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Citation	Hall, P. A., and K. Thelen. 2008. "Institutional Change in Varieties of Capitalism." Socio-Economic Review 7 (1) (October 8): 7–34. doi:10.1093/ser/mwn020.
Published Version	doi:10.1093/ser/mwn020
Citable link	http://nrs.harvard.edu/urn-3:HUL.InstRepos:33896772
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Institutional Change in Varieties of Capitalism

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Abstract

Contemporary approaches to varieties to capitalism are often criticized for neglecting issues of institutional change. This paper develops a perspective on institutional change designed to be applicable to the equilibrium analyses of such approaches but distinctive relative to competing understandings of institutions. It begins by outlining an approach to institutional stability, which suggests that the persistence of institutions depends not only on their aggregate welfare effects but on the distributive benefits they provide to underlying social or political coalitions and not only on the Pareto-optimal quality of their equilibria but on continuous processes of mobilization through which the actors test the limits of existing institutions. It then develops an analysis of institutional change congruent with this starting point, which emphasizes the ways in which reform, defection and reinterpretation emerge out of contestation and compares this account of institutional dynamics to recent developments in Germany and France. The paper concludes by elaborating the implications of this perspective for analyses of liberalization in contemporary political economies.

Comparative political economists have become deeply interested in processes of institutional change, and especially in those taking place in response to the opening of world markets associated with ‘globalization’ (Pierson 2001; Djelic and Quack 2003; Rieger and Leibfried 2003; Campbell 2004). They are asking a number of questions. When do the institutions of the political economy change? What factors drive change? Are changes in the international economy enforcing institutional convergence on the developed economies?

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

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

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

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

1. The Institutional Terrain

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

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

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

Second, this perspective implies that institutions are not simply the embodiment of strategic action, as some would have it, but can be the target or objects of such action (cf. Calvert 1995a). Because they face a multiplicity of institutions, actors sometimes have a choice about which institutions to operate within. Any given strategy adopted by a firm or other actor is also likely to be conditioned, not by one, but by a number of institutions. Because the varieties-of-capitalism approach emphasizes institutional interaction effects, it argues that firm strategies are conditioned simultaneously by multiple institutions, often in different spheres of the political economy (Hall and Soskice 2001: 21-36).

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

However, neither of these approaches fully conveys the 'institutions as resources' element of our perspective and, if carried to extremes, both overstate the degree to which any one institution determines action. To say that an institution specifies patterns of behavior seen as appropriate to the culture should not be taken to imply that all or even most in that culture adhere slavishly to it. There is always room, and often reason, to be critical of what is deemed ‘appropriate’. Similarly, although the mutual benefits of strategic interaction may render an institution more stable, that observation says only a little about how institutions are sustained, because it ignores the omnipresent processes of search and negotiation whereby entrepreneurial actors look for alternative ways in which to advance their interests (Knight 1995). There is more intrinsic openness to the institutional arena than these two perspectives imply.

2. Institutional Stability as a Political Problem

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

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

Moreover, our perspective calls for some revision in the way in which ‘coordination’ is construed. In game-theoretic analyses, ‘coordination’ is often seen as a pattern of behavior that arises relatively spontaneously, when the opportunity for it appears among actors who are viewed as contractors.[4] Coordination is said to follow directly from the presence of supportive institutions. By contrast, from the perspective we are elaborating, the achievement of coordination appears as a political problem. Coordination is not easily secured and rarely follows automatically from the presence of certain institutions. Instead, active support for a specific mode of coordination must be mobilized on a relatively continuous basis from actors who are conscious of its limitations as well as its advantages (Thelen 2001).

A good deal of the politics surrounding institutional stability flows from the loose coupling between self-interest and institutions. From the broadly rationalist perspective we adopt here, the durability of an institution can rest substantially, if rarely wholly, on how well it serves the interests of the relevant actors. Where an institution fails to serve those interests, it becomes more fragile and susceptible to defection from its rules. But the calculation about whether an institutional practice serves the actors' interests is a complex one, dependent on a range of considerations. It entails balancing the multiple interests any single actor has in a potential course of action, where time discounts and estimates about the effects of one's actions matter (Hall 2005).

The varieties-of-capitalism perspective draws attention to several factors that can militate in favor of the stability of institutions. One of the most important is the presence of institutional interaction. As we have noted, the strategies an actor, such as a firm, follows and the benefits to be expected from them are usually conditional on the presence, not of one, but of a number of institutions. Many German firms might be more willing to withdraw from the institutions that coordinate wage bargaining if they did not also face powerful German unions or operate particular types of production regimes.[5] Where the benefits of changing one institution are likely to be realized only when a substantial number of other institutions are also transformed, that institution should be more stable. Conversely, where there are alternative institutional means available for accomplishing a task, a firm's interests may bind it less tightly to one institution.

