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1 Introduction: Corporate Governance from a Comparative Perspective – Bridging East and West

Michał Federowicz

1.1 The problem[1]

1.1.1 The scope of analysis and comparative perspective

The main challenge of cross-national analyses is to identify and conceptualize the most significant concepts so that they can be applied across borders. Corporate governance, the key notion of this book, has evolved over the last ten years from the single principal–agency problem to a much more complex structure of stakeholders' relations in the agency game (Aguilera and Jackson, 2003). This development is the result of comparative studies of advanced economies, which took the concept of the agency problem from the American-based debate over managerial incentives and set it in the institutional context of other countries, most notably Germany and Japan (Hoshi et al., 1991; Gerlach, 1992; Roe, 1993; Berglöf and Perotti, 1994; Soskice, 1994; Lehrer, 1996; Vitols et al., 1997; Casper, 1999; Aoki, 2000). The broader meaning of corporate governance, utilized by the authors in this book, contributes to an understanding of the profound differences between institutional settings of the three leading national economies in contemporary capitalism. The triad comparisons – US/UK, Germany, Japan – became the most persuasive evidence in debates over the deeply rooted divergence between advanced economies that persists in spite of strong converging pressures. It has also contributed to the Variety of Capitalism (VoC) approach (Dore et al., 1999; Hall and Soskice, 2001), which points, in political economy terms, to the "comparative institutional advantage" of each country. The lesson from the substantial body of literature in this field is that not only the three leading models but also other advanced economies operate in significantly different institutional settings at the national level, which was the result of long-term evolution, and carried out institutional adjustment in very individual ways (Albert, 1991; Berger and Dore, 1996; Zigler, 1997; Rhodes and Apeldoorn, 1998).

This book builds on the literature devoted to the varieties of capitalism. It takes the three most extensively researched models as a point of reference, but it goes beyond them and beyond the scope of advanced and stable economies. The book is the result of a number of country-based research projects on corporate governance, which implicitly had a common purpose of developing a definition of corporate governance that might contribute to understanding the dynamically changing institutional settings for business activity. As these projects overlapped in their research questions we could envision a common language and understanding of corporate governance issues across countries. The volume bridges Western and Eastern Europe. It covers the cases of ten countries on the European continent, from Spain to Ukraine, and focuses on understanding how institutional settings at the national level will affect micro-level decisions. The book concludes with a chapter discussing the impact of European integration on the national settings of corporate governance, which is more binding for candidate countries than for member states.

We selected ten European countries so that we can examine the dynamics of changing corporate governance in both the advanced economies that have well-established institutional settings but are still exposed to internal and external pressures for change, and economies in the process of transformation from planned economies to market economies with hardly any consolidated institutions. We do not suggest that there is a continuum between the countries nor any linear vision of development. Although the question of "stage of consolidation" or "degree of consistency among corporate governance institutions" may be addressed, we do not claim that one country necessarily follows the path of another. In this sense, we hope to avoid any simplified analogies between country cases. Instead, we discuss the very individual ways each country has of coping with internal and external uncertainties of a changing environment. If there are a variety of models among the advanced economies, then one may also observe a large diversity of trajectories towards sound governance in countries that are deeply transforming their institutional settings (Chavance and Magnin, 2000).

The broad comparative perspective in this book suggests that institutions do not travel well. That results from the "tightness of fit" (Berger, 1996) in the national models of capitalism in advanced economies. We can take for granted, after 12 years of post-communist transformation, that with few exceptions any attempts at direct institutional transplant are first rejected in the new locations and then need a long evolution before they start functioning (Campbell and Pedersen, 1996; Swaan, 1996; Silitski, 1999; Kuzio et al., 1999; Higley and Pakulski, 2000; Zeman, 2000; Lane, 2001). The diffusion of institutional solutions does not work in a simple and direct way, although it certainly does exist. The perception of other countries' solutions does not go unnoticed. In addition, international commitments and

the impact of international organizations on such relations within or with the European Union, attitudes towards foreign investors and the level of their engagement, and other pressures from international markets will affect the outcomes of the corporate governance. All of these external factors contribute to the continuous reshaping of the domestic dynamics of institutional change. Our comparative perspective is not about cookie-cutter solutions or specific models that might often be barely identifiable in a given country. It is more about the mechanisms of institutional change that in turn will define corporate governance. The question is how the national economies carry out institutional adjustment. It assumes examining the incremental change in a given country to identify both domestic and external factors of that change, and specifically seeing what constellations of economic and political interests have determined its dynamics and direction. This kind of question may travel much easier.

1.1.2 The challenges of conceptualizing diversity

The theoretical task is to find a way of comparing Eastern and Western Europe that helps in understanding and unpacking the complexity of the process of establishing and continuously adjusting sound corporate governance. The book focuses mainly on the eastern part of the continent and aims to show its dramatic diversity and to point out that the mechanisms of privatization that initiated institutional change in the early 1990s were largely incomplete (Hellman, 1998). The comparison with Western countries helps uncover inconsistencies in the emerging systems in the Central-Eastern European (CEE) countries. But conversely, some problems of contemporary capitalist evolution are revealed in a "distorting mirror" of the East, pointing the way towards a more general investigation of the future of capitalist development. In this sense the East–West comparisons may contribute to a more general theory of institutional adjustment (Dobry, 2000). The joint work in the book attempts to combine the debate on corporate governance in contemporary (advanced) capitalism with the debate on privatization, economic adjustment, and institutional reforms in the post-communist environment. The East–West comparisons refer to a more general comparison between "capitalism after communism" in the East and "continuously evolving capitalism" in the West.

