Analysing ‘System Change’: The Role of Institutional Complementarity in Corporate Governance

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Abstract
The objective of this paper is to critically review the theory of institutions, in particular, path dependency theory and the concept of institutional complementarity (IC), i.e., a process of mutual reinforcement, and suggest a possible means of assessing ‘system change’ that goes beyond thick descriptions that highlight either institutional resilience and/or change. To this end, the paper gives greater theoretical specification to the concept of IC, and demonstrates how the concept can be amended and applied to explore change in capitalist system, taking corporate governance as an illustrative case study.

Keywords:
System change, varieties of capitalism, theory of institutions and institutional change, theory of path dependency, institutional complementarity, and corporate governance.

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Introduction

The objective of this paper is to explore a way in which to analyse system change using the theory of institutions. The aim is to go beyond the conventional institutional analysis that provides thick descriptions of institutional resilience and/or change that can be read one way or the other. Here, system refers to a set of connected institutions (i.e., established laws and practices) functioning together as a complex whole. The ‘system’ of interest for this paper is capitalist system; in other words, the issue of growing convergence and/or continued divergence between varieties of capitalist systems with the homogenising forces of globalisation.

The significance of the paper lies in that it critically reviews theory of institutions, in particular the theory of path dependency and its concept, institutional complementarity (IC), which have become popular tools of analysis for those interested in the problem of system change. It also demonstrates a possible means of overcoming the classic problem of “glass half-empty or half-full” associated with the conventional analysis.

To this end, this paper begins with an in-depth discussion on theory of path dependency and concept of IC. In the process, it challenges the common usage of IC by the “varieties of capitalism” school, and underscores areas for revision. On the basis of these discussions, this paper devises a framework to analyse system change using the concept of IC. The rest of the paper is devoted to applying this framework to analyse change in capitalist systems, looking in particular, at the change in the corporate governance system.

Theory of path dependency and institutional complementarity

Path dependency

Path dependency arguments have increasingly come to the fore in institutional analysis, and are widely adopted in social sciences to explain institutional stability and
– to lesser extent – institutional change (see North 1990; Knight 1993; Thelen 1999, 2003; Mahoney 2000; and Pierson 2000a, 2000b, 2000c). The writers of so-called “varieties of capitalism” (VoC) approach have also followed suit, applying path dependency arguments – and in particular the concept of institutional complementarity – to the analysis of change in various capitalist systems (see Whitley 1999; Hall and Soskice 2001; Amable 2004; Yamamura and Streeck 2003; Morgan et al. 2005).

There are many variations in the use of the concept of path dependency with “weak” form at one end, and “strong” form at the other. The ‘weak’ form of path dependency defines a path dependent process very broadly to mean “what happened at an earlier point in time will affect the possible outcomes of a sequence of events occurring at a later point in time” (Sewell 1996:262-3, cited in Djelic and Quack 2005). Often found in history or social sciences with a historical bend, this version of path dependency is seen to have little theoretical bite.

Of interest to this study is the “strong” form of path dependency, which can be found in economics and political science. This version, as articulated by Pierson (2000a, 2000b, 2000c) and Mahoney (2000), is influenced by the works in the ‘new economics of organisation’ tradition, such as that of economic historian David (1985) when used to explain the development of technological trajectory, and further developed by Arthur (1994) and David (1994) to explain the growth of firms. Pierson (2000a:74-77) defines a path dependent process as one characterised by a “self-reinforcing sequence of events”. For Pierson, path dependence involves three phases: the first is the ‘critical juncture’ in which events triggers a move towards a particular path out of at least two possibilities; the second is the period of reproduction, that is, the period in which positive feedback mechanisms (discussed below) reinforce the movement along one path; and finally, the path becomes to an end when new events dislodge the long-lasting equilibrium. Thus, for Pierson, every path begins and ends with a critical juncture (or what has been frequently referred to as a ‘punctuated equilibrium’).²