Considerations about how readily alternative institutions can be constructed also condition the judgments actors make about whether to adhere to an existing institution. Because institutions are collective constructs, it can be difficult to replace one institution with another. In a few cases, an alternative can be secured by fiat: the Swedish government shifted drivers from the left to the right-hand side of the road in one fell swoop. But, in many instances, as Culpepper

(2003) shows, it can be difficult to persuade actors to coordinate on new ways of doing things, even when there are reasons to think they might be Pareto-improving. Before a new institution is established, one cannot prove it will deliver benefits and the relevant actors cannot be sure of the behavior of others on whom its efficacy may depend. The presence of such uncertainties is a crucial factor underpinning institutional stability (Shepsle 1986). Thus, the availability of meta-institutions for deliberation and rule-making can be crucial to the stability of existing institutions and to the prospects for reform (Hall and Soskice 2001: 10-12). When the world throws up shocks that unsettle the benefits flowing from existing institutions, deliberative forums facilitate the re-equilibration of cooperative endeavor, by allowing for 'diagnosis', where the problem is to agree on the cause-and-effect relations generating the problem and pertinent to the solution, and for agreement on 'distributive justice' where the problem is to apportion the risks and benefits that can flow unequally from cooperation.

Considerations such as these also draw our attention to the fact that the stability of most institutions depends on a relatively thick body of 'common knowledge' (Hall and Soskice 2001: 12-14). To cooperate, actors must feel confident about how others will behave in the face of many contingencies. That demands a set of shared understandings considerably thicker than the thin conceptions of 'common knowledge' assumed by many models, and the firmest basis for such understanding is prior experience of interaction with each other. The more extensive that experience, the more stable an institution is likely to be. In short, the stability of institutions does not rest on instantaneous calculations about self-interest, but on bodies of experience from which important reservoirs of common knowledge are filled.

However, if actors are daunted, they are not altogether deterred, by uncertainty. Actors are usually engaged in an ongoing reassessment of both their own scope for action and the intentions of those with whom they are interacting. They need to be reassured that existing institutions continue to serve their interests and that better alternatives are not available. While some actors probe the outer limits of existing arrangements, others try to defend these institutions by assuring others that they are better than available alternatives. The result is a *politics* of institutional stability, one of whose features is continuous experimentation, as the relevant actors test the bounds of what others will deem acceptable behavior, seek new information about their partners, assess the effects of alternative courses of action, and consider how severely defection from institutionally-sanctioned patterns of behavior will be punished. For some actors at some times, of course, institutional stability might depend on habit. But, in the political economy, it more often depends on a stream of action that is political in the sense that it entails conflict designed to test the limits of cooperative arrangements and mobilization to bring other actors in line with those arrangements (Thelen 2001: 73 ff.).

The history of industrial relations in Germany provides excellent examples (Thelen 1991; Streeck 1994; Hall 1994). For many decades, Germany has had a set of institutionalized practices for wage bargaining that are highly coordinated, capable of delivering wage restraint, and relatively stable. There is no doubt that the resilience of the system depends partly on the satisfaction of key employers and employees with the results it has generated, and a standard institutional logic can be adduced to explain why the system generates such returns (Soskice 1990). Some see this as a 'consensual' system of industrial relations, but on closer inspection it is clear that industrial relations in Germany have been anything but smooth or consensual. Behind its wage settlements lies a politics marked by periodic conflict between employers and employees, including lockouts and strikes. Why should a conflictual politics be necessary to sustain a system that most participants have seen, over the long run, as one that serves their interests? The answer is revealing about the politics of coordination.

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

Moreover, if power relations in a cooperative context are based on the relative opportunity costs to each side of failing to cooperate, as Knight (1992) has argued, those costs usually depend heavily on the other institutional practices in which the actors are imbricated. When deciding whether to bargain cooperative with the unions, employers were influenced by other institutions impinging on their interests, such as the works councils they faced, the work practices and production regimes they had evolved, and a range of institutions affecting the costs a prolonged strike or lock-out would impose on them. The general point is that institutions do not simply resolve collective action dilemmas: they reflect and contribute to the balance of power found in many parts of the political economy (see also Moe 2005).