Institutional fine-tuning is of vital importance nowadays (Hall, 1995; Gourevitch, 1996). The major problem is to develop a response to the constantly new pressures coming mostly from new product markets. This is necessary not only at the firm level but also at the national level in terms of a significant reconfiguration and modification of previously institutionalized practices (Hancké and Casper, 1996; Vitols et al., 1997; Amable and Hancké, 2001). In this regard, the East–West comparison may lead to new observations concerning the mechanisms and prospects of such reconfigurations. The question is where and how this may be successful,

under what conditions, and how it risks reproducing the old institutions (Zon, 2000) that have not been able to meet new challenges.

The overall thesis of the book is that each national system copes with challenges of corporate governance in its own way, because it tries to rely as much as possible on its existing institutional resources. This is how the domestic elite and other domestically critical actors, including social actors such as unions, think about their adaptability to changing circumstances. In this sense, even under strong converging pressure, what tends to be experienced is "long-term resilience of national systems" (Berger, 1996) or "incremental change" (Vitols, 1999) rather than adaptation to external patterns or a radical shift to a different logic of institutional arrangements. The issue of "national institutional resources" (Hancké, 2002) is common to East and West, and in both interests arises to protect them as much as possible at the expense of external adaptability. That is why, using Stark's term, "recombination" of existing institutional assets is typically more likely to happen than radical institutional change.

However (here is the core of our thesis), the more stable the economic situation of a country, the more successful will be the institutional change that only "recombines" institutional assets with some new elements. Similarly, the more problematic the economic position of a given country, the more damaging this natural desire and attempt to preserve existing constellations of domestic forces may be, and the more promising it may be to abandon them as quickly as possible. The chapters on Bulgaria and Ukraine elaborate on this dilemma. In other words, recombination of the existing resources is likely to succeed in countries that, while facing the necessity of change, enjoy a stable economic situation and relatively coherent institutional settings, such as France (analyzed in this volume by Hancké) or Germany (Vitols, 1999). In contrast, the countries characterized by a weak position and disintegrating institutional settings (often initially not acknowledged by domestic actors), sooner or later face a massive and fundamental transformation and find that they must be open to the external factors of change. Spain, the latecomer to the European democratic family, had to quickly open to foreign investment in comparison to Italy or France. But Hungary had to do so much more than Spain, replacing initial attempts to "recombine" existing assets (Stark, 1996) with the profound "reconstitution" of capitalist institutional arrangements that underpin sound corporate governance (Gray and Hendley, 1995; Pistor, 2000), and let foreign direct investment (FDI) fill in the new structure. Alternately, Ukraine remained vague toward rudimental institutions of contemporary capitalism and tried to promote preexisting constellations of domestic economic and political actors (D'Anieri et al., 1999; Zon, 2000).

While the advanced economies have been powerful enough to withstand external pressures and modify their institutions in their own way, there has been little room for such a strategy in the transforming economies of

Central and Eastern Europe. A detailed understanding of this contrast, we believe, helps explain the successes and failures in the process of deep institutional transformation in Central-Eastern Europe. Moreover, it may also aid in suggesting necessary future transformations among advanced economies. Countries that wish to support the most successful business strategies must continuously reconsider their practices of corporate governance. The East–West comparisons also provide an opportunity to examine how the same terms used across country contexts may differ. For instance, the terms “the state” and “state regulation” may carry diverse associations and actually may refer to different types of political and economic relations. And in a less obvious example, “cross-ownership” may have different connotations in, say, Germany and Ukraine or Russia. Understanding these country differences helps in examining more precisely the institutional gaps and inconsistencies in incomplete processes of change.

1.1.3 Existing and changing institutions

There is one more point to raise in the context of dynamic change. This is the issue of the “path-dependence” approach (Granovetter, 1985; Stark, 1992). In the book we build upon an individualized perspective of each country and this is very much in line with path-dependence. On the other hand, however, we see significant limitations to the approach as far as explanatory capacity is concerned (Moss, 1997; Greskovits, 2000; Bohle, 2000). In *post facto* explanations everything might be interpreted as path-dependent, but this offers little insight into the mechanisms of institutional change.

If we object to the path-dependence approach, it is not to deny it entirely. History matters and we essentially agree that the role of national politics and national history is absolutely fundamental in framing specific incorporation of capitalist institutions in a given country. This is in fact how the path-dependent national embeddedness of capitalist institutions is manifested (Granovetter, 1985; Chavance and Labrousse, 1998; Chavance and Magnin, 1999, 2000). But while this may perhaps work for advanced economies, as they are relatively stable, when applied to the East it may often be misleading, for it does not solve the problem of massive and fundamental institutional change. It does not tell us how each of the countries, to a certain and differentiated degree, was able to both build on and go beyond its past. It promotes a bias towards easy *post facto* explanations, instead of focusing on the dynamics of the change. Even for stable economies, if we dig deeply the approach is not satisfying. For instance, France was able to overcome the *dirigiste* state coordination, but path-dependence does not offer much in understanding how a series of institutional innovations, together with standardized macroeconomic policies, led to a shift in the leading role of the state in favor of “firm-led” corporate adjustment. Such a dynamic eventually resulted in the substantial

modification of institutional settings of French corporate governance, as discussed by Hancké in this volume.

