 2004. New York: Cambridge University Press.

Moe, Terry. 2005. “Power and Political Institutions,” *Perspectives on Politics* 3, 2 (June): 215-234.

Offe, Claus and Helmut Wiesenthal. 1986. “Two Logics of Collective Action: Theoretical Notes on Social Class and Political Form”. In Claus Offe, *Disorganized Capitalism*. Cambridge: MIT Press.

O'Sullivan, Mary. 2005. "Studying Firms to Understand Institutions: Gloablisation, the 'French Touch' and the French Financial System."

Pagano, Marco and Paolo Volpin. 2002. "The Political Economy of Corporate Governance" Centro Stude in Econia e Finanza, Departimento di Scienze Economiche, Universitya degli Studi di Salerno, Working Paper No. 29.

Palier, Bruno. 2005. "Ambiguous Agreement, Cumulative Change: French Social Policy in the 1990s. In Wolfgang Streeck and Kathleen Thelen, eds., *Beyond Continuity: Institutional Change in Advanced Political Economies*. Oxford: Oxford University Press: 127-144.

Rhodes, Martin. 1997. "Globalisation, Labour Markets and Welfare States: A Future of 'Competitive Corporatism'?" in Martin Rhodes and Yves Meny, eds., *The Future of European Welfare* London: Macmillan.

Rieger, Elmar and Stephan Leibfried. 2003. Limits to Globalization. Oxford: Polity.

Roe, Mark. 2003. *Political Determinants of Corporate Governance*. Oxford: Oxford University Press.

Rothstein, Bo. 2005. *Social Traps and the Problem of Trust*. Cambridge: Cambridge University Press.

Sabel, Charles. 1982. Work and Politics. New York: Cambridge University Press.

Scharpf, Fritz. 1997. *Games Real Actors Play*. Boulder: Westview.

Scharpf, Fritz and Vivien Schmidt. 2000.*Welfare and Work in the Open Economy: From Vulnerability to Competitiveness*. Oxford: Oxford University Press.

Schmidt, Vivien. 2002. *The Futures of European Capitalism*. Oxford: Oxford University Press.

Shepsle, Kenneth. 1986. "Institutional Equilibriaum and Equilibrium Institutions." In Herbert Weisberg, ed., *Political Science: The Science of Politics*. New York: Agathon: 51-81.

Soskice, David. 1990a. "Wage Determination: The Changing Role of Institutions in Advanced Industrialized Countries," *Oxford Review of Economic Policy* 6, 4: 36-61.

Streeck, Wolfgang. 1991. "On the Institutional Conditions for Diversified Quality Production" in Egon Matzner and Wolfgang Streeck, eds., *Beyond Keynesianism*. Aldershot: Elgar: 21-61.

Streeck, Wolfgang. 1992. *Social Institutions and Economic Performance* Beverly Hills: Sage.

Streeck, Wolfgang. 1994. "Pay Restraint Without Incomes Policy: Institutionalized Monetarism and Industrial Unionism in Germany." In *The Return of Incomes Policy*. Ed. Ronald Dore, Robert Boyer and Zoe Mars. London: Pinter: 118-30.

Streeck, Wolfgang. 1997. "The German Economic Model: Does it Exist? Can it Survive?" in Crouch and Streeck, eds., *The Political Economy of Modern Capitalism* London: Sage.

Streeck, Wolfgang. 2004. "Taking Uncertainty Seriously: Complementarity as a Moving Target." *Workshop Proceedings of the Osterreichische Nationalbank*. 1, 1: 101-115.

Streeck, Wolfgang and Kathleen Thelen. 2005. eds. *Beyond Continuity: Institutional Change in Advanced Political Economies*. Oxford: Oxford University Press.

Swenson, Peter. 1991. "Bringing Capital Back In, or Social Democracy Reconsidered: Employer Power, Cross-Class Alliances and Centralization of Industrial Relations in Denmark and Sweden," *World Politics* 43,4: 513-44.

Swenson, Peter, 2001. *Capitalists Against Markets*. New York: Oxford University Press.

Thelen, Kathleen. 1991. *Union of Parts: Labor Politics in Postwar Germany*. Ithaca: Cornell University Press.

Thelen, Kathleen. 2000. "Why Germany Employers Cannot Bring Themselves to Dismantle the German Model." In Torben Iversen, Jonas Pontusson and David Soskice, eds., *Unions, Employers and Central Banks*. New York: Cambridge University Press: 138-69.

Thelen, Kathleen. 2001. "Varieties of Labor Politics in the Developed Democracies" in Hall and Soskice, eds., *Varieties of Capitalism*: 71-103.

Thelen, Kathleen 2004. *How Institutions Evolve*. New York: Cambridge University Press.