This conception of the politics of stability speaks to one of the principal criticisms leveled at the varieties-of-capitalism perspective, namely, that it adopts an overly functionalist approach to the problem of institutional change (cf. Crouch 2005, Streeck 2005). We can see precisely just what it borrows from functionalist approaches and where it rejects them. As we have noted, this perspective shares the functionalist premise that the support groups provide for an institution is motivated, to some extent, by the benefits the institution provides, closely linked to the functions it performs. However, our perspective differs from functionalist accounts in two key respects.

First, we do not assume that support for an institution derives primarily from the contribution it makes to aggregate economic welfare. Varieties-of-capitalism analysts devote a good deal of attention to explaining how the institutions of the political economy contribute to national well-being. But they do not generally claim that the existence of an institution depends on that contribution. Institutional politics as we understand it turns, not on issues of aggregate welfare, but on the actions of self-interested actors seeking better outcomes for themselves or the groups they represent (Hall and Soskice 2001: 57-8).[6]

Second, in contrast to some types of functionalist analysis, we think it dangerous to assume that the institutions of the political economy were originally created to serve the interests they advance at much later periods of time. German employers, for instance, expressed vociferous opposition to the legislation of the 1950s that enhanced labor's rights on the shop floor (Höpner 2003). However, once those institutions were in place, employers organized production strategies and a range of ancillary practices around them, aiming at high-priced, high quality production (Streeck 1992). As a result, they now overwhelmingly support works councils, because their market and production strategies rely on them. In this as in many other such cases, the institutions of the political economy are instruments that actors gradually adapt to their purposes and in which many become invested only after they have accommodated their practices to them (Thelen 2004).[7] Thus, the current effects of an institution help explain contemporary support for it, but only rarely can those effects explain the origins of an institution.

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

3. Institutional Change in the Political Economy

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

Multiple Agents of Adjustment

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

Recent analyses by Culpepper (2006) and O'Sullivan (2005) of changes in the structure of French financial markets are revealing. Although those shifts began with government initiatives to privatize national enterprise and expand the ambit of French equity markets, the traditional networks binding French business to the state were unwound only when key firms took the initiative to dissolve their core shareholdings in the newly-privatized enterprises and to seek foreign acquisitions and investors. Much of the impetus for their strategies derived from the opening of international markets made possible by agreements the French governments signed, but those strategies were driven by new market pressures and opportunities. Many large French firms realized they would prosper only if they secured global market share, and higher stock prices became a major asset in the stock swaps used to secure new acquisitions. Thus, French companies undertook a series of measures to solidify their market position, and the government obliged with congenial regulatory reforms in the sphere of corporate governance (Tiberghien 2002).

Similar developments can be observed in the German political economy, where more open global markets put pressure on large German firms, especially in the financial, pharmaceutical and automotive sectors, to internationalize their operations and to seek a favorable regulatory environment in which to do so. Shifts in firm strategy lay behind government initiatives that made it easier for large firms to wind down their domestic shareholdings in order to amass capital for foreign expansion. In short, governments do not have the luxury of responding to international economic developments on a *tabula rasa*. In many cases, they have to react to corporate strategies that are shifting even more rapidly in response to those developments. Changes in rules often follow the accumulation of "deviant" behavior, in effect to bring formal rules or legal regimes back into alignment with behavior (Streeck and Thelen 2005, 15-16).

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

In short, although the role of states should not be underestimated, institutional change in the political economy is driven by the shifting strategies of several sets of important actors, each acting out of different sets of interests.[8]

The Impetus for Institutional Change

There is no doubt that developments in the international political economy are important stimuli for contemporary institutional change. Among the OECD countries, these developments include: the growing weight of the service sector in employment and falling barriers to trade or communication that intensify international competition and open up opportunities for sales or production elsewhere in the world. The liberalizing initiatives of the European Union, the collapse of Communism, and the reunification of Germany have been of special importance to Europe. These developments have shifted the opportunity structures and returns to existing institutions for many firms and workers, inspiring institutional ferment in Europe, and some analyses treat the problem of institutional change as if the impetus were invariably exogenous to the institutions themselves (cf. Frieden and Rogowski 1996).

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

We see a similar dynamic of endogenously generated change in the German economy, where firms took advantage of early retirement policies to resolve structural crises in declining industries, such as coal and steel, during the 1950s and 1960s in unanticipated ways that fuelled increases in non-wage labor costs (Trampusch 2005). Although effective at facilitating orderly workforce reductions in the 1980s and 1990s, these retirement practices had a deadening effect on job creation and imposed heavy burdens on social insurance funds. The effect was to spark, not only revisions to the early retirement regime, but broader pressures for labor market reform.

