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Bridging East and West: Re-examining the notion of corporate governance in explaining institutional change

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Michał Federowicz

Bridging East and West:
Re-examining the Notion of Corporate Governance
in Explaining Institutional Change^{*}

Best.-Nr. P 2003-004

**Wissenschaftszentrum Berlin
für Sozialforschung (WZB)**

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**Beim Präsidenten
Forschungsplanung und -koordination**

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Abstract

The paper discusses the theoretical framework for cross-national research on corporate governance. Although the field of corporate governance is largely explored, the existing analyses focus rather on advanced economies and detailed comparisons between them, and sometimes try to apply the same theoretical framework to other countries. However, the development of a sound governance structure in 'catching-up' economies is typically affected by the political process of reforms. Quite often informal institutions, which still exist in the political proceedings, undermine formal settings of governance existing in these countries. The paper starts with the assumption that considerations of corporate governance in the "East - West" comparisons can not neglect a broad perspective of the political nature of governance arrangements both formal and informal. It also examines the adequacy of 'path-dependency' approaches. It adds to the perspective of "Varieties of Capitalism" some dimensions which make this perspective more sensitive towards "East - West" analyses.

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Introduction

The decade of the 1990s in Central and Eastern Europe was a period of intensive systemic change, ushering in significant and major transformations in fundamental institutions in both the political and economic spheres. However, the debates on change and restructuring revealed a tendency to an isolationist approach conceptually, where (re)building institutions was often viewed as solely specific to countries of one region. If broader conceptual comparisons were undertaken, these were primarily in the context of the Latin America or Far East Asian experience rather than with neighbouring countries in Western or Southern Europe. Irrespective of how misleading these distant comparisons may have been, they appeared to have had the most visible impact on perceiving and projecting likely trajectories of institutional change in the region in the initial stage of post-communist transformation. At the same time, the institutional developments in Ireland or Finland, let alone the French experience in overcoming the *dirigist* past or the Swedish policy shift, found almost no echo in debate when considering possible lessons learnt in major institutional change. Instead, discussion revolved almost entirely around an ideologically biased quarrel over “gradual” and “shock” therapy, obscuring any genuine perception of the concrete problems to be faced.

One reason why more justified cross-country comparisons were not undertaken seems likely to be found on the analytical level, where some key notions were unable to serve as analytical tools in the new context; such notions had not been related to the former communist system, and were difficult to adapt quickly to the ‘post-communism’ reality. The notion of corporate governance, and its relation to privatisation and other segments of institutional change, would be an example of one such concept. Although the question of privatisation in the CEE countries awoke wide-ranging and substantial interest, for more than five years at least practically nobody linked it to the vital problem of corporate governance¹. Yet how was it possible that it took so long before the core problem of property relations was given an adequate institutional underpinning? The answer to this lies partly in the mystery of why well-established scientific notions sometimes prove reluctant to cross borders, and if they do, why then they then travel so slowly in the jet age.

¹ One of the first publications was Berglöf, 1995. Then a major work on corporate governance in the region was issued in 1996 by R. Frydman, Ch. W. Gray and A. Rapaczynski (eds.): *Corporate Governance in Central Europe and Russia*, CEU Press. This two volume joint work applied the notion of corporate governance to various aspects of the extensive and comprehensive plans for privatisation in the CEE. Surprisingly, it did not provoke widespread debate on a broader understanding of the notion and how it relates to other segments of institutional change. The more detailed analyses appeared by the end of the decade, see e.g. K. Pistor et al, 2000, or E. Voszka, 2000.

This paper is calling for the re-examination of several notions that serve analyses of institutional change. The profound systemic transformations occurring in the CEE countries have brought the issue of institutional change sharply into focus, in contrast to many factors that have remained in shadow. Despite concentrating on a specific group of countries, this research may produce findings surprisingly relevant for a more detailed understanding of the quite universal issue of institutional change. This paper focuses on the notion of corporate governance, but other related notions may equally benefit from substantial debates on both the content and theoretical associations. For example, one such notion would be the renowned concept of civil society, now re-appearing in conjunction with the new experience in the CEE context². Further concepts in need of debate might relate to those questions of democratic deficiencies and democratic governance that have been placed firmly on the agenda as the prospect of the EU25 draws ever closer. In general, one might say that in the wake of a perspective of 'Europeanisation', the need to reconsider a range of theoretical notions has become more pronounced³.

I believe in the importance of taking an historical orientation in re-considering a notion. In order to help fine-tune cross-country comparisons (representing, in other words, mutual understanding), such re-consideration ought to uncover significant differences in country specific contexts (regions, etc.) which have been historically shaped. Research into the specific historical processes in each country (generally, each territorial/cultural unit of observation) can be viewed as a methodological imperative helping to avoid any simplistic explanations of institutional change, such as diffusion or transplantation. In this approach, rather than taking concrete institutional solutions as the subjects of cross-country comparisons, we concentrate on the socially and politically embedded processes that have led to concrete solutions. Historically sensitive analysis, however, does not inevitably imply a 'path-dependency' perspective. With all due respect to the specific developments taking place in each individual country, taken as a whole, the 1990s in Central Eastern Europe reveal only yet another instance of a period of intensive institutional evolution, frequently observed during the long historical development of capitalism though, each time, with different circumstances that were responsible for the successes and failures.

² The issue was recently taken up at the First Edmund Mokrzycki Symposium "Building Civil Society and Democracy East of the Elbe", a joint venture between WZB, UMK, CEU/CSS and IFiS PAN, Warsaw, September 27-28, 2002, and the Workshop "Civil Society in the Making", and initiated by the Social Science Net Workshop 4, Warsaw, September 20-21, 2002. See especially Leszczenko, 2002; Reichard, 2002.

³ This equally affects the issue of corporate governance as primarily related to business structures and the business environment, and the broad meaning of 'governance' in the core political context, see e.g. G. Grabbe, 2000; 1999; 2001). The issue of democratic deficiency is also related to the problem of 'poor' or 'premature' democratic consolidation in the CEE countries (Greskovits, 1998; Mokrzycki, Rychard, Zybortowicz, 2002).