Thelen, Kathleen and Ikuo Kume. 1999. "The Effects of Globalization on Labor Revisited: Lessons from Germany and Japan," *Politics and Society* 27 (December): 477-505.

Tiberghien, Yves. 2002. *Political Mediation of Global Market Forces*. Ph.D. Dissertation, Stanford University.

Tsebelis, George. 1990. *Nested Games: Rational Choice in Comparative Persective*. Berkeley: University of California Press.

Vogel, Steven. 2004. "Routine Adjustment and Bounded Innovation: The Changing Political Economy of Japan." In Wolfgang Streeck and Kathleen Thelen, eds. *Beyond Continuity: Institutional Change in Advanced Political Economies*. Oxford: Oxford University Press:145-168.

Watson, Michael. 2003. "Ricardian Political Economy and the Varieties of Capitalism Approach: Specialisation, Trade and Comparative Institutional Advantage," *Comparative European Politics* 1 (2): 227-40.

Whitley, Richard. 1999. *Divergent Capitalisms: The Social Structuring and Change of Business Systems*. Oxford: Oxford University Press.

Wood, Stewart. 1997. *Capitalist Constitutions: Supply Side Reform in Britain and West Germany 1960-1990*. Ph.D. Dissertation, Harvard University.

Wood, Stewart. 2001. "Employer Preferences, State Power and Labor Market Policy and Germany and Britain" in Hall and Soskice, eds., *Varieties of Capitalism*.

Notes

We are grateful to the Wissenschaftskolleg zu Berlin for support while we reflected on these issues and to Martin Hoepner and Jonathan Zeitlin for comments on an earlier version.

---

[1] For relevant critiques see Howell 2003, Goodin 2003, Watson 2003, Blyth 2003, and those collected in Coates 2005 and *Stato e Mercato* 69 (December 2003).

[2] While analytically distinct, it is worth noting that the more formal and the more informal-conventional aspects are often linked empirically. For example, the convention that large firms supply apprenticeship slots is supported, albeit at slight remove, by a number of more formal institutions – e.g., compulsory membership in employer chambers, strong unions pushing firms up-market, and relatively centralized wage bargaining institutions that compress wages and allow firms to earn rents on training.

[3] The contention here is that all individuals are 'entrepreneurial' to some extent in the broad sense of that term (i.e. this does not refer exclusively to business 'entrepreneurs'), although some individuals are more so than others and with respect to some institutions and not others. Thus, institutional enterpreneurialism varies across individuals and institutional fields.

[4] In a powerful analysis, Streeck (1991) has described this last feature as one that supplies 'redundant capacities' to actors. As he notes, some of these capacities are more available in some places and for some purposes than others.

[5] Bates (1988) and Knight (1992) have drawn attention to this problem.

[6] This is one of the key points developed in Thelen (2001).

[7] This is confirmed by studies that show a strong correlation between membership in employers associations and union presence in Germany.

[8] Note we are not claiming that they rest entirely on this foundation or that the power to accept or reject an institutional practice is equal across actors. See our discussion of power below.

[9] Hoepner's (2003) analysis of corporate reform in Germany provides a nice example. As he notes, it can be difficult to explain why German trade unions supported legislation requiring more transparent balance sheets. Such moves could enhance the power of shareholders relative to stakeholders. However, he found that the trade unions supported greater transparency because they believed it would enhance their negotiating position vis-à-vis firms, by supplying them with more information about the firm's balance sheet. Distributive concerns about what they could secure in the collective bargaining process, rather than concerns for the well-being of the economy as a whole, drove the position of the unions on this issue.

[10] As Streeck (2004) notes, even institutional complementarities are often 'discovered' rather than designed, as actors work to adapt their strategies and the institutions around them to their purposes.

[11] Organized labor is another actor whose strategies, including those organized around maintaining coordination across a diverse membership, is obviously important.

[12] These are not exhaustive of the modes of change that can be observed in contemporary political economies, and a somewhat broader (though, again, not exhaustive) inventory is discussed in Streeck and Thelen (2005). Defection is the mechanism that defines the mode of change that Streeck and Thelen call

institutional "displacement," and their mode of "conversion" features reinterpretation as the main mechanism of change (p. 31).

[13] For a review of the co-evolution of the literatures on varieties of capitalism and cross-class alliances, see Thelen 2002.

[14] Over long periods of time, of course, the effects of incremental change can be profound (see, especially, the contributions in Streeck and Thelen eds., 2005). If there is anything Darwinian about institutional change in the political economy, it lies in the fact that small adaptations to the environment, limited by the degree to which so many features of the institutional ecology remain the same and continue to impinge on the strategies of the actors, can lead, nonetheless, to significant changes strategies over time. But this is a slow process and one that is as likely to produce divergence as convergence in institutional forms.