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

4. Three Routes to Institutional Change

Many analysts of institutional change focus their attention on major legislative initiatives, such as Margaret Thatcher's reforms to industrial relations or Gerhard Schröder's reform of corporate taxation, marquee events of undeniable importance. However, the framework we have outlined suggests there are at least three routes to institutional change in the political economy, each with a distinctive dynamic. Beyond explicit reform, which is widely theorized in the literature, we find also significant change through what we call processes of defection and reinterpretation.[9]

Reform

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

The implication of this analysis is that institutional reform often originates in political compromises among actors, whether producer groups or political parties, diversely motivated in contexts of distributive conflict (Palier 2005). Thus, there are no guarantees that the process of institutional reform will advance national well-being. If firms decide to support the regulatory regimes that sustain the comparative institutional advantages of the nation, it is because they also underpin the competitive advantages of the firm. Behind many reform debates lie other conflicts of interest, such as those that habitually divide capital and labor and, on each side, different types of firms and workers. Institutional change is a process of continuous mutual adjustment inflected by distributive concerns.

However, the varieties-of-capitalism perspective reminds us that the alignments central to these conflicts can be deeply influenced by the character of existing institutions. Firms and other actors do not judge proposals for reform as if the new institutions will operate on a blank slate but from the perspective of how they will interact with existing institutions in other spheres of the political economy. Actors' assessments of whether a new set of institutions will benefit them often turn on how well those institutions fit with strategies into which they have been drawn by virtue of the presence of supportive institutions elsewhere in the economy. Institutional arrangements in one sphere can condition the positions actors take on institutional reform in another sphere.

Swenson's (2001) comparison of pension politics in Sweden and the U.S. provides a nice example of this dynamic. He shows how institutions developed in the arena of industrial relations during the 1930s conditioned the types of pension policies employers were willing to support in the 1950s. Because Sweden's centralized bargaining system created wage floors and kept wage competition in check, it inspired new forms of competition for skilled workers based on the provision of company pensions. Given the rising costs of the latter under conditions of full employment, employers were willing to support a social democratic initiative to institute generous public pensions. By contrast, the Wagner Act of 1935 left wage bargaining at the company level in the United States, fostering a division between low-skill firms operating with low non-wage costs and high-skill firms that used using generous company pensions to attract skilled labor. Each had interests in the existing pension regime, and there was no broad business constituency for generous public pensions in the U.S..

Goyer's (2005, 2006) comparison of reforms to corporate governance in France and Germany identifies a similar dynamic. In response to international economic developments, both nations made some such reforms. But the character of the reforms firms were willing to support in the sphere of corporate governance was influenced by the character of institutional arrangements in the sphere of labor relations. Many French firms were willing to accept measures that made hostile takeovers more feasible and corporate restructuring to raise share prices more urgent because they faced weak works councils and trade unions in the industrial relations arena. They knew the opponents of restructuring would be weak and management's room for maneuver substantial. In Germany, by contrast, where powerful works councils and trade unions were institutionally entrenched, firms were receptive to the adoption of international accounting standards and measures to strengthen the position of minority shareholders, but resisted efforts to expose them to hostile takeovers, because industrial relations institutions made it more difficult for them to restructure quickly in response to demands for 'shareholder value'.

Defection

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

Recent developments in the German metalworking sector provide a good example (see Kume and Thelen 1999; Thelen 2000). Over the 1970s and 1980s, many large German firms in metalworking took advantage of new opportunities to extend their supply chains and revamp production processes. Those changes made them more efficient but more vulnerable to disruptions in production. Therefore, these firms developed strong interests in labor peace and were able to offer skilled workers higher wages and more generous benefits in return for it. Lacking the scale to shift production in this way, however, many smaller firms, later including some in East Germany, still had to restrain wages in order to remain competitive. As a result, a cleavage opened up between firms in the sector with respect to the appropriate strategy to take in collective bargaining rounds.