² Mahoney, arguing much along the lines as Pierson, takes this point as step further. In the words of Mahoney (2000:507) “path dependence characterises specifically those historical sequences in which contingent events set into motion institutional patterns or event chains that have deterministic properties.” As pointed out by Deeg (2001:9), Mahoney thus specifies more clearly than Pierson the properties of the ‘early events’ in a historical sequence; namely, these events must be contingent in that they cannot be explained by prior events or ‘initial conditions’.
One of the most important contributions made by the supporters of the “strong” version of path dependency – and which gives more theoretical bite to path dependency arguments than their weaker versions – is their effort to specify mechanisms of institutional reproduction (or the ‘second phase’), i.e., what keeps things moving along the same path. Drawing from institutional economics, Pierson (2000a, 2000b, 2000c) argues that mechanisms for institutional reproduction are “positive feedbacks”, that is, the realisation of ‘increasing returns’ to move along a given path. A variety of feedback mechanisms can be operative, such as the following: (1) large set-up costs or initial costs, i.e., once actors have made a substantial investment in a given path they have a strong incentive to sustain the path to recover their costs; (2) learning effects, i.e., actors learn to utilise more effectively the institutions constituting this path, and thereby enhancing their value and utility; (3) coordination effects, i.e., other actors follow the initial actors in their commitment to a given path and thus enhances the benefits accruing to all actors from this path; and (4) adaptive expectations, i.e., actors adopt or support a particular path because they expect others to do so.3

**Institutional Complementarity**

**What is it, and why is it important?**

Important to the VoC approach – and to this paper – is also the argument made by Pierson drawing on the work of economic historian Douglass North (1990), namely that “not only single institutions are subject to positive feedback effects, but configurations of complementary institutions in which the performance of each is affected by the existence of others.” (Pierson 2000a:78). This suggests that a complementarity of a set of institutions can generate high levels of feedback effects, or “increasing returns”, because the effectiveness of each is dependent upon the existence and functioning of the others. By this reasoning, eventually those institutions that are not integrated effectively with other institutions would be forced out of existence in the sense of ‘evolutionary functionalism’, thereby reinforcing the existing complementarities. Institutional complementarity is a powerful mechanism of institutional reproduction (this point will be addressed in greater detail below).

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3 Mahoney (2000:516-8) sees these mechanisms of reproduction as having little relevance outside the market place and introduces other mechanisms, namely (1) the application of power or authority by actors to preserve a given institutional path; and (2) deep-seated legitimacy (for example, see Schmidt 2002).
IC is important because it is what gives coherence to a system and examining the interaction between institutions undergoing change makes the analysis of system theoretically more rigorous and empirically more realistic, given that institutions do not stand in isolation, but are in reality interactive.

**View of institutions and system coherence**

The concept of institutional complementarity, first emerged when analysing a narrow set of issues concerning technology and industrial strategy in economic organisations (Milgrom and Roberts 1990, 1995), and later more widely applied to national-level institutions (Aoki and Dore 1994) and further developed, to explicate functional links between subsystems of national models of capitalism (Hall and Soskice 2001). They take on essentially a rational-choice view to institutions, and in this line of thinking institutional complementarity means mutual reinforcement based, sustained and perpetuated through economic reasoning (i.e., economic gain). Whilst Hall and Soskice (2001) are not rational-choice institutionalists in the strict sense of the meaning, they tend to use and adopt the rational-choice narrative. However, transplanting the concept of complementarity to macro-level analysis of a political economy requires making some adjustments to such a narrowly defined concept.

In this regard, drawing from Jack Knight (1993), Amable (2004) in particular has made important contribution. Taking a more ‘historical’ view to institutions, Amable (2004:10) underscores the fact that institutions – in general, but particularly so at a macro-level – represent “a compromise resulting from the social conflict originating in the heterogeneity of interests among [various] agents.” This observation has important implication for institutional complementarity, for it suggests that complementarity in national capitalist systems embody not merely an economic function (i.e., increasing returns and economic performance), but also that which is social and political (i.e., social cohesion, political stability, etc.) For instance, one oft-cited example is Germany where the ‘patient’ capital of bank-based financial system and co-determination in industrial relations reflect not only her economic strength, i.e., comparative institutional advantage in "incremental innovation", but also post-war distributive settlement, which is the social fabric of German capitalism (Yamamura and Streek 2003).