This paper takes a balanced approach to the dynamics of institutional change to account both for ‘past and future dependency’, or rather, the past and future orientations of the actors involved. The first section attempts to create an adequate framework for East-West comparisons, approaching the main thesis on the basis of national institutional resources. In the second section, specific issues of the post-communist environment as related to the corporate governance are indicated, and a broader meaning of the notion called for. Before moving on to further elaboration, the third section tackles the complexity of the notion within the context of advanced economies⁴. And finally, the fourth section points more precisely to the gap between East and West, suggesting the issues that need to be taken into account in considering how a sound governance structure emerges. The concluding remarks place the meaning of corporate governance in the broader context of European integration and a ‘political and economic equilibrium’.

I. The search for an adequate framework for East-West comparisons

Over the last twenty years, economic history has witnessed a substantial change in nation-wide economic systems and their institutions. From the long term perspective, after the oil crises in the early 1970s and years of stagnation in capitalist economies, growth in the importance of supply side economics made way for tighter monetary policy, privatisation, the shifting role of the state, more independent central banks, and careful education and training policies, or special measures for SME development. These changes have also provoked major scientific interest in firm governance, inter-firm relations, and the institutional environment of business activity, with a number of substantial changes running parallel to these interests. Institutional change has been evolutionary, occurring within the frame set by domestic politics; however, those domestic players were acting in the context of strong international interdependence and a growing detailed scientific knowledge about the variety of institutional solutions and practices that exist.

At various points in the past, different states in the large family of advanced capitalist economies have taken it upon themselves to modify those institutional settings that had formerly been regarded as the core of their system of political economy. For

⁴ This section is based on David Soskice’s work presented at the Workshop: “Corporate Governance in a Changing Economic and Political Environment: Trajectories of Institutional Change on the European Continent”, WZB, 17-18 March, 2000. I am grateful to David Soskice for his contribution to the workshop and remain in his debt for the way he structured the problem so clearly, preparing the ground for further discussions. Of course, any mistakes that may appear in this section, or its context, remain entirely my own responsibility.

example, in the 1980s the French attempted ‘regionalisation’ in a move intentionally opposed to the prevailing system of state-centred coordination (Levy, 1994), and further examples can easily be found in other countries. In the first half of 1980s, for instance, Denmark significantly lowered the institutional level of wage bargaining, simultaneously introducing tighter monetary control, and was followed a few years later, after some political upheavals, by Sweden (Iversen, 1995). In fact, practically all (‘west’) European states were involved in substantial institutional changes. On one hand, they were reacting to pressure on markets in the throes of globalisation and the signs of tougher competition posing questions to institutions that had emerged and functioned well in the periods of prosperity during the 1950s and 1960s; on the other hand, new possibilities for old and new EU members were emerging in the wake of a deepening European integration taking place within the context of globalisation.

Between 1989-1991, those trends towards both globalisation and European integration were given a new impetus from the decline of the Soviet-style economies and states. Although the forces driving these two trends lay elsewhere, the end of the Cold War between the ‘capitalist world’ and the ‘socialist world’ (or ‘communist’, or ‘party-state-socialist world’) suddenly opened a new perspective on political and economic evolution in future.

Furthermore, it demanded a new theoretical vision, and resulted in a series of new world economy convergence theories running through public debate in the early 1990s. The convergence idea itself derived from the Anglo-Saxon way of organising and controlling business activity, allegedly the method dominating the global perspective, and hence stimulating and inducing all national economies to move towards this system. There were two aspects particularly that fostered this notion of convergence: first, disillusion over state-socialist ideas on economic coordination, and second, partial disappointment with Japanese performance and the Japanese model, that had been so eagerly studied before. However, the vision of converging capitalism and the ‘end of history’ provoked new, more sensitive research devoted to advanced national economies, focusing on specific, historically developed, national economic institutions (Berger, 1996). The findings showed country specific trajectories of institutional reforms, taking place within the context of globalisation, revealing each mature and coherent national system as having certain advantages over the other, yet simultaneously suffering some disadvantages; taken together, these then provoke different reactions to the current market game from the firms involved (Soskice, 1994; Hancke and Casper, 1996; Vitols et al, 1997). Indeed, if we take the last two decades in the integrating world into account, we find international debate has not been focused on a simplified juxtaposition of convergence and divergence, but rather has been giving detailed consideration to the evolution of historically shaped national systems in the process of growing interdependence. Such a

perspective can be found in the Variety of Capitalism (VoC) approach (Hall and Soskice, 2001).

In the context of post-communist transformation countries, the VoC approach helps to overcome a prolonged, but rather artificial controversy; in this case, between those advocating radical change towards a ‘targeted’ system, and others intent on building a new institutional system with ‘recombinant’ (Stark, 1996) elements of the past, and viewing them as the assets of gradual change. As Greskovits pointed out (Greskovits, 2000), this debate was lacking the sensitive analytical tools needed to distinguish between instances where reformers had to act quickly and often unilaterally, and where they needed to involve extensive social forces, relying on an interactive process to gradually shape institutions. In any event, the question of the country’s institutional resources remains unresolved, regardless of how radical or gradual the pace of transformation is.

I refer to the Variety of Capitalism perspective to move beyond the quarrel between simplistic ‘designers of capitalism’ with their prescription for one way performance, and equally simplistic advocates of a ‘path-dependency’ approach, which tends to rely heavily on explanations oriented towards the past. The VoC approach, by definition, exposes diversity within the capitalist family, while considering the interplay between various models, as well as between those domestic and external forces that shape the dynamics of institutional change. Similarly, it allows the context of globalisation and European integration to be a present factor in considerations, while the typical attempts to preserve and reproduce existing domestic constellations are analysed in terms of a variety of possible responses to external challenges. In such a view, there is no doubt that the same institution, embedded in one economy and society, works differently (or does not work at all) after being transplanted to another economy and society; the aim, though, rather than offering suggestions to other countries, is to observe incremental changes in one or the other country, and see which factors (both domestic and external) and constellations of economic and political interests have determined its dynamics. In this way, performance in one country may contribute to shaping the strategies of economic and political actors in other countries. In other words, the VoC approach allows us to deal with country specific and dynamic models, providing a framework where the outcome of East-West or cross-country comparisons do not imply a direct analogy (always questionable), but rather suggests reasons for the different dynamics of change.