Metalworking exemplifies the institutionalization of coordinated wage bargaining in Germany. Negotiations are conducted at the sectoral level between *IG Metall* and *Gesamtmetall*, two of the nation's most powerful producer groups, and they worked well because *Gesamtmetall* managed to retain the support of most firms in the sector. To do so, it bargained hard, seeking modest settlements so as to hold down the wage bill for smaller firms, at the cost of mounting lockouts to remind *IG Metall* of its resolve. When the most advanced firms in the sector developed new supply chains whose effectiveness depended on uninterrupted production, however, they developed an aversion to lockouts, and *Gesamtmetall* began to agree to wage and working time settlements higher than some firms could afford. Smaller firms in particular began to defect from *Gesamtmetall*, either dropping their membership or finding ways to avoid paying the wage rates it negotiated. Through a process of defection, the institutions governing wage coordination in the metalworking sector are being transformed. Similar processes of defection are shifting institutional practices in some other spheres of the German and European political economies.

Reinterpretation

A further route to institutional change from below lies in what we call 'reinterpretation'. In these instances, the actors associated with an institution gradually change their interpretation of its rules, and thus its practices, without defecting from or dismantling the institution itself. In some cases, that entails the reinterpretation of a legal or regulatory regime, for example through the courts. In others, it involves the gradual acceptance of practices that would not formerly have been seen as congruent with the continued existence of the institution. In comparison to 'reforms' that formally revise or abolish an institution, the process of reinterpretation shifts existing practices in piecemeal fashion from below (Aoki 2001, Streeck and Thelen 2005).

Recent developments in German collective bargaining display many examples of reinterpretation, as employers and workers attempt to bend existing practices to suit their interests, without formally abolishing them. A good example lies in skirmishes over the meaning of a core provision in German labor law known as the 'favorability principle' (*Günstigkeitsprinzip)* (Rehder 2004). That principle stipulates that certain issues normally reserved for collective bargaining at the industry level can be decided at the local level, in bargaining between works councils and individual employers, provided that the outcome operates “to the advantage of the worker”. Thus, firms can pay wages in excess of the industry rate, but they cannot demand concession bargaining. In recent years, however, employers began to try to take advantage of an ambiguity in the meaning of ‘favorability’ (*Günstigkeit)* to justify local employment pacts that offer workers greater job security in return for lower wages. Their argument was that anything offering greater job security in a context of high unemployment operates “in favor of the worker” (“*zu Gunsten des Arbeitnehmers)*”.

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

Processes such as these can act as shock absorbers in the face of new economic developments, reflecting an elasticity in the institutions of the political economy that analysis focused on formal rules sometimes misses. However, our point in the present context is to emphasize reinterpretation as a mode of change. Opponents of a given institution may prefer to seek change through reinterpretation of existing rules, especially if (as is often the case) this avenue poses fewer obstacles than they might confront if they were to launch a frontal assault on the formal arrangements. Among other things, this type of change can often be sought more quietly, for example through the courts, avoiding noisy public legislative battles that are sure to mobilize the opposition and may even alert more distant stakeholders of interests they did not realize they had but for which they can exact concessions.[10] Moreover, and especially to the extent that such reinterpretations can be sold as a way to "fix" problems with existing arrangements, they also offer more opportunities to forge coalitions with an institution's supporters (Palier 2005). The latter may resist an institution's dismantling but be more than happy to cooperate in "clarifying" rules or institutions in novel ways, particularly if failure to act would bring defections and de facto institutional erosion In short, these forms of elasticity may be important to the survival of strategic coordination, even though they also often entail important changes in the functions the institutions perform and the substantive outcomes with which they are associated.

5. The Implications for Varieties of Capitalism

What does this analysis imply about the survival of distinctive varieties of capitalism in Europe and about the trajectories of change in its political economies? The magnitude of the challenges facing those economies should not be minimized. Europe's largest economies suffer from low rates of growth and high levels of unemployment. Aging populations burden many welfare states, and the rise of the service sector has called into question economic models attuned to the demands of industrial capitalism (Iversen and Wren 1998). In such contexts, there is bound to be institutional change.

Beyond Liberalization

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

First, liberalization is a multidimensional process. The types of initiatives we have just listed need not accompany one another and often they do not. Denmark has made major cuts to unemployment benefits even as it has shored up tripartism and strengthened unions. France has encouraged part-time work without cutting its minimum wage. To what extent these measures tend to occur together should be an object of inquiry but, for that kind of inquiry to be possible, we need to disaggregate the concept of 'liberalization' and explore each of its dimensions.

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

Third, if our analysis is correct, the impact of any institutional reform on the operation of the political economy should be dependent on the structure of other institutional arrangements in that economy. There is evidence, for instance, that the economic effects of reforms to corporate governance depend on the character of labor relations in the country at hand (Hall and Gingerich 2004). A number of studies have suggested that the impact of making the central bank more independent of political control will depend on the character of the nation's wage bargaining (Iversen 1999; Hall and Franzese 1998). Even when a comparative analysis focuses on identical institutional reforms, to assume they will have identical effects in all nations is misleading. Because of institutional interaction effects, the impact of reform may vary dramatically across nations.