Moreover, as Deeg (2003:15) points out, macro-level change generally require actors to change the higher-order formal institutions, or ‘rules of the game’, which are
politically constituted or codified – either in a statutory form or in formal political regulation – and this process more than ever involves not just economic actors whose interests are primarily (and overwhelmingly) about economic efficiency, but also political actors whose interests are far more complex (Amable 2004). In short, the concept of institutional complementarity as that which merely encompasses the notion of ‘increasing returns’ may work – for the sake of argument – in a more limited context such as firm relations, but social and political purpose must be taken into account in a broader context (Morgan and Kubo 2005).

The general position of this paper is more closely associated with historical and sociological variant of new institutionalism, rather than that of the rational-choice variant (see a detailed explanation of the three variants of new institutionalism, see Thelen and Steinmo 1992; Hall and Taylor 1996). This study retains the notion of complementarities as encompassing a functionalist logic, and even, as used in Hall and Soskice’s (2001a) VoC literature, i.e., equilibrium functionalist sense, while leaving room for more historical-political approaches (Amable 2003, Streeck and Yamamura 2001, Yamamura and Streeck 2003, Thelen and Streeck 2004, Morgan et al. 2005, and Hancké et al. forthcoming) (see table 1). Although the former has the methodological advantage of clarity – which has undoubtedly contributed to the popularity of the VoC approach – and the latter approach makes analyses comparatively more “messy”, it cannot be overlooked given that it depicts complexities of economic reality, as is increasingly borne by empirical evidence, i.e., radical changes without system collapse.

[Table 1 about here]

**System change**

Turning to the problem of system change, the strong version of path dependency – such as Pierson’s – leaves little room for the possibility of path-breaking change. As pointed out by Morgan (2005:422), in contrast to most economic accounts which assume that there is a point where continued investment will bring decreasing returns and that the goal of the actor(s) is therefore to find the equilibrium moment at which returns are at the highest before the inevitable decline, the path dependency argument posits no such limits to returns. The only way change can enter the system is through exogenous shocks i.e., an event outside the path that radically alters the incentives/constraints confronting actors on path that makes it impossible to continue with the existing path (e.g., wars, revolutions, conquests, or natural disasters). As a
result of the lock-in effects of increasing returns, even as the actors gradually modify aspects of the existing path the overall trajectory will remain unchanged.

With regard to IC, the concept leaves even less possibility for change. The perception that increasing returns effects at the level of each institutional subsystem being reinforced by the complementarity of various subsystems gives a picture of profound entrenchment of national models and nearly unshakable stability (Crouch and Farrell 2002). By the same token, should pressures for change somehow penetrate one subsystem through an exogenous shock, one can theoretically assume a possibility for snowball of changes (Hall and Soskice 2001). This scenario being “rare”, it is therefore not surprising that most works that rely on the concept of IC argue for continuation of a system (e.g., VoC), given their reliance on path dependency arguments to explain change.4

In amending the concept of IC, writers like Crouch (2002, 2005) and Deeg (2003) have made profound contribution by giving greater theoretical specification to the concept. As pointed out by Crouch (2002, 2005), the term IC is often disconcertingly despite the fact that it embodies two opposing logics, i.e., logics of similarity and contrast. The logic of similarity – or logic of ‘appropriateness’ as Deeg (2003) calls it – refers to an institutional link where institutions with similar properties are found together as actors adopt similar approaches or institutional solutions to different spheres of action. Crouch (2003) gives VoC (Hall and Soskice 2001:17-21) as an example, arguing that particular institutions tend to develop similar capacities in neighbouring spheres, such as corporate governance, vocational training, and collective bargaining, through isomorphic pressures. Yet, emphasising the aspect of mutually reinforcing effects of compatible incentive structures in these neighbouring spheres, Deeg (2003) identifies another logic, i.e., logic of synergy, and views VoC – and comparative capitalism literature in general – to be more accurately reliant on logic of synergy, rather than on logic of similarity.