Path-dependence should be supplemented and modified by some other concepts. We propose two of them. First is the concept of the hierarchy of institutions, which means that some institutions to a large extent determine some others. Thus, to explain a massive change, it is important to consider the more influential institutions and look at how they balance the "old" and "new" driving forces, as well as their influence on institutional change. For instance, the interplay between political and economic institutions may turn out to be an "influential" part of the explanation, such as in the Soviet Union where political institutions heavily determined the economy. The degree of political change in a given country might influence the nature and outcome of economic change. As Hellman demonstrates, relying on data from a large sample of transforming countries: the more democratic the regime, the more robust the economic development (Hellman, 1998). This was not so obvious to many researchers at the beginning of the post-communist transformation. The nature of political institutions also affects the nature of the dominant business networks that encompass business activity, which in turn contributes to the game between reshaping and reproducing economic institutions. This aspect was often neglected by network analyses, and the concept of a hierarchy of institutions helps to fill this gap.

But one can still argue that the "core institutions" are indeed path-dependent, even though a part of their evolution certainly contradicts historical dependency. The puzzle is how to conceptualize what is beyond path-dependence. Typically, the answer is that change comes from outside. In such an approach, domestic forces would be treated as path-dependent and external forces as innovative. We believe that this is wrong. The agents of change are both inside and outside the domestic arena. More importantly, both of them modify their strategies according to their future-oriented expectations and calculations. These future-oriented calculations of actors participating in and contributing to change are often a neglected step in analyses of institutional development.

Thus, the second aspect, besides the hierarchical nature of institutional settings, is the strong strategic orientation of (some) economic and political actors, based on *anticipated* outcomes. When the existing institutional settings are continuously less satisfying, these actors acquire a stronger voice and greater audience, and provoke other actors to more future-oriented speculations about likely change. In turn, their redefined expectations create a new environment, which may reinforce the change. What is essential in these "path-finding" cycles (Federowicz, 2000) is that some actors go beyond the existing institutional settings, and often devote a great deal of effort to escape from them. In their calculations about the future, they try to anticipate the change and take advantage of being ahead in this process.

Doing so, they contribute to the shift of the core institutions, or to establishing new ones. Then, in a medium- and long-term perspective, before a new institutional setting is really established, they may be praised or punished for their path-finding activity, according to the hierarchy of other intervening institutions. These two concepts: hierarchy of institutions and "anticipated institutions" that are employed by some actors before institutions are fully established may help in understanding radical institutional change.

1.2 The notion of corporate governance

The key definition of corporate governance should be a good tool for cross-country investigations and be able to identify to detect factors of dynamic change. The major focus of this book is on the conditions, mechanisms, and constraints in the process of establishing sound corporate governance and then adjusting them to meet the most immediate needs. We believe this kind of approach provides a bridge between the emerging markets and advanced economies, both experiencing internal and external pressures for institutional change, but each country with its own scope, starting point, and current position. The process is gradual, as it requires a series of agreements on the firm, country, and sometimes international levels, and involves a multiplicity of actors as stakeholders. But by definition it also needs some shaking and prodding to promote that change, and sometimes quite strong, for the implicit nature of social and economic institutions tends toward stability and status quo rather than change and adjustment.

We conceptualize sound corporate governance as an abstract goal rather than a concrete model of continuous institutional adjustment, which partly builds on path-dependent institutional stability, but also partly works against it by disrupting the status quo in order to reduce new internal and external tensions. By sound corporate governance we mean a set of institutionalized (but not only formal) settings and practices that orient the key actors of decision-making towards the sustainable development of the firm. By contrast, "distorted corporate governance" may provoke key actors, sometimes even the owners, to act against the firm, as is displayed in this volume.

1.2.1 Beyond the single principal–agent problem and beyond stylized models: a political economy perspective

Assuming the principal–agent problem and dealing practically with one-country institutional arrangement, the notion of corporate governance did not need to explicitly refer to the American institutional environment. Settings such as liquid capital markets, high-level market capitalization, dispersed banking systems, a highly competitive environment in inter-firm relations, or flexible labor market (not to mention the state's lack of

involvement in microeconomic decisions) were taken for granted when considering managerial strategies in the game with the owners and their impact on the firm (Shleifer and Vishny, 1986; Roe, 1994; Shleifer and Vishny, 1997). However, the literature of the late 1970s and early 1980s, referring to the agency problem, implicitly asked a broader question: how was it that the earlier autonomy of managers, which brought the flourishing results of the preceding decades, contributed to the eventual deterioration of many large American concerns? There was no answer within the narrow paradigm of corporate governance, with its main focus on managerial incentives.

At that time, European economies were still not integrated or expansive enough to provoke serious analyses of a corporate model that would be distinctive from and provide comparative advantage to the American solution. The expansion of the Japanese economy in the 1970s and 1980s, especially through successful confrontation with American firms in their own markets, prompted a new agenda of scientific investigation into institutional arrangements. Not all of the literature devoted to the Japanese economy referred to the corporate governance issue; in fact, the term was not used initially. Mainstream research attempted to reconstruct Japanese economic relations within and outside a single firm, which is essentially a broader definition of corporate governance. This has led to a detailed description of institutional underpinnings that were behind Japanese firms' strategies, strategic alliances, and managerial decision-making (Gerlach, 1987, 1992). Not surprisingly, the Japanese system turned out to be closer to the German system than to the American, but is still quite distinct from the German (Kester, 1992; Soskice, 1994; Streeck, 1996). Among the most significant differences is that Japanese banks play a much larger role than those in Germany, and they have the technological capacity to monitor the effectiveness of corporations. The relation between owners and managers is based on regular formalized as well as informal meetings on the one hand, and long-standing financial ties on the other. But unlike large German firms, Japanese firms tend to compete among themselves in their home markets, which is more an American type of relation. Still, like German firms, they try to cooperate on some strategic goals, such as R&D.