If I partially object to the path-dependency approach, this is not to say that it is wrong. In historical terms, I can agree essentially that national politics and national history has an absolutely fundamental role in framing how capitalist institutions become specifically incorporated, and indeed this is actually how the path-dependent

national embeddness of capitalist institutions manifests itself⁵ (Chavance and Magnin, 2000). This generally works for advanced economies and, in this aspect, also finds endorsement in the VoC approach. The point is, however, that applying the same path-dependent perspective to the east may often be misleading, precisely because it does not resolve the problem of massive and fundamental institutional change. It provides no information on how and to what extent consecutive countries have been able to ascertain or, in varying degrees, overcome their past. Instead, it generates a bias towards simple *post facto* explanations. And when we turn to advanced countries – for example, France, which was not only able to build but also overcome a *dirigiste* state co-ordination – the path-dependence approach similarly is not extremely helpful, since one needs to move beyond it to understand how a series of institutional innovations, together with standardised macroeconomic policies, led to a shift in the leading role of the state in favour of ‘firm led’ corporate adjustment, eventually culminating in substantial modification to the institutional settings of French corporate governance (Hancke, 2000).

In other words, path-dependency needs to be supplemented and moderated by other concepts; in this context, I would suggest two additional notions are required. Firstly, the hierarchy of institutions, where some institutions, to a large extent, determine others; hence, explaining massive change requires examining the more influential institutions and looking both at how they balance ‘old’ and ‘new’ driving forces, and the way they exercise influence on institutional change, where, for instance, the interplay between political and economic institutions may turn out to be a key part of such an explanation. In the Soviet world, political institutions had an all-pervading influence on the economy. The degree of political change, then, in any given country influenced the nature and outcome of economic change, with, as Hellman demonstrated taking data from a large sample of transforming countries, the more democratic the regime, the more robust the economic development (Hellman, 1998) – although this was not so obvious to many researchers when post-communist transformation first began. The nature of political institutions affects the nature of dominating business networks that encompass business activity, and this, in turn, contributes to the game between reshaping and reproducing economic institutions. This aspect was often neglected by network analyses, but the concept of a hierarchy of institutions would help to avoid such a gap.

Nonetheless, one might still argue that the ‘core institutions’ are themselves path-dependent, even though a part of their evolution certainly is derived from contradicting historical dependency. The unresolved issue revolves around how to conceptualise what is beyond path-dependency, and, typically, the answer is that

⁵ I am grateful to Bernard Chavance for clarification of this point during our several discussions; see also Chavance and Labrousse, 1998).

change comes from outside. However, such an approach results in seeing domestic forces as path-dependent and external forces as innovative – a view I cannot subscribe to. Change agents can be found both inside and outside the domestic arena; more importantly, both of them modify their strategies according to their future oriented expectations and calculations. It is precisely the future oriented calculations of actors who are participating and contributing to change that is overlooked in analyses of institutional development.

Thus, the second aspect, in addition to the hierarchical nature of institutional settings, is the strong future orientation of (some) economic and political actors. As existing institutional settings become less and less satisfying, these actors gain both in voice and audience, provoking other actors to more future oriented speculations about likely change. In turn, their redefined expectations create a new environment that may reinforce the change. The essential feature in these ‘path-finding’ cycles (Federowicz, 2000) is that some actors transcend the existing institutional settings, frequently devoting considerable effort to escape from them. In their calculations about the future, they try to anticipate the likely change and reap the benefit from being ahead in this process. In doing so, they contribute to the shift of core institutions, or to the establishment of some new core institutions. Then, in the medium and long-term perspective, prior to a new institutional setting becoming firmly established, they either receive praise or punished for their path-finding activity, depending on the hierarchy of other interfering institutions. In my view, these two concepts – the hierarchy of institutions, and the ‘anticipated institutions’ undertaken by some actors before they are really established – may help us to understand massive institutional change better.

The thesis of this paper is that each national system copes with new challenges in its own way, because it tries to rely as much as possible on its pre-existing institutional resources. It is in these terms that (with some exceptions) the domestic elite and domestically important actors, including major social actors, think about their adaptability to changing circumstances. Similarly, society also organises its major economic activity, and mobilises resources for change in this same way. In this sense, even given strong converging pressure, what tends to be experienced, rather than adaptation of external patterns or a radical shift to a different logic of institutional arrangements, is actually an incremental change. The issue of ‘national assets’ is one shared in both the East and the West, with a similar temptation to protect them as much as possible at the expense of external adaptability. However, the more stable the position of a country, the more successful is an institutional change that ‘recombines’ pre-existing institutional assets with just a few new elements. Similarly, the more problematic the economic position of any given country is, the more damaging such a natural attempt to preserve pre-existing constellations of domestic

forces, and the more promising it may be to abandon them as quickly as possible (Minev, Zheliazkova, 2000). In other words, 're-combination' of existing assets is likely to succeed in countries that, though facing a need for change, enjoy a stable economy and relatively coherent institutional settings, like France or Germany. On the contrary, countries marked by weakness in the economy and disintegrating institutional settings (often unacknowledged initially), sooner or later will need to challenge massive and fundamental transformation with the requisite openness to the external change factors.

Advanced economies are powerful enough to resist outside pressure, modifying their institutions in their own way; however, economies in the throes of intense transformation have little space for such a strategy. Understanding this contrast in detail, I believe, helps to explain the successes and failures in the process of transformation. This comparison is also fruitful when taking the contents of the same terms in the context of a different country and seeing what variations there are. For instance, 'the state' and 'state regulation', as a notion, may evoke essentially different associations, and even actually refer to a different type of political and economic relations; a less obvious example would be how the notion of 'cross-ownership' may refer to different denominations in, say, Germany and the Ukraine. In exposing all these differences, the VoC approach assists in examining institutional gaps and inconsistencies, or incomplete processes of change, more precisely. Instead of one-way directives, it provides an insight into multiple international pressures, without losing sight of domestic development and the prevailing interests in the domestic arena.