The logic of contrast, on the other hand, refers to the opposite kind of institutional link where institutions with contrasting properties find balance, as one makes up for the deficiencies of the other (the “missing ingredient”). An illustrative example give by Crouch (2005) is non-transferable company pension schemes in the US corporations, which offsets the tendency towards high labour mobility of many other US labour

4 Lane (2005) is an exception.
market institutions. Another is the highly portable skill certification of the German vocational training system, which offsets the tendency towards low labour mobility of many other German labour market institutions.

Why is greater specification required in relation to the logic, other than the obvious reason for clarification? Deeg (2003:5) makes an interesting observation here, namely that the very logics of similarity and contrast may suggest different degree of positive feedback (tightness). Intuitively, he contends, the logic of contrast would create strongest cohesion because the functionality of a set of institutions would be eroded or compromised in the absence of complementing institutions. Whilst this reflection, i.e., logic of contrast as strongest mechanism of reproduction, may indicate that the issue of system change can best be tested by examining complementarities embodying contrasting logics, this study accepts the claim made by Deeg (2003) that the common nature of complementarities in national models of capitalism is in fact reliant on logic of synergy. Therefore, this paper uses the concept of institutional complementarity in a synergetic sense of functional interdependence – a process of mutual reinforcement. This also means that “tightness” in complementarity between different sub-systems may not be as strong as presumed by the VoC approach.

Faced with empirical observations in advanced capitalisms that suggest profound changes without an exogenous shock, writers interested in institutional change – including those within the comparative capitalism camp – have pointed to the limits of such a picture and have called for the re-introduction of the possibility of change in the theory of path dependency (see Crouch and Farrell 2002; Thelen 2003; Deeg 2003, 2005; Djelic and Quack 2003; 2005). They do so by providing arguments for endogenous change and the on-going cumulative effects of this change. Thelen (2003), for instance, argues that mechanisms of change can operate at the same time as mechanisms of reproduction of a given path. Overtime, however, the mechanisms of change may outweigh those reproducing the path, leading to a major change in the overall trajectories of the path. She identifies two mechanisms in particular that may lead to such change: (1) institutional layering, i.e., when actors use institutional material already available but in new ways or combinations or new institutions are added ‘on top’ of existing ones; (2) institutional conversion, where existing institutions are turned to new purposes.

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5 Some, like Djelic and Quack (2005) goes as far as to argue that life and evolution of institutions – generally speaking – have more to do with processes of path generation than with patterns of path dependency.
Deeg (2003) introduces the notion of ‘variable complementarity’, giving a more flexibility to the concept. The writer contends “subsystems can complement each other in different ways under different conditions” (Deeg 2003). Variable complementarity can come about either through a process known as ‘functional conversion’ (Thelen 2000, 2003), where ‘unchanged’ subsystem draws on new features of the changed subsystem that helps it to sustain its old path, or conversely, through a process where the more radically changed subsystem finds new ways to remain compatible with –or draw kinds of support from –the relatively unchanged subsystems, e.g., see Goyer (2002). Whilst the notion of variable complementarity makes theorising change more ‘messy’, it seems to fit better with evidence arising out of growing body of case studies, i.e., repeated observations of some key subsystems in a given national model of capitalism undergoing radical change while other subsystems do not (see Streeck and Yamamura 2003).

Without going into the age-old debate on structure-agency, it is worthwhile stressing that these works give greater acknowledgement to ‘human’ institutions, i.e., institutions without the rigid and ultimately constraining attribute of mechanical or many biological systems, and shed light on the importance of ‘innovative’ actors within path to overcome the constraints of a given structure, and make path-altering decisions (Crouch 2002, 2005; Deeg 2003; Morgan 2005). The idea that actors within a particular path will not reproduce institutions mechanically, but will be aware of new opportunities that may emerge has important implication for institutional complementarity, namely that actors may seek out new complementarities that provide a different level of pay-offs. However, it is important to note that this is not to suggest that institutional complementarities emerge out of intentional design by ‘innovative’ actors (Amable 2004; Streeck and Yamamura 2003; Morgan 2005). This study accepts Pierson’s claim that in many situations, the problem of bounded rationality makes it impossible to arrive at a confident analysis of what the appropriate institutional solution is and how it might ‘emerge’ and be ‘selected’ (Pierson 2000b:260). This is particularly true in relation to complementarity of institutions, where complementarities emerge over time as institutions actually begin to change their function and manner of working as a result of adapting to contingent events and the impact of other institutions. In this sense, complementarities can be considered – to borrow Morgan’s (2005:437) words – as something that emerges from “behind the backs of actors”.
Finally, this suggests that in order to unravel the notion of institutional change that goes beyond superficial descriptions to the extent where one can argue for convergence or divergence (or even hybridisation), one must be able to capture the change in logic (economic as well as social and political). This raises the question, how is this to be done? Analysing change requires, firstly, existing whether the pressure has come about at a time of critical juncture (so as to exert serious pressure to the existing logic of complementarity), and secondly, whether the key actors have accepted the new institutional logic (Lane 2003), if any. But how is this to be measured? Drawing from Schmidt (2002) and Streeck and Yamamura (2001), this paper argues that any serious discussion on institutional change at a fundamental level must involve an investigation into the discourse between the key actors.