The impact of the vast research on the Japanese economy was to weaken the dominant American position in an "intellectual market for institutions," and make room for Europe-oriented research. Together with ongoing European integration, in the late 1980s and early 1990s the concepts of "European," "continental," and "Rhenish" corporate governance were formulated, in contrast to the Anglo-Saxon (or Anglo-American) system. However, the Rhenish model relied mostly on the German matrix (with some elements of the Japanese model that seemed at the time the most valuable), only rather loosely referring to other European countries. It was more a desire than the reality of continental

Europe. In fact, each country continued with its own approach to institutional adjustment, trying to combine its typical institutional resources with some new solutions that would be more open to globalizing pressures than to any idea of pan-European institutional settings. Too many spheres of institutional systems are involved in real corporate governance to expect easy harmonization.

An example is France, that although relying on the leading role of the national elite, was able to develop a significant financial market, yet maintains stable shareholder agreements and long-standing financial systems. With strong management both within and outside the company, the French system is quite different from both the German and the Anglo-American systems, and more importantly, does not have much in common with the French *dirigiste* past.

We can also see significant changes in Italy and Spain. Although one might expect that these two countries would share similar systems by virtue of belonging to a Southern European–Mediterranean culture, they are in fact significantly different, as Aguilera persuasively demonstrates in this volume. Italy, while engaging in intensive industrialization after World War II and getting the state and politics involved in economic development, kept the banking sector out of industry, due to its earlier negative experiences. In addition, it has significantly reduced state engagement, 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 of the past, but was more open to FDI, which largely contributed to economic development as well as to the institutional shift.

These national cases show the reality of a given economy from the perspective of stylized models and show the continuous change of institutional settings of advanced economies. Germany, too, although it exemplifies the most self-reproducing institutional system, has been witnessing a growing number of exceptions to governance arrangements, especially in new industries, where firms are trying to escape from, or modify, traditional arrangements and practices (Vitols et al., 1997; Casper, 1999). Yet, the desire of a synthesis of "best practices" is always debatable (Berger, 1996; Kester, 1996).

The political economy of corporate governance analyzes the structures in which the governance game takes place. Corporate governance, or governance structure, is considered here a coherent part of the institutional system that underpins economic life. It is the part of the system that sets the rules of the game for managers and other stakeholders who affect strategic decision-making. In a stable economic system, these are rather complex but coherent arrangements. The incentive structure explicitly addressed to top managers, or their formal relations to the shareholders, are only a part of the story. Thus, transposing just one or a few elements of

corporate governance to one country from another does not really mean that corporate governance will work there. Considering corporate governance in the much broader framework of political economy means seeing the institutional gaps and inconsistencies within the system and looking for the economic and political forces behind them.

Nevertheless, the broad meaning of corporate governance cannot be expanded without limit. It should be explicitly stated that the center of investigation is the firm, and the rules of the game focus around top management and top managerial decision-making, which will eventually shape firm strategy. The political economy of corporate governance reconstructs the structures inside the firm. But to do so, it builds on a vast 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. These are different in each country and subject to different dynamics of institutional change. This is why a broad understanding of corporate governance helps establish a comparative perspective. The main question is not just the reconstruction of a model or models. It is, rather, seeing how coherent corporate governance is likely to be reshaped, responding to changing circumstances as is typically the case in well-established and stable economies, or established and consolidated in the emerging capitalist economies. The firm here is not considered as the object of typical organizational studies, but as one of the key segments of the political economy of contemporary capitalism. Corporate governance bridges the micro and macro levels of investigation.

1.2.2 What is still missing?

The importance of corporate governance lies precisely in its centrality, linking microeconomic (firm-level) decisions with critical institutional arrangements that may interfere with strategic decision-making, and which in fact constitute the economic system in a given country. This is also how politics may affect corporate governance. Let us now reconstruct the major aspects of corporate governance.

First of all, in the principal–agent relation the owners are the finance providers, expecting a return from their investments. But ownership is not the only form of channeling resources to the firm; the whole banking system and more broadly the system of financial flows are involved in a struggle for sound corporate governance. To put it more generally, what is in question is the provision of resources to the firm, where ownership is only part of the story.

Second, the question of management comprises at least a double principal–agent relation, between owners and top managers, and between managers and workers, each of them strongly capable of influencing strategic decisions. In this regard, not only is the traditional field of

industrial relations involved but also the increasingly relevant field of training and education (Aguilera and Jackson, 2003).

Third, some other areas of institutional regulation strongly affect top managerial decisions, such as antitrust policies and those that more broadly regulate entry and exit from the market, as well as contract law, self-regulation, and legal policies (Pistor, 2000). Also relevant are interfirm relations and institutionalized policies that affect the firm's sharing of some nonfinancial assets with other firms in, for example, R&D.

Finally, various settings should be regarded not as universal and generating catch-all solutions, but as concrete product market needs, which largely determine the type of principal–agent relations, based on different skills, flexibility, and autonomy, and the likely monitoring at all levels (Soskice, 1994). It is specific product market arrangements that create concrete comparative advantage in international competition. The most visible pressure on continuous rearrangements comes from the highest value-added product markets.

This synthesized revision of critical aspects of corporate governance shows its complexity and provides the tools to examine this complexity. At the same time, it allows for the great diversity within the contemporary capitalist family of advanced economies. However, it still does not include some important aspects that may be at play in establishing sound corporate governance as the result of deep systemic change.

To do so, our analyses are also sensitive to the specific situation of "capitalism after noncapitalism," that is, the highly intensive process of capital formation. In the (re)constitution of capitalism that took place in Central and Eastern Europe the rapid capital formation provoked both large uncertainty and high potential gains to the actors involved. In this new situation formal settings often played a secondary role. Each of the aspects listed above contributed to a reinterpretation of governance structures, with the first one concerning finance provision certainly being the most important. Not surprisingly, it touches on the initial problem of corporate governance.