II. Transformation in a post non-market economy and the meaning of corporate governance

The last twenty years unfolded in a totally different way in eastern and western Europe. Naturally, there were also variations between countries within both East and West, yet, in terms of governance issues, the most striking difference between the two groups of countries was that in the East, unlike in advanced capitalist economies, the economic stagnation occurring after the late 1970s (no matter what official statistics may claim) was initially more delayed, but then provoked substantial institutional change. In no country could the proposed changes satisfy the need for major reforms, without substantial structural change. The principal result of economic stagnation in the East was exhausting the existing material assets, including human resources, which finally contributed to the collapse of the system. Until the symbolic collapse of the Berlin wall, with very few exceptions, the firms located between the Elbe and

Kamchatka were not subject to any typical market pressures, international or domestic, but this was precisely the pressure behind the necessary changes in western economies, even if governments tried to dampen or delay it. After 1989, the East became similarly subject to this same pressure, though at different speeds in different countries, branches and sectors. Indeed, this helps further explain the differences between them, although, in a sense, eastern enterprises were thrown into the context of globalised economy overnight, while western European countries had taken gradual steps towards globalisation, powered partly (although not in all cases) by the advantage of exceptional prosperity of 1950s and 1960s. At the same time, in the East, the fruits of earlier economic developments were largely exhausted in trying to cover up the costs involved in the desperate reproduction of one-party political and economic control.

This is why direct market pressures, with all their positive and negative aspects, became so important in large-scale activation of economic life. Whatever the former economic system was, and whether it is termed communist, socialist or a party state economy, it was quite simply a non-market system. In other words, the market game as such hardly existed and, hence, could not contribute to shaping relations between the participants of economic life, or their individual strategies (Kornai, 1980; Beksiak et al, 1990; Mlcoch, 1992). Of course, there were some small niches where a quasi-market periodically emerged in some countries, but all these spheres were totally dependent on decisions taken in the non-market core of the system and fundamentally lacked the stability necessary for economic development. As mentioned before, very few enterprises had any expertise in the international market game. Instead, they reflected the whole complexity of ambiguous dependencies found in a centralised and poorly functioning decision-making system. Thus, at the micro-level, the most striking difference between East and West was that even the best firms in the East were practically cut off from that expertise on genuine institutional development, which, in the context of growing internationalisation of business activity, was gradually evolving in the West. It was in this situation that the momentum of globalised confrontation came onto the agenda in a far stronger form than ever. Nonetheless, the most efficient strategy for catching up with and joining the capitalist family proved to be a strategy of openness running in parallel with coherent institutional shifts, at the expense of domestically protected interests.

Shifting towards privatisation in post-communist countries during the early 1990s did not simply reflect an intellectual fashion, or occur under pressure from international financial institutions. Instead, it was a consequence of the weakest points in previous micro-economic performance and its institutional settings. The most significant part of institutional transformation in the East has been privatisation; however, although the aims formulated at the beginning of the decade of 1990s took account of many aspects, the question of corporate governance was never raised.

Now, more than ever, it is obvious that the most important goal of privatisation is a healthy corporate governance structure: the most crucial concern is not the nominal transfer of titles, nor financial income to treasury, but the factors governing the future development of privatised firms. When we turn to the central-eastern economies, we find the Hungarian experience offers a model for the most efficient way of achieving this goal. In spite of early attempts by domestic groups to protect their interests via obscure cross-ownership structures, the key strategy of maximising direct foreign investments in privatised firms inevitably provided the most transparent corporate governance, as has been systematically documented in the work of Eva Voszka (Voszka, 2000).

But even where FDI cannot be accessed, as, for a number of reasons, in the case of Hungary, corporate governance still remains the most significant outcome of privatisation. This similarly brings the issue of property transfer into a much broader context, since it inevitably addresses problems that are typically neglected when title transfer is taken in isolation. Essentially, when facing deep institutional change, it is not sufficient to rely on any one of those models of relations, well known from advanced economies, between (new) owners and management, or management and workers, to produce a healthy governance structure. In addition to any formal aspect of principal-agent relations, it is crucial to know what kind of choices, opportunities and constraints the existing institutional system, together with its informal part, is offering to all of these economic actors. The Hungarian success did not rely solely on FDI, but built principally on the most complete and coherent institutional settings in all other spheres, e.g., bankruptcy law, contract law, banking law, etc. (Gray and Hendley, 1995). From the perspective of corporate governance's political economy, the prime factor, however, is that the need for FDI inflows, and the high levels they were at, formed the best incentive for consecutive governments, regardless of their political options, to build relatively clear institutions that could and did encourage important investments. Rather than in the majority of other countries, where FDI inflows divided the elites, in this case they contributed to consolidating the position of the political and economic elite; sometimes, in the former instances, there was a perverse elite consolidation around the greed for domestic assets, with concomitant obstacles for foreign investor access.

The importance of corporate governance lies in the centrality of its position, interfacing micro-economic (firm level) decisions to those all important institutional arrangements that constitute the system of economy in any given country, not only including those concerning financial markets and government financial flows, but equally those dealing with labour markets and the workers' position in decision-making, entry and exit regulations, contracts, inter-firm relations, self enforcement, and the judiciary.

When examining corporate governance in emerging market economies, one needs a broad and detailed understanding of (un)available strategies and (non-)existing constraints on managers, owners, bureaucrats, politicians, and labour. This requires moving beyond the single principal-agent approach, which only makes sense after all other institutional determinants of this relation have been clarified – and that is typically not the case with transforming economies.

The point is, however, that even in advanced economies the notion of corporate governance does not simply rest on the narrow basis of the relation between owners (shareholders) and top managers. At least, this is not the only way to understand the corporate governance issue, and certainly not the most helpful in any comparative analysis. What we need is an analytical tool capable of showing the relations between corporate governance in its narrow meaning to broadly understood determinants derived from other parts of institutional settings. Such an approach will enable us to see how corporate governance really works (or why it does not work), and more importantly, identify the institutional circumstances that have led to a particular shape of corporate governance developing in any given particular country, while simultaneously helping to reveal reasons for the different dynamics of change in different countries. What is missing in the ‘after-communism’ economies is this type of harmonisation and coherence between formal corporate governance institutions in a narrow sense, and the real game over control and decision-making.