Without denying that the concept of 'liberalization' has an important political reality that derives from its association with the 'move to the market' begun in the era of Reagan and Thatcher, we question its value as an instrument for diagnosing the impact of institutional reform or for predicting the direction of the developed political economies. Britain and Sweden both experienced what can be called significant "liberalization" in the industrial relations arena during the 1980s and 1990s (Wallerstein and Golden 1997). But liberalization in Britain was associated with the demise of unions and employers associations, substantially reducing some kinds of coordinating capacities. In Sweden, by contrast, liberalization involved a movement away from national-level wage coordination but also a cross-class realignment that brought much closer coordination between blue and white collar bargaining within the export sector, while leaving the public sector to bargain separately (Thelen and Kume 2005). Not all changes grouped together under the banner of liberalization produce meaningful 'convergence' between coordinated and liberal market economies. To make sense of such developments, "liberalization" is too blunt a tool; we need alternative categories with which to secure more fine-grained assessments of the impact of institutional change.

In fact, the framing of debates on change in terms of an undifferentiated view of "liberalization" squanders one of the greatest advances offered by the varieties-of-capitalism framework over its precursors. The traditional corporatist literature of the 1970s was built around the practice of arraying countries along a single continuum, and differences between them (i.e., between "more" versus "less" corporatism) were seen as differences in degree (Thelen 1994). By contrast, the varieties-of-capitalism framework recast the debate by organizing the analysis of political economies around ideal-typical models that operate according to wholly different logics – the differences among them, in other words, are in kind and not in degree. The current debate, which centers on the extent of liberalization effectively re-situates countries on a single continuum and reduces the question of change to movement along that continuum.

By now an impressive body of research has accumulated that demonstrates that, even after two decades of liberalization, a substantial gap remains between the coordinated and liberal market economies (Hall and Gingerich 2004: Table 8). Despite increases in part-time and/or temporary employment, and reductions in unemployment benefits, employment protection and union membership, still the most generous welfare states remain the most generous (Garfinkel et al., 2007). Countries where firms have traditionally relied on specific, as opposed to general, skills, they continue to do so (Campbell et al, 2006; Estevez-Abe et al., 2001). Although wages are now rarely coordinated at the peak level and sectoral wage coordination is looser than twenty years ago, there is still extensive wage coordination in coordinated market economies (Hassel and Williamson 2004). More dramatic changes are visible in the areas of corporate governance and finance, though even there moves in the direction of pure liberalization have provoked resistance (Callaghan 2004; Guillen 2000).

The Nature and Direction of Change

The observation that contemporary changes have not erased (and are unlikely to erase) the core distinction between liberal market economies and coordinated market economies does not imply that the changes currently underway are insignificant. It merely points to the need to build out from the core categories around which the varieties-of-capitalism framework is organized in ways that improve on accounts of change based on the alternative liberalization continuum.

As a first step, we need to distinguish between specific sets of institutional arrangements present in a sphere of the political economy and the types of coordination they sustain. The distinctions drawn by Hall and Soskice (2001) emphasize the extent to which a nation's institutions support, and its firms make use of, market-oriented versus strategic modes of coordination. Whether each type of coordination is sustained in a realm of the political economy is analytically separable, however, from the issue of which set of institutional arrangements are maintained there. Critics of varieties of capitalism sometimes view any changes in formal institutions as a sign of change in coordinating capacities. However, consistent with the more dynamic view of institutional stability outlined above, we know that formal institutions persist only when they are actively adapted to changes in the political and market context. This means that significant revisions in existing formal arrangements may not only be consistent with continued coordination, they are often necessary to sustain such coordination. For example, Thelen (2004) traces changes in many of the formal institutional arrangements underpinning the German skills system, that, far from undermining the type of coordination on which the German high-skill equilibrium is based, were crucial to its survival in the face of successive shifts in the economic and political environment over the course of the twentieth century.

Conversely, however, formal institutional stability is no guarantee of continued coordination. As noted above, many of the formal features of the German industrial relations system have proved resilient over the past decade. Yet processes of defection and reinterpretation have resulted in very significant erosion in the scope and functioning of bargaining. Among other things, the devolution of new powers to local labor representatives have reduced the ambit of such coordination and reoriented it around the interests of large firms and their core workforces. Analogous developments can be found in other political economies.