We need here to "reverse" the traditional perspective. According to Shleifer and Vishny's well-known assertion, corporate governance is about "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments" (Shleifer and Vishny, 1997: 737). Let us turn this upside down. Corporate governance concerns the ways in which top managers try to ensure finance for their companies, and they do this by different mechanisms available in the formal and informal institutional environment, with all the necessary economic and political commitments. This is why in the context of intensive capital formation, including massive privatization, not only financial sectors but also the state institutions (with their flows of public money) are the important parts of the system with which corporate governance interlocks, regardless of formal ownership ties.

The narrow meaning of corporate governance, of course, does incorporate the numerous regulations that largely determine business relations. The broad understanding of corporate governance, however, has to make sense of these detailed regulations. It helps to investigate the institutional and macroeconomic context of microeconomic strategies and see how the actors involved in corporate governance are continuously testing the micro–macro relations. This uncovers the real alternatives behind managerial choices. In considering corporate governance we need a broad and detailed understanding of the (un)available choices and (non)existing constraints on managers, owners, bureaucrats, politicians, labor, and other likely stakeholders.

Essentially, corporate governance is about the range of opportunities and types of constraints that mostly top managers face in their strategies related to the firm. It is here where a sound or distorted governance is conceived. The institutionalized opportunities and constraints differ across countries, and they may differ across product markets, but this general perspective is valid for both emerging and advanced economies. It ensures a flexible research framework that is very sensitive to country-specific performance and yet maintains the major attributes of corporate governance. Instead of forcing one-way directives, it helps to see the multiple international pressures, without losing sight of domestically determined interests.

1.3 Political economy of how to get there: East–West comparisons

The essence of the problem of corporate governance is actually capitalist development and its evolutionary nature. It initially came from the split in the roles of the owner and of management, which took place in the early decades of the last century. As John Scott put it: “industrial capitalist societies have undergone a transition from *personal* to *impersonal* forms of ownership and control” (Scott, 1997: 15). That split was the source of capitalist vitality in the twentieth century. It made capital more flexible and open to new possibilities of technological and organizational innovation, and made available a broad field for managerial selection (no longer based on heritage, political loyalty, or tribal or mafia rule). Finally, it created a market for corporate control, if not through the stock market, then through mergers and strategic alliances.

This evolutionary transformation from *personal* to *impersonal* forms of ownership and control that took place within capitalist logic may be characterized by two poles. In its Anglo-American version (closer to a free market ideal but not equal to it), ownership became dispersed over time, but management was specialized and concentrated and subject to a highly competitive environment (Roe, 1994). In the German or Japanese versions of capitalist development (less oriented to a free market concept yet also

subject to market-type competition), the ownership became institutionally interlocked within cross-ownership and in this way avoided dispersion, while management became less concentrated and had more obligations toward both finance providers and employees. The latter is more prevalent in the Japanese case although it is not as formalized there as in Germany (Soskice, 1994).

Now, to identify the most striking differences between East and West of Europe let us first underline that World War II and the cold war stopped the typical capitalist evolution in the central-eastern part of the continent. Both of the above-mentioned trajectories of institutional capitalist development (Anglo-Saxon and continental models) sharply contrast with the experience of socialist economies in the east of Europe. It is enough to notice that in the latter, the role of the owner disappeared in a nondefinable ideal of "social" (all society) ownership, and the role of management became dispersed in multilevel, hierarchical, and politically controlled bureaucracy. The vanishing sense of ownership and the growing complexity of structures (formal and informal) of decision-making characterized the evolution of governance under Communist Party regimes, with a dramatic increase in the significance of informal relations that eventually led to the ungovernability of the system. In the same period, and specifically since the 1970s, capitalist countries saw an intensive fine-tuning of all kinds of institutional arrangements related to governance and decision-making, such as capital flows and instruments, managerial incentives, the banking system, and the labor market.

The shift toward privatization in the post-communist countries in the early 1990s was not just an intellectual fashion or the result of pressure from international financial institutions. It targeted the weakest point of earlier microeconomic institutional settings. Privatization in the East has been the most significant part of institutional transformation. However, privatization has not dealt with all the institutional areas related to governance, even failing to question the likely governance structures after privatization in an environment that is still an institutional mix. This has inevitably led to the partial and noncoordinated course of reforms.

The inconsistency of the institutional system in the East is a critical difference in the East–West comparison. There were many reasons for this inconsistency during deep transformation, especially in the discrepancy between reformers' visions and real forces behind the change. Typically, the reformers both within and outside the involved countries opted for American-style development; to create as quickly as possible institutionally guaranteed competitive environments. At the same time, a part of the former *nomenclatura*, although not objecting to the American type of business relations, made steps toward cross-ownership to institutionally protect their long-term corporate control. As a result, the trajectories of institutional change were not coherent. On the one hand, the cross-ownership

relations were not the same as in, say, Germany or France, mainly due to the weak financial sector. On the other hand, the financial markets did not resemble those in the US or the UK (Coffee, 1996, 1998) in terms of both their low market capitalization and poor transparency. The state, being still heavily involved through the nominal ownership of large portions of the economy and through huge financial flows, did not correspond to a Western understanding of state involvement. The more consistent policies were able to consolidate only after some serious macroeconomic tensions, like those in Hungary in 1995, or later and more seriously in the Czech Republic, in 1997. The price for the inconsistencies was always high, and sometimes extremely high, like the 1996/97 banking crash in Bulgaria.