To explain, in tracing the origins of non-liberal capitalism, namely Germany and Japan, Streeck and Yamamura (2001) demonstrate that throughout modern history, liberal and non-liberal elements coexisted. They view the non-liberal laws and practices having emerged through critical junctures where liberal alternatives were historically suppressed and non-liberal patterns were institutionalised. In short, they place a strong importance in historical sequence in distinguishing the liberal and non-liberal capitalist worlds. Lehmbruch (2001), in particular, argues for the importance of historical sequence in moulding the “hegemonic discourse”.

According to Lehmbruch (2001, cited in Streeck 2001:9), “most societies most of the time simultaneously entertain a number of contradictory discourses that compete for hegemony. But once hegemony is achieved, it may become self-perpetuating; its further evolution taking place in a path-dependent fashion. This is because a discourse that has achieved hegemonic status supports the formation of institutions that fit its logic, thereby preventing the development of alternative institutions and ensuring that, when crises...
arise, the possible responses is limited to those that are cognitively conceivable, normatively legitimate, and instrumentally feasible inside the dominant discourse.\textsuperscript{7}

Again, taking Germany and Japan as examples, Lehmbruch shows that in Germany – albeit to lesser extent in Japan (although informed by German traditions, see Pyle 1974, cited in Streeck 2001:10) – the ascendancy of non-liberal economic ideas took place against a backdrop of early experiments with liberal solutions. Economic liberalism had far preceded political liberalism, which goes a long way to explain why at the end of the century it was possible, and indeed necessary from the point of view of state officials, to turn to more conservative politics in critical moments of industrialisation and nation building – moments when, in the perception of policy-making (political, administrative, and intellectual) elites, economic liberalism appeared as a threat, either to the power and independence of nation or to domestic economic and social stability (Lehmbruch 2001).

A similar development did not take place in Japan, where pre-industrial associations and corporations had been suppressed in the course of modernisation (in line with liberal idea). Instead, regardless of the presence of German corporatist ideas in contemporary debates in Japan, Japanese anti-liberalism based itself mostly on a segmentalist pattern of social organisation in which the large enterprise was reconstituted as a social community, as opposed to German-style solidarism of nation-wide bodies of functional representation (Lehmbruch 2001).

Schmidt (2002) is another supporter of discourse amongst the policy-making elites in examining capitalism for the reasons stated by Lehmbruch (2001), and the writer integrates discourse analysis into the study of comparative capitalism. Here, discourse refers to “whatever policy actors say to one another and to the public in their efforts to generate and legitimise a policy programme.” (Schmidt 2002:210). As such, Schmidt (2002:210) states that “[i]n its ideational dimension, discourse performs both a cognitive function, by elaborating on the logic and necessity of a policy programme, and a normative function, by demonstrating the policy programme’s appropriateness through appeal to national values...In its interactive dimension, discourse performs a coordinative function by providing a common language and framework for the

\textsuperscript{7} For this reason, Schmidt (2003) integrates discourse analysis in her examination of change in European models of capitalism.
construction of a policy programme and a communicative function through the public presentation and deliberation of the policy programme.”