From a varieties-of-capitalism perspective, then, one of the key analytic challenges is to distinguish cases in which the effects of institutional reform are to supplant strategic with market coordination from cases in which strategic coordination is sustained on a different institutional basis. The demise of unions and employer associations in Britain in the Thatcher years is in this sense a very different phenomenon than the flexibilization of industry level contacts in Germany. At one level up, one can also ask whether contemporary institutional changes erode irreversibly the capacity for strategic coordination, or leave such capacities sufficiently intact that they can be recovered later. The kinds of coordinating capacities that exist in countries like Germany and Sweden emerged out of complex historical processes , and they can certainly be lost amidst the politics of the present. Precisely because many contemporary changes in coordinated market economies take the form of renegotiations, rather than breakdowns, however, nuanced analysis is required to establish whether they have eroded ongoing capacities for strategic coordination.

Second, and related to this, the breadth of the categories of 'market' and 'strategic' coordination, can mask important changes in the quality of the equilibriums secured under each modality. This suggests the need to build out from the core dichotomy on which the original varieties of capitalism framework rests to develop more nuanced analyses of what might be described as non-trivial movement within the broad categories of 'coordinated' and 'liberal' market economies. In Germany for example, evidence from a number of realms, from industrial relations, to vocational education and training, to welfare state reforms point strongly not so much to a shift in the system toward the Anglo Saxon model, but rather to new forms of dualism and labor market segmentation – features that in the past have been more closely associated with an alternative "segmentalist" version of coordination, as featured for example in Japan. The narrowing of collective bargaining coverage, the closure of internal labor markets especially in large companies, the trend toward more enterprise-oriented modes of in-plant training, and welfare state reforms that sharpen the divide between labor market insiders and outsiders all represent significant changes with enormous distributional consequences (Thelen and Busemeyer

2007). The systemic features of the varieties-of-capitalism framework provide a crucial tool for understanding the timing and direction of change across these various institutional realms, and lend insight into the coexistence of looser coordination at the national-political level and heightened coordination and cooperation between labor and capital at other levels (e.g., between works councils and employers in the large firm sector). These changes are not well captured on a simple liberalization continuum, though it is also clear that analyzing their causes and consequences will require further development of more differentiated categories than the simple but powerful dichotomy between strategic and market coordination.

In developing such categories, our perspective suggests promise in distinctions based on variation in the political coalitions that support the institutional arrangements underpinning each type of coordination. Influenced by the varieties-of-capitalism perspective, an emerging literature in comparative political economy is beginning to link institutional analysis to coalitional analysis (Iversen and Soskice 2007, Gourevitch and Shinn 2005x, Thelen, 2004, Mares 2003, Huber and Stephens 2001, Swenson 2002). Much of it traces the genesis of important institutional configurations to specific sets of coalitions, formed either among producer groups or within the electoral arena. Many of the relevant political configurations are cross-class coalitions.[11]

A related series of analyses explains changes in the form or function of institutions over time by reference to shifts in coalitional patterns that alter the political foundations on which they rest (Iversen 1996, Thelen and Kume 2005, Martin and Thelen 2007). These analyses suggest that important distinctions among liberal and coordinated market economies, bearing on the resilience of coordination there and especially on the distribution of its benefits, can be based on variation in the sources of political support for the types of coordination they display (see also Pontusson 2005). Such studies have also begun to uncover the sources of resiliency in more solidaristic forms of coordination, even as they provide insights into the drift in other countries toward more decentralized, segmentalist forms (e.g., Martin and Thelen 2007). In sum, the kind of coalitional analysis that has been so important in explaining the origins of many of the key institutions that anchor coordination in coordinated market economies (e.g., Swenson 2001, Mares 2001, Thelen 2004) also provide the basis for a dynamic account of how shifts in interests and alignments bring about important reconfigurations of traditional institutions and forms of coordination in both liberal and coordinated market economies.

Not all forms of change, however, amount to renegotiations of coordination; it is certainly possible for some forms of strategic coordination to give way to the market. The ‘mixed market economies’ of southern Europe thus provide another set of cases against which the perspective on change introduced here can be assessed (Hall and Gingerich 2004). Historically, they have been characterized by high levels of strategic coordination in the spheres of corporate governance and labor relations, but coordination secured largely by the actions of relatively-interventionist states (Schmidt 2002). Therefore, they are hard cases for our proposition that institutional change is led as often ‘from below’ as ‘from above’.