It is now clearer than ever though that the most important goal of privatization is a healthy corporate governance structure. Among the CEE economies, the Hungarian experience displays the most efficient way of achieving this goal. Starting with an intentionally gradual, case-by-case approach, Hungarian leaders were the first to achieve positive results. In spite of early attempts by domestic groups to protect their interests in murky cross-ownership structures, the strategy of maximizing FDI in privatized firms eventually provided the most transparent corporate governance, as is systematically documented by Voszka in this volume.

But even if there is no such access to FDI, corporate governance remains the most significant outcome of privatization. It also puts the question of property rights transfer in a much broader context, because it inevitably addresses problems that are typically neglected in a single issue of transfer of titles. The point is that when facing deep institutional change, in order to build a healthy governance structure it is not sufficient to rely on one or another model of the relations between (new) owners and management, or management and workers, which are well-known from the advanced economies. As stated in the previous section, in addition to the formal principal–agent relations, it is crucial to know what kinds of choices, opportunities, and constraints the existing institutional system, together with its informal part, offers to all economic actors. The Hungarian success was not based solely on FDI, but rather on the most complete and coherent institutional settings in all other spheres such as bankruptcy law, contract law, banking law, and so on (Gray and Hendley, 1995; Pistor, 2000). From the political economy perspective of corporate governance the necessity and high level of FDI inflows became the best incentive for change in consecutive governments, regardless of the political option. It also allowed the building of relatively transparent institutions that could and did encourage further investments. In addition, in the Hungarian case, FDI inflows contributed to the consolidation of the political and economic elite, unlike in other countries where FDI divided the elites.

Another dimension to examine is the East and West difference and similarities in interconnection between corporate governance systems and the

type of product markets, and vice versa. The success in particular product markets depends on initial corporate governance settings and their further development. Obviously, the departure point, in a time of growing interdependence of the globalizing world economy, may differ significantly. The impact of leading product markets in the global economy is clearly visible when comparing the outstanding performance of Japanese firms in the 1980s, before the era of telecommunications and other information technologies and their increasing difficulties in the decades that followed. This is also a challenge for Western European economies, which may need further changes in their corporate governance settings. Indeed, in countries such as Germany, Switzerland, Sweden, or France for that matter, it remains uncertain – and in recent times this uncertainty has significantly grown – whether they will follow the same course they have taken over the last 20 years. 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 these sorts of internally changing but divergent paths will continue, or whether there will be a convergence toward a more Anglo-Saxon system. Leading technological developments of the last five to ten years put the weight toward the Anglo-Saxon experience, but this is surely not the last word. In our comparison of East and Western European corporate governance systems, we are interested in understanding the growing interdependence between firms, economies, and institutional systems. For this task, it is important to look at specific product markets, which tend to dominate economic development and evaluate what type of governance best promotes such development.

There exists a lot more uncertainty when it comes to the developing economies, including those of Central and Eastern Europe. The lesson from the product markets means that the question of corporate governance is not as abstract as some theories of capitalism would like us to believe. It is an open question regarding the transforming economies, which kind of market niches they are likely to explore, and how their efforts to consolidate the governance structures consort with their potential markets. For example, one of the determinants of recent Irish success, the most recent "newcomer," was its potential in terms of institutional resources. However, such a fortunate happy coincidence is an exception rather than the norm, and it is not the case in Central-Eastern Europe.

Markets produce their own specific hierarchy in the value chains, with some of them being more lucrative than others. In fact, this is the game in advanced economies when it comes to high-tech competition. It is also the reason for continuous modification in corporate governance and is a measure of its efficiency. In the case of the profoundly transforming economies, however, it is more complex. These countries do not actually freely pick up the desired elements of the existing models and practices.

Instead, besides their institutional legacy they face many constraints, lack capital and the capacity to enter international markets. They have to reconstruct their production regimes, and they also need to find a new place in product markets and (re)establish recognition in the international division of labor. Thus, they face deep reform of corporate governance in time of large uncertainty about potential niches in the markets, while national arrangements do matter as they largely determine adaptability of firms to global pressures of specific product markets.

The East–West comparison is also significant when considering the way international institutions influence the national and firm levels. This especially affects those countries and firms that badly need capital but are suffering from the inconsistency of institutional arrangements. Without doubt, core–periphery-type relations exist here. Early dependency literature taught that to a certain extent economic development in peripheral countries takes place as long as the core nation states accept it taking place. Although the accession of CEE countries is a different experience, it is not entirely clear how much equalization and dependency are behind the European harmonization. As Grabbe states in the closing chapter of this volume, the Copenhagen Conditions strongly suggest the necessary "capacity [of the candidate countries] to cope with competitive pressure and market forces within the Union." However, "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 single 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: "Europeanization may conflict with globalization where the EU is imposing rigid and potentially inappropriate policy frameworks." Although the perspective of accession generally encourages political and economic reform, the process of accession itself, in terms of European harmonization, is not necessarily equal to the economic transformation that would improve the firms' competitiveness. Still, much depends on domestic politics and the consistency of domestic institutional reforms, which clearly might improve the bargaining position of the candidates.

Finally, the East–West comparison highlights how the system of corporate governance interlocks with other key elements of capitalist systems, such as labor markets, education and training, or intercompany relations. The list of the other elements is very much country sensitive and has 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 the case of the UK, it is the type of contracting arrangements that is important. And for countries transforming after communist periods, the emerging governance structure interlocks with the state, defined as a set of (exhausted) institutions. For example, the

way the Ukrainian state was constructed after 1991 has hampered the reform of corporate governance and other economic institutions. In all countries, the nature of business networks with their political involvement affects intercompany relations. As stated before, in Central-Eastern Europe corporate governance is intertwined with a variety of arrangements that contribute to a rapid process of capital formation with preexisting non-financial capital exchanged for financial capital.