**Analysing System Change: Institutional Complementarity in Corporate Governance**

Taking into consideration the discussions above, analysing change in a capitalist system requires following steps: (1) locating core sphere(s) of the system; (2) identifying the logic of complementarity in the old system (including economic as well as social and political purposes) that gives coherence to the system; and (3) analysing the impact of institutional changes on the logic, i.e., investigating whether the defined threshold has been crossed to determine whether it is an on-path of a path-off change.

**Core Spheres: Capital Market and Labour Relations**

The two spheres that are particularly deserving of attention are capital market and labour relations because they comprise of key elements of production regime in any capitalist society. Also the process by which the pressures of change is played out by the complementarity between the two is expected to shed important insights on the dynamics of change; capital market as a sphere vulnerable to external pressures for change (after all, financial globalisation which entails capital market liberalisation is the now viewed to be the greatest isomorphic pressure), and labour relations, as institutions resilient to such change given that it is heavily ingrained in national socio-political arrangements.

There are a number of key features of finance which may be identified: the source and types of finance; the objectives of finance providers; and the intervention rights and practices associated with different forms of finance. These provide a set of constraints and opportunities which influence managerial choices, including those in the labour area (Gospel and Pendleton 2005:4). Sources of finance are essentially threefold: internally generated funds, debt, and share equity. Once established, most firms rely mainly on internally generated funds and these can give managers significant freedom (or discretion) over how resources are used. However, the exposure of firms to pressures from other financers and claimants can have a powerful influence on the allocation and sought-for returns from these internal funds. From time to time (and
increasingly to in today’s world of international competition, where size matters and firms are pressured to expand), firms have to raise capital from outside. One way is through indirect financing, i.e., debt, which can be a considerable constraint on firms, but large and long-term debt may draw lenders into a close relationship with management. Another way is through direct financing, i.e., share equity, where shareholders are many and small, investors may compensate for weakness in their relationship with managers by exerting pressure via market trading; where ownership is concentrated, equity owners may intervene more directly with management. An important dimension of finance refers to the means by which finance providers exert influence on managers. At one extreme, holders of tradable bonds or share equity may eschew any direct involvement and instead exert influence via market mechanisms (e.g., by the threat of selling or the actual sale of their investment). At the other extreme, those with financial claims may play a very direct role by occupying seats on the corporate board. Some may be speculative, other may have longer-term more patient time horizons, and this in turn impacts on management decisions and consequently, has implications for labour (Gospel and Pendleton 2005:5).

Labour relations by definition should ideally encompass three main areas of labour regime in the sphere of production, namely employment, work, and industrial relations (see Gospel 1992, cited in Gospel and Pendleton 2005:4). Employment relations deal with the arrangements governing such aspects of employment as recruitment, training, job tenure, and reward systems. Work relations concern the way work is organised and the deployment of workers around technologies and production processes. Industrial relations is defined to cover the so-called “voice”, that is institutional arrangements such as joint consultation, works councils, and collective bargaining. It should be pointed out that that “industrial citizenship”, i.e., institutionalized form of employee voice, e.g., co-determination in Germany, is considered to be a part of corporate governance (certainly by writers interested in German corporate governance). Given the absence of industrial citizenship in other models, employee voice is viewed to be an institution of contestation, and part of labour relations.

**Identifying the Logic**

The breadth of interconnectedness between the capital markets and labour relations can be captured through corporate governance, defined in the political economic
literature, i.e., corporate governance as an issue of who owns and controls the firm, in whose interest the firm is governed, and various ways whereby control – directly or indirectly – is exercised (Gospel and Pendleton 2005). Corporate governance has been viewed differently by various disciplines, influenced by how they view the firm (refer to table 2 for a summary of the perspectives).

[Table 2 about here]

The complementarity link between spheres of finance (capital markets) and labour relations asserted in corporate governance has been asserted in the varieties of capitalism (Aoki and Dore 1994, Hall and Soskice 2001, Hall and Gingerich 2001, Amable 2004) (see table 3). In the liberal market model, the fluidity of capital markets in large firms encourages flexibility in the labour market that allow firms to respond swiftly to changing market demands, and comparative institutional advantage in radical innovation. By contrast