III. The complexity of a coherent governance structure in advanced economies⁶

To uncover the complexity of governance structure at the corporate level, it is quite instructive to make use of the well-known comparison between two durable and stable systems, the Anglo-Saxon and the German. Despite a certain degree of pressure towards convergence, the two systems retain their contradictory quality, with each of them marked by the logic of incremental change, rather than any openness towards substantially new solutions (Vitols and Casper, 1997; Casper, 1999). The differences between them facilitate identifying those basic parameters that play a role in the governance functioning at present. In other words, the contradiction between these two systems provides a foundation for the initial and central step towards constructing an analytical framework for cross-country comparisons that inevitably depart from the American type of business environment.

⁶ See footnote 4.

In corporate governance terms, three general institutional factors can be found in any advanced economy: on the one hand, the actual system of corporate governance itself, in its narrow sense, i.e., supervisory boards, stable shareholder agreements, and management, which is, on the other, interlocked with two other segments of the capitalist system.

For example, tuning to Germany first, we find a set of product markets radically different from those engaged in by either the United States or the United Kingdom. This leads us to our first point: the system of corporate governance interlocks with the product markets engaged in, the innovation strategies implemented, and the general economic activities undertaken in different countries.

Secondly, the system of corporate governance interlocks very closely with other key elements of advanced capitalist systems; in particular, the regulations governing the labour market, the system of education and training (especially of vocational training at work) and the nature of the linkages between companies (networks), embodied in institutions like technology transfer and standard-setting.

In other words, it is crucial to understand that there is little point in examining a system of corporate governance in isolation. Instead, a more fruitful approach is to analyse how it interlocks with 1) the type of economic activity and type of markets which companies in that country are engaged in, and with 2) other, key elements or capitalist systems: labour markets, education and training, and inter-company relations.

As to the corporate governance system itself, there is no doubt that the narrow interpretation is presently beginning to change – a process becoming even more evident if we briefly review developments. In the last twenty years, economists have evolved the corporate governance issue in ways that view it centrally as a problem between owners of companies, or between those people providing financial resources to companies and, on the other hand, the top managers of those companies. In such a model, the corporate governance issue has become referred to as the critical principal agency problem. In this scenario, owners have certain goals they would like the executive management to carry out, and corporate governance is essential, from the owner side, to facilitate this control over what the top managers decide. This gives us, more or less, the classic approach adopted by economists, or the way they have approached it in the recent past.

This language used here talks of aligning executive managers' incentives with owners' incentives. But there is a second principal agent problem: how do top managers, or management, get employees - researchers, scientists, engineers,

technicians, field workers, clerical workers and so on - to carry through the strategies they want to see implemented. In other words, we are dealing with two separate but closely inter-linked principal agency games. In the first, owners attempt to control top managers and get them to do what *they* want, and, in the second, top managers, in turn, try to get employees to do what *they* want.

Three elements of critical importance in the system of corporate governance are central to solving these games, relating both to the owner-top manager question and to the top manager-employee question. First and foremost is the question of monitoring: how do owners measure how a company is performing – in this instance, how top management is performing–, and secondly, how does management measure what employees are doing. Hence, the first critical question of corporate governance is the monitoring issue: how can an external owner monitor what is going on internally in the company, and how does management monitor what employees are doing? There issue of corporate governance would evaporate if owners had could see exactly what everybody was doing.

The second central issue concerns incentive structures. What incentives do owners provide managers to ensure that the owners' interests are implemented as far as possible, and what incentives do managers, in their turn, give employees, to ensure employees behave in appropriate ways as far as the managers are concerned?

The third element is the nature of decision-making: do decision-making procedures in any given company primarily allow managers to have unilateral control over decision-making, or have they primarily evolved around the model of *Mitbestimmung*, or co-determination, where managers and employees co-determine decisions, working within the basic framework of a consensus-oriented decision-making system? But decision-making does not solely cover the managers and employees axis, and can be extended to the relations between owners and managers. Is there consensus decision-making system between owners and managers that may be loosely classified as a kind of co-determination, as found in the German system, or is there a procedure characterising the Anglo-American system, where owners, dispersed shareholders, are actually under no particular obligation to the managers of the company as such. In other words, under this latter system, somebody might buy a large share package, take over the company and then impose completely different decisions.

Thus, these three elements – monitoring, incentives, and the nature of decision-making – can be seen as characterising both of the two interlocked principal agency games, between owners and managers, and between managers and employees.

In fact, when looking at practical cases, much depends on two aspects of what is required from employees, and these two aspects are derived from the type of product markets actors are involved in. The first aspect relates to the type of competencies and skills employees need to offer, and the second concerns the amount of autonomy required from employees to carry through the strategies in the particular product markets their company is actively engaged in. We could formulate this as the question: How far is it possible to actually monitor or measure exactly what employees are doing? After all, if they need a substantial amount of autonomy, it is not easy to measure what they do.

These two contradicting systems are obviously not the only systems of governance. Even within the Anglo-Saxon system, there are different systems related to small companies, like, for instance, the venture capital system that, to a certain extent, modifies the strategies of large firms as well. Moreover, the two systems both try to absorb some elements from the others that might be helpful in their constant task of adjusting to the changing global environment. Nevertheless, these two models, taken together with the Japanese one (briefly referred to in the following section) still dominate as major points of reference in cross-country comparative research.

IV. Establishing governance structure during profound systemic change

As mentioned in the previous section, the notion of corporate governance can already draw on a historical evolution. It started as a typically American principal agency problem, tacitly assuming country specific institutional arrangements, without any need to explicitly refer to the typical American institutional environment, i.e., liquid capital markets, high level capitalisation, dispersed banking system, highly competitive environment in inter-firm relations, or flexible labour market, (not to mention the state not involved in micro-economic decisions), since all of these could be taken for granted in examining managerial strategies in the manager-owner game, and the impact this would have on the firm's performance. However, in a sense, the body of literature emerging in the late 1970s and early 1980s referring to the principal agency problem, came to pose the broader question of how the earlier autonomy of managers that generated such flourishing companies and outstanding results over the preceding decades had then contributed to the eventual deterioration in many large American concerns. But this was a question almost impossible to answer from within the narrow paradigm of a corporate governance principally focused on managerial incentives.