The level of consistency among various institutional segments of the political economic system encompasses the overall comparisons of the East and West. Surprisingly, however, the tensions between inconsistent institutional segments may provoke additional pressures for change. In this regard the nature of the political regime matters. 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). Low-level equilibrium addresses the relation between the political system and the economic system in these countries. It reflects the initial concerns about their capacity to consolidate democracy while at the same time facing deep economic reform, which could have led to massive social protests. The protests did not occur to the extent that would threaten the continuity of the reforms. As the low-level equilibrium thesis states, these countries managed to build formal democratic institutions and the foundations of market relations. However, these are rather poor democracies and deeply imperfect markets. The result is that a kind of equilibrium between those deficiencies makes the low level (low quality) of the system rather stable and durable.

The field of corporate governance, the subject of this book, suggests that the durability of low-level equilibrium would only be justified if the economic system were closed. The analysis points out the numerous partial disequilibria in the broadly approached issue of corporate governance. These disequilibria could of course be (and often have been) 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 balance increasingly questionable. In addition, domestic social protests in this context may encourage further institutional change toward a more mature democratic system, because they precisely help to deconstruct such a perverse equilibrium. In other words, it is predicted that the more open the economic system, the more pressure there is to build upon a low-level balance among domestic institutions and improve their quality.

It is worthwhile to ask what contributes to the emergence of new institutions in Central and Eastern Europe. When the Soviet Union dissolved, the economies of the region found themselves typically between two poles, the

US and Western Europe. Not only the legacy of the past but also many other factors shaped the new corporate governance model, such as: a vision of the contradicting corporate traditions, the actual exercise of relations with individual countries, FDI inflows from various directions, and the countries' capacities for flexible policies resulting from domestic politics. Recently, the prospect of EU enlargement has come into the equation for candidate countries, although the outcome for the individual (pre and post) accession games is not entirely determined. This holds as well for the outcome of a larger game over globalization, which will affect all European countries, from Portugal to Ukraine.

There is not really a "market for institutions." Market forces do not directly decide the corporate governance settings in a particular country. The "best" arrangements (in a certain period, for certain product markets) do not necessarily go to where the highest demand is for them. The best models of corporate governance constantly change, and there is no strong selection mechanism at the institutional level. This is why the historically shaped domestic political scene plays a crucial role in the county's adaptability and contribution to permanent, capitalist, institutional change. Nevertheless, the long-term economic strength of a country, coming from its international market position, as well as its political position in the international power structure, strongly intervene in the process.

1.4 Conclusion

What can we learn from the East-West and cross-continent comparisons? The East–West comparison highlights the extraordinary transformation of the last decade as a long-standing outcome of specific historical development resulting from World War II. This general comparison points out major inconsistencies of partial reforms taking place in emerging markets in the former "post-war Eastern Europe." These are striking in comparison with the fine-tuning of institutional settings in the West. However, the country case studies presented in this volume show that the trajectory of institutional change is very much country-specific and the old East–West cleavages are becoming less and less relevant. Among the advanced economies, for instance, we do not observe any homogeneous continental model. Countries continue to search for their own way of institutional adjustment to the pressures of new markets. The stylized and contradicting models of governance structures are present in these efforts only as one of many points of reference. Similarly, the catching-up countries try to benchmark changes in the advanced economies, but the outcomes tend to be tailored to individual countries. In all cases, the dynamics of institutional change strongly depend on domestic politics even when the domestic scene interferes with international commitments, and it does so probably most visibly in the EU candidate countries.

Regardless of international commitments, the first and clear message of all country cases examined is that the role of national governments is of critical importance. Cross-country comparisons persuasively show that the state (government and other institutions) is the key actor in the game for sound economic performance. It is not surprising that, for example, privatization (de-statization) should be organized and controlled by the state, and in general, deregulation or a proper balance of regulations is also a matter of state activity. As in France, where the major move opposing *dirigisme* was provoked by concrete measures arranged by the state, seemingly post-communist transformations could be triggered only by the reformers' adequate use of state institutions. In the "hierarchy" of institutional settings, the proper functioning of the state comes prior to the proper functioning of business. The lesson is that the capability of state institutions is decisive in establishing and adjusting sound corporate governance. If the international or regional organizations want to address the issue of corporate governance, they have to be sensitive toward governability of the public sphere as well. Otherwise, they are not able to deal with a mixture of "public" and "private" (Wedel, 2003). Such a mixture exists everywhere, which is not to advocate that governments should not be encouraged toward increasing transparency of the links between the two spheres. There is no room here for ambivalence.

Second, the mixture of public and private spheres indicates that there is one more element to be considered when dealing with institutional change in the field of corporate governance. That is the framework of macroeconomic policy. The nature and consistency of macroeconomic policy affect all financial flows, and thus may significantly change the environment in which the influential actors shape their strategies, anticipate their likely gains and losses, and build their understanding of macro–micro relations. In this way, macroeconomic policy contributes to (re)shaping governance structures. It is probably the most influential factor in changing the nature of business networks in the continuum from rent-seeking (wealth distracting) to wealth creating. The context of macroeconomic policy helps in understanding the pace and quality of institutional change.