France is the paradigmatic case, and large-scale change in its political economy was initiated by a series of governmental decisions to forsake *dirigiste* policies in favor of market-oriented coordination, beginning in March 1983 (Hall 1987). By virtue of the prominent role its state played in strategic coordination, France was peculiarly vulnerable to the disillusionment with state intervention that followed the economic crises of the 1970s and the institutional transformation of its political economy more profound than elsewhere in Europe. As Culpepper (2006) has observed, however, once given a freer hand, French firms led the movement that was to transform corporate governance and industrial relations in the private sector. Large firms took responsibility for devising new modes of inter-corporate coordination to replace those that had once been operated by the state (Hancké 2002). Although the endpoint was more dramatic and the state the initiator, on close inspection, France displays processes of institutional change that correspond to the model presented here (Culpepper *et al*. 2006).

Conclusion

The object of this article has been to elaborate the theory of institutional change we associate with a varieties-of-capitalism perspective on the political economy. We have tried to show that an approach that understands institutions, at least in part, in equilibrium terms can accommodate an analysis of institutional change and that its broadly rationalist approach can comprehend many of the subtle features of such processes of change. We have emphasized that, even when institutions are Pareto-improving in the context of strategic interaction, their stability should not be taken for granted but rests on a highly-political process of mobilization marked by conflict and experimentation through which informational issues are resolved and distributional issues contested.

We have portrayed the political economy as an institutional ecology in which the strategies of the actors are simultaneously conditioned by multiple institutions, and the process of institutional change as one of mutual adjustment, inflected by distributive concerns, with incremental impacts on the strategies of firms and other actors. The model we have proposed acknowledges more change than analyses focused entirely on regulatory regimes or public policy normally recognize. Because we see firms as initiators of institutional change, virtually as important as the state, and highly responsive to shifts in the economic environment, we observe a widespread transformation of the European political economies that is only partly reflected in policy regimes. Alongside familiar processes of reform, we see processes of defection and reinterpretation that are shifting institutional practices 'from below'. Related to this, our image of the political economy as an ecology of interacting institutions suggests that the process of change itself is likely to be incremental, based on mutual adjustment among the relevant actors, operating via small alterations to existing practices (Streeck and Thelen 2005). In some respects, this is simply an extension of the processes of institutional experimentation that are a regular feature of political economies, though we have also stressed how incremental processes of this sort can result in major transformations over the medium and long run.

Beyond this, we have elaborated several ways of moving beyond the current fixation on the 'liberalization' of the European political economies, and suggested that the most promising way to extend the varieties of capitalism perspective is to devote more attention to the types of political coalitions that support the principal institutions of the political economy, with a view not only to elucidating them but to exploring how institutional arrangements in one sphere of the political economy condition perceptions of interest and the coalitions that form around institutional reform in other spheres. That yields an account of institutional change that is eminently political.

Moreover, we see institutional change as more than a matter of producer group politics. Although we have emphasized the interests that firms and workers have in particular modes of coordinating economic endeavors, we have also suggested that capacities for coordination depend on a sociological underlay, subsumed in many models under the rubric of 'common knowledge'. Although summarized as a set of shared understandings about how other actors will behave under a variety of circumstances, this common knowledge extends to conceptions of social justice, about what one can reasonably expect from others, that are crucial to resolving the distributive conflicts that arise when actors try to coordinate with one another (Rothstein 2005, Streeck 1997, Goldthorpe 1978). Such conceptions are features of the polity as a whole, and potentially the Achilles heel of the European political economies.

If workers no longer believe that the industrial relations institutions or social regimes within which they labor will deliver a just set of rewards, a nation's capacities for coordination may be threatened, even if its institutions remain intact. Ultimately, a varieties-of-capitalism perspective draws attention to this dimension of institutions as well, and it is here that the most serious question marks hang over the European political economies. In the face of a changing economy, as firms and governments decide how to reallocate work, benefits and leisure, and what to demand of those who receive them, the settled expectations of the post-war decades are being called into question. These issues render developments in the realm of electoral politics salient to the effectiveness of coordination in the political economy, and they too will have to figure in on-going analyses of institutional change.

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Notes

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

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

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

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

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

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

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

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

[9] These are not exhaustive of the modes of change that can be observed in contemporary political economies, and a somewhat broader (though, again, not exhaustive) inventory is discussed in Streeck and Thelen (2005). Defection is the mechanism that defines the mode of change that Streeck and Thelen call institutional "displacement," and their mode of "conversion" features reinterpretation as the main mechanism of change (p. 31).

[10] We thank Terry Halliday for emphasizing this point to us.

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