At that time, European economies were still not integrated or expansive enough to provoke any serious analyses of a likely corporate model distinctive from the American one, and offering a competitive version. However, a new area in scientific investigations into institutional arrangements opened up as the Japanese economy expanded in the 1970s and 1980s, and they became increasingly successful at confronting American firms in their own markets. Naturally, the emerging literature devoted to the Japanese economy could not all be classified as referring to the corporate governance issue, especially since the term was not used initially. The main stream of research has undertaken attempts to reconstruct the structure of the Japanese economic relations within and outside a single firm, which is essentially a broader meaning of corporate governance, and eventually led to a detailed description of those institutional underpinnings behind Japanese firms' strategies and managerial decision-making. Not surprisingly, the Japanese system turned out to be much closer to the German system than to the American one, (and, in certain aspects even more remote from the American model), but it also had its own distinctive features. One prime difference, for example, can be found in the role of the banks: Japanese banks play a much larger part, and have the technological capacity to monitor the effectiveness of corporations. The relation between owners and managers is based on regular formal and informal monitoring on one hand, and long-run financial provisions on the other. But in contrast to large German firms, Japanese firms tend to compete between themselves in their home markets – more of an American style relation. Nevertheless, as with German firms, they try to co-operate on some strategic goals, like R&D.

The impact of the mass of research on the Japanese economy weakened the dominant American position on the 'intellectual market for institutions' and made room for Europe oriented investigations. The process of ongoing European integration, in the late 1980s and early 1990s, powered the notion of a 'European' corporate governance and helped formulate the concept of 'continental' or '*Rheinisch*' corporate governance, in contrast to the Anglo-Saxon (or Anglo-American) model. However, the idea underlying the *Rheinish* model drew heavily on the German matrix (with a few Japanese model elements that seemed most relevant at that time), and only referred to other European countries rather loosely, in the end expressing less the reality of continental Europe, and far more the mere desire for a unified Europe. In fact, each country continued institutional adjustment in its own way, trying to combine its typical institutional resources with some new solutions, showing themselves more open to the pressures of globalisation than any idea of pan-European institutional settings. There are simply too many spheres of institutional systems involved in real corporate governance to be able to expect any easy harmonisation.

France, although relying on the leading role of the national elite, was able to develop a significantly growing role for its financial markets, while keeping shareholder agreements and long-running financial systems stable. The French system, with its strong management both within and outside the company, is quite different from both the German and the Anglo-American systems, and more importantly, has little in common with the French *dirigiste* past.

Similarly, countries like Italy and Spain were also experiencing significant changes. Although one might expect that these two countries would have similar systems, by virtue of sharing a southern European - Mediterranean culture, they are in fact significantly different (Aguilera, 2000). Italy, engaging in intensive industrialisation after World War II, and involving the state and the political sphere in economic development, was determined to keep the banking sector out of industry because of the negative experiences in this field in the past. However, recently it has significantly reduced state engagement, and is looking rather for cross-country alliances with some major firms. Spain, in its post-dictatorship acceleration, relied on a relatively strong and state-protected banking system as an asset from the past, but has proved to be more open to FDI, a factor making a substantial contribution to economic development as well as to the institutional shift.

These cases contrast the reality of a given economy and the perspective of stylised models, showing how institutional settings are in permanent change in advanced economies. Germany, with the most self-reproducing institutional system, has been witnessing a growing number of 'exceptions' in governance arrangements, especially in new industries, where firms are trying to escape from, or modify, traditional arrangements and practices. This again is a sign that real governance structures tend to follow specific product market determinants rather than traditional institutional settings.

Corporate governance's political economy uncovers the analytical structure in which the governance game takes place. Corporate governance, or governance structure, is considered here as a coherent part of the institutional system underpinning economic life. It is that part of the system that sets the rules of the game for managers and other important actors, and which affects strategic decision-making. In a stable economic system, these are rather complex but coherent arrangements. As was shown in the previous section, the incentive structure explicitly addressed to top managers, or their formal relations to the shareholders, only comprise a part of the story. Thus, transporting a sole corporate governance element, or even a few elements, from one country to another does not then mean that corporate governance will work there. Placing corporate governance within the much broader framework of the political economy leads to an awareness of the institutional gaps and inconsistencies within the system, and leads to a search for the economic and political forces behind them.

Nevertheless, the broad meaning of corporate governance cannot be expanded without setting limitations on research. To put it explicitly, the centre of investigation is the firm, and the rules of the game focusing on top management and the top managerial decision-making that eventually shape business strategies. The political economy of corporate governance reconstructs the structures inside the firm. But to do so, it builds on a extensive knowledge of the institutional environment of the firm, exploring a broad economic, political, and social context. It challenges the interplay between new and old constraints and opportunities in the game. Since these are different in each country and subject to different dynamics of institutional change, a broad understanding of corporate governance helps set a comparative perspective. Instead of the core concern relating solely to reconstructing a model or models, it concentrates on seeing the way in which coherent corporate governance is likely to be reshaped, responding to the changing circumstances, (typically the case for well established and stable economies), or how it is set and consolidated in emerging capitalist economies. The firm here is not considered as an object of typical organisational studies, but as one of the key segments of the political economy system of contemporary capitalism, which itself can be seen as its nexus⁷. The key factor is that corporate governance institutions bridge the micro and macro level of investigation.

At the core of the corporate governance problem lies capitalist development. The corporate governance problem initially derived from the split in the roles of the owner and of management, sometime in the early decades of the last century, that generated capitalist drive and energy in the twentieth century. On one hand, it made capital more flexible and open to new possibilities of technological and organisational innovations; on the other, it made positive selection for managerial positions possible (in place of heritage, tribal, or mafia rule). Finally, it created a market for corporate control, if not through the stock market, then at least through mergers and strategic alliances.

As far as corporate governance is concerned, the twin poles of capitalist development are firstly, the Anglo-American version, (closer to a free market idea but not equal to it), where the owner became dispersed during institutional evolution but management was very concrete and concentrated and subject to a highly competitive environment, and, secondly, the German or Japanese versions of capitalist development, (less oriented to a free market idea yet also subjected to a market type competition), where the owner became quite concrete and institutionally interlocked within cross-ownership, while management became less concentrated and had more obligations towards both finance providers and employees.

⁷ One of best synthesis of this perspective has been presented by Peter Hall (Hall, 1995). His work on Western Europe may be successfully extended into Central Eastern Europe.

Let us now briefly contrast both trajectories of institutional capitalist development with the experience of socialist economies in the east of Europe. For this purpose, it is sufficient to note that in the latter the role of the owner was absorbed into a non-definable idea of ‘social’ (all society) ownership, while the role of management became dispersed in a multi-level, hierarchical, and politically controlled bureaucracy. The evolution of governance after the Second World War under the Communist Party regime is marked by a disappearing sense of ownership coupled with growing complexity in decision-making structures (both formal and informal) and that dramatic growth in the significance of informal relations which eventually led to the ungovernability of the system. In contrast, in the same period, and specifically since 1970s, all kinds of institutional arrangements related to governance and decision-making, such as capital flows and instruments, managerial incentives, and the banking system and labour market, underwent intensive fine-tuning in the capitalist countries.

Undoubtedly, the initial idea of major privatisation in the East together with a political turn around was definitely the right approach. However, this did not deal with all institutional areas related to the governance, and did not even pose the question of likely governance structures after privatisation in a continuing institutional environment, an oversight that inevitably resulted in a partial course of reforms without any systematic coordination. But there was a further inconsistency between the premises and their practical application. While the reformers, both from within and outside the countries involved, typically opted for American style development to create institutionally ensured competitive environments as quickly as possible, part of the former nomenclatura, although not objecting to American style business relations, took steps to ensure cross-ownership as a means of institutionally safeguarding long term corporate control. As a result, the trajectories of institutional change were not coherent. On one hand, primarily due to financial sector weakness, the cross-ownership relations could not evolve as in say, Germany or France; on the other hand, financial markets, with both low capitalisation and poor transparency, did not reassemble those in the US or the UK either (Coffee, 1996). The state, still heavily involved through nominal ownership of large portions of the economy and vast financial flows, did not reflect a Western understanding of state involvement. The more consistent policies were only able to be consolidated after serious macro-economic problems, like those in Hungary in 1995, or those experienced later and more seriously in the Czech Republic, in 1997; the price for the inconsistencies was always high – sometimes extremely high – as in the banking crash in Bulgaria, in 1997.

In terms of Section 3 of this paper then, let us then summarise what needs to be taken into account in a broad understanding of corporate governance.

First of all, the system of corporate governance interlocks with the type of product markets, and vice versa. The success in particular product markets depends on initial corporate governance settings and their further development, as can clearly be seen when comparing the good performance of Japanese firms in the 1980s, before the impact of telecommunication and other information technologies, and their steadily more difficult conduct in the following decades. This is also a challenge for western European economies, which may need further changes in their corporate governance settings. Indeed, in countries like Germany, Switzerland, Sweden, or France for that matter, it remains uncertain whether things will continue in the same pattern as has been pursued over the last twenty years, whereby recent years have suggested significantly greater uncertainty over whether they can do so. These European countries have become more flexible and competitive than they were before, but have nonetheless retained an underlying form of capitalism that is distinctly different from the Anglo-Saxon system. It is not clear whether this sort of internally changing but divergent paths model will continue to develop, or whether there will be a convergence towards a more Anglo-Saxon system. Leading technological development of the last five to ten years lean towards the Anglo-Saxon experience, but it is too early to say what the final outcome will be. Rather than debating convergence versus divergence, understanding the growing interdependence between firms, economies, and institutional systems requires looking at specific product markets that tend to dominate economic development and seeing what type of governance best promotes such development.

There is much more uncertainty, however, concerning the developing economies, including those of Central-Eastern Europe. The lesson of the product markets suggests the question of corporate governance is not as abstract as some theories of capitalism would like to believe. Issues in transforming economies remain unresolved as regards the kind of market niches they are likely to explore, and how their efforts to consolidate the governance structures coincide with these potential markets. For example, one factor in the recent Irish success was how the Irish potential, in terms of institutional resources, to follow the Anglo-American governance structure went hand in hand with the rapid development of lucrative industries. However, such a happy coincidence remains the exception rather than the rule.

Secondly, as was pointed out above, the system of corporate governance interlocks very closely with the other key elements in capitalist systems, such as the labour markets, education and training, or inter-company relations. But, in this instance, the list of the other elements is very much country sensitive and needs to refer to country specific circumstances. For instance, as the French case shows, the arrangements of elite circulation may turn out to be crucial in reshaping corporate governance; in contrast, in the UK, the type of contracting arrangements is important. For countries

in post-communist transformation, the emerging governance structure interlocks with the state, where the latter is defined as a set of (exhausted) institutions – for example, the construction of the Ukrainian state after 1991 hampered both the reform of corporate governance and economic institutional reforms⁸. In all countries, the nature of business networks, with their political involvement, affects inter-company relations. In general, in Central Eastern Europe, corporate governance interlocks with all kinds of arrangements contributing to the rapid process of capital formation by exchanging pre-existing non-financial for financial capital.

Essentially, as far as corporate finance is concerned, the problem of corporate governance is not only “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments” (Shleifer & Vishny, 1997: 737), but it also comprises a reverse perspective. It also concerns the ways top managers try to secure finance for their companies – and they do this in all the ways provided by the formal and informal institutional environment, with all the business and political commitments necessary. This is why, regardless of formal ownership ties, the financial sector and the state (with the flows of public money) are important parts of the system which interlocks with corporate governance.

Thirdly, this last point clearly indicates one more part needing to be considered when dealing with institutional change in the field of corporate governance: the framework of macro-economic policy. This is visible in the French experience, for example, but it is equally clear in other countries as well. The nature and consistency of macro-economic policy affects all financial flows, and thus may significantly change the environment for reshaping governance structures and managerial decisions. The context of macro-economic policy helps to understand the pace and quality of institutional change in both West and East.

The narrow meaning of corporate governance, of course, does retain its importance, together with those numerous regulations that largely determine business relations. The broad understanding of corporate governance, however, is essential if we are to make sense of these detailed regulations, to see the real alternatives behind managerial choices, and to investigate the institutional and macro-economic context of micro-economic strategies. In more general terms, it is necessary to address the question of the equilibrium / inequilibrium of institutional systems, which, in turn, indicates how we need to address the dynamics of the change of governance structures. For advanced economies primarily engaged in high-tech competition, (in the long run, determining their economic position), the general equilibrium is permanently disturbed by the new product markets putting pressure on both macro-

⁸ See, for example. D’Anieri, P., Kravchuk, r., Kuzio T., 1999; Kuzio, T., Kravchuk, t., D’Anieri, P., (eds.), 1999; Sidenko and Kuziakiv, 2000.

economic policies and existing institutional settings. For transforming economies, the broad understanding of corporate governance uncovers how difficult it is to attain an institutional equilibrium, even where some of the detailed regulations for corporate governance may be very well designed (Pistor, 2000). In other words, the broad understanding of corporate governance uncovers institutional gaps and inconsistencies.

V. Concluding remarks

Looking at the institutional dynamics of emerging systems, one can refer to a broader thesis of ‘low level equilibrium’, as formulated by Greskovits, for countries transforming after the period of communist dominance (Greskovits, 1998). This model addresses the relationship between the political system and the economic system in these countries, and reflects the initial worries about their capacity to consolidate democracy coupled with, simultaneously, a challenge to any significant economic reform, which allegedly inevitably results in massive social protests. Yet the protests did not occur to an extent that would have threatened the continuity of the reforms. According to the low equilibrium thesis, this is because these countries did manage to build formal democratic institutions and the rudiments of market relations, although they are rather poor democracies and deeply imperfect markets. Consequently, the kind of equilibrium between those deficiencies makes the low level (low quality) of the system rather stable and durable.

The field of corporate governance suggests that the last statement about the durability of low equilibrium would only be justified if the economic system were closed. The analysis points out the numerous partial disequilibria in the issue of corporate governance, approached in broad terms. Of course, these disequilibria may be (and often were) balanced by an ‘imperfect democracy’ where the formally democratic mechanisms of political control do not really function. Yet, growing economic pressures, coming from both international product markets and financial markets, make such a kind of balance increasingly difficult. In addition, domestic social protests in this context may encourage a further institutional change towards a more mature democratic system, precisely because they help destroy the equilibrium which is itself proving to hamper development. In any case, we can say the more open the economic system, the more pressure there is on a low level balance of domestic institutions.

The broad perspective on corporate governance can also make another contribution here. The product markets know their specific hierarchy in the value chains, some of them being more profitable than others, and indeed, this is all part of the game between advanced economies in high-tech competition. This itself is one reason for permanent modifications to corporate governance, and a measure of its efficiency. However, in the case of deeply transforming economies, this is even more complex: they actually do not freely pick up the desired elements of existing models and practices. Instead, they face many constraints, lacking the capital and ability to enter international markets, and being forced not only to reconstruct their production regimes but also to establish themselves, in terms of recognition and location, in the international division of labour. This is, both in advanced and developing economies, the primarily activity of concrete firms, and the game's outcome is clearly visible on the firm level. Nevertheless, as the VoC approach demonstrates, the national arrangements, as well as the trajectories of their change, do matter because they largely determine the firm's adaptability to global pressures.

Similarly, the supra national level influences the national and firm levels, and does it more to those countries and firms that, on one hand, are badly in need of capital and, on the other hand, suffer from the inconsistency of institutional arrangements; in other words, this is undoubtedly where we can find the core-periphery type of relations. Early dependency literature taught that economic development in peripheral countries takes place to a certain extent providing the core states accept development as needed. Although the accession of Central and Eastern European countries cannot be considered totally on a par with this experience, it is not entirely clear how much equalisation and dependency lie behind European harmonisation. As Grabbe states, on the one hand, the Copenhagen Conditions make much of the necessary "capacity [of the candidate countries] to cope with competitive pressure and market forces within the Union", yet, on the other hand, "the EU has so far focused on rote adoption of legislation, with little attention to the impact that the resulting micro-institutional structures have on efficiency". There is clearly no one 'European' model of corporate governance and, as Grabbe argues, the EU seems to have more influence on market regulations in central Europe than it has in western Europe: "Europeanisation may conflict with globalisation where the EU is imposing rigid and potentially inappropriate policy frameworks" (Grabbe, 2000). Although the perspective of accession generally encourages political and economic reforms, the process of accession itself, in terms of European harmonisation, is not necessarily equivalent to an economic transformation that would improve the firms' competitiveness. Nonetheless, the role of domestic politics and the consistency of domestic institutional reforms are clearly significant here since they do much to improve the bargaining position of the candidates.

When the Soviet Union dissolved, the economies of the region found themselves typically between two poles, the US and western Europe. Under such circumstances, the emergence of new institutional settings owed much not only to the legacy of the past, but also to a vision of the two contradictory corporate traditions, and the actual exercise of relations with each of the poles, FDI inflows from various directions, and, last but not least, each country's own capacity for converting domestic policies into flexible ones. More recently, EU enlargement tends to take over this process for candidate countries, but neither the outcome for individual (pre and post) accession games is entirely determined, nor, for all European countries, from Portugal to Ukraine and Russia, is the outcome of the larger game over globalisation.

There is not really a 'market for institutions'; market forces do not directly decide what the corporate governance settings in a particular country are – and if they sometimes do, this is not inevitably the best solution. The 'best' (in a certain period, for certain product markets) arrangements do not necessarily go to places with the highest demand for them. The 'best' models change and, at the institutional level, there is no strong selection mechanism. For this reason, the historically shaped domestic political scene plays a crucial role in a country's adaptability, and, with it, makes a contribution to establishing permanent, capitalist, institutional change. Nevertheless, the long-term the economic strength of a country has a marked effect on this process, and derives just as much from its international market position, as from its political (and to certain extent cultural) position in international power structures.

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