Finally, contrasting the countries with profound distortions of institutional settings and those most successful in permanent institutional adjustments/transformation helps to bring to light some phenomena amplified in the "distorting mirror." The normative aspect of capitalist transformation is explicitly taken up by Minev and Zheliazkov in the Bulgarian chapter of this book, but it certainly concerns other countries as well. The argument is that a capitalist order (like any other) is not possible without a clear social sense of the basic norms and values that underpin that order. The normative background that includes but goes beyond legal regulations has often been disregarded in the capitalist transformations of the last 30 years in the advanced economies, and has been neglected even

more in the post-communist transformations. However, the normative sense directly affects governability of the system at the macro level and the efficiency of economic performance at the micro level. One of the issues raised in most of the chapters is the problem of the "real owner," that is the owner who cares about the property in the long run. Lack of real owners in privatization in the East resulted from various factors, like the large scale of the privatization, the lack of capital, and the lack of a middle class, but it was fostered by the ambience of the unconstrained (in the normative sense) conduct of the rule-makers. By contrast, if for instance the French state was able to bring about a significant shift in institutional settings, that was due to the French economic and bureaucratic elite's ability to keep the self-sanctioning mechanism working, in which shared and transparent values have remained a viable reference for individual participants in the game. This normative capability provided institutional resources for the French *noyau dur* solution. Nothing comparable happened on a national scale in the cases of post-communist interwoven ownership, which is why eventually FDI became a major factor in transforming corporate governance.

Without easy analogies, one may expect that concerns about the real owner, as well as more general concerns about the normative underpinnings of economic relations (one might say embedded in a social sense of fairness), are more universal than appears in the distorting mirror. The problem goes back to the source of capitalist dynamics. As mentioned before, not only real owners, but also the split between ownership and management lay behind capitalist development in the twentieth century. Each country has dealt with the problem of governability of the relations between managers, owners, and other stakeholders in its own way, building country-specific models within a few generations. But recently the dominant models have suffered turbulence. The once admired Japanese performance, attributed to the perfect design of *keiretsu*, can hardly meet the challenges triggered by new product markets, such as information processing. Until now, there has not been a clear sign that Japanese firms and banks are able to adjust the design of governance and overcome internal weaknesses. Together with the last boom in telecommunications and energy, American firms seemed best organized for the new product markets. That image vanished, however, when consecutive flagships turned out to be deeply defective and disappeared from view.

The universal problem is how to deal with the growing uncertainty of quickly changing social and economic realities. New product markets offered to firms, as well as to the financial sector, carry huge promises and risks. The Japanese *keiretsu* were too slow to react in time, but many other firms all over the world were too quick and too ambitious in taking new risks. In fact, the managers often took the risk, with little capacity on the owners' part to understand and control strategic decisions. The managers

themselves had to rely on speculations that reflected more the dominant trends than economic calculations. As we now know from several cases, politicians at the highest levels were sometimes involved in the strategy building of large firms. The financial sector also contributed to shaping strategy, making use of the gaps in legal regulations and sometimes acting unlawfully. In the end, in spite of large corporate risks, individuals involved in the corporate game could also be observed taking less risk. Stories from the largest recent bankruptcies in the West resemble stories from post-communist privatization, which may have been on a smaller scale but were far more numerous. Essentially, Eastern "double bookkeeping" does not differ much from Western "creative/aggressive bookkeeping"; subordinated "supervisory boards" work similarly, not digging deeply into managerial decisions; and the politicians involved have similar motives. Finally, there are the managers who have to face uncertainty that is hardly calculable in purely economic terms, while being exposed to huge temptations offered by new and temporary opportunities, with little individual risk at the end. The problem is that the institutional systems lack the tools of adequate adjustment to the new situations that are continuously arising that expose a small number of participants in the game to quick and temporary gains while the others have limited means to impose accountability. The gaps in the institutional systems are more visible and damaging in the East, but the problem is much more general.

In the book, we undertake a broad West–East comparison of corporate governance national systems in five advanced economies and five catching-up economies. It helps us highlight and trace changes over time and the multiple paths to punctuated equilibrium. The cross-continental comparison underlines the individual nature of country-specific scenarios and outcomes of institutional change. It puts into question any stereotypic grouping of countries. Among the cases presented in the book are, for instance, three countries of Latin tradition – France, Italy, and Spain – but, as we can see, in terms of institutional development each of them is substantially different. Similarly, the countries of Central Europe – the Czech Republic, the Slovak Republic, Hungary, and Poland – show diverse trajectories of institutional change. Different pathways emerged in each of them in spite of their strong common roots in the prewar German legal tradition of the commercial law, which all of them reinstated during post-communist transformation, and yet modified in their individual ways. One may also uncover important differences in the institutional evolution of Balkan countries such as Bulgaria or Romania, or post-Soviet states such as Belarus, Russia, or Ukraine. These differences come from country-specific constellations of influential actors that affect the process of (re)making the institutions. In this sense domestic politics matter, and the lesson is that one cannot avoid the political dimension when looking for more sound and adequate corporate governance.

The sequence of the chapters intentionally avoids any grouping of the countries covered in this book. We start with an analysis of two Western countries, Italy and Spain, presented explicitly as two “outlier” models, to show the specific arrangements of each, as well as the way they have transformed over time. Then Ukraine, Bulgaria, the Czech Republic, Poland, and Hungary are presented. These countries are faced with deep institutional change, with differentiated pace and scope of the transformation process, and various approaches and constellations of actors behind them. In the end, we come back to a Western exemplification of a long-term transformation, that is: France, Switzerland, and Sweden, which were able to recombine national institutional resources when introducing some important new factors. Each chapter presentation builds on its own theoretical framework adjusted to specific national needs. The last chapter reassesses the evolution of corporate governance to explicitly put on the agenda the growing importance of the European Union dimension. This, at present, has a greater impact on candidate countries than member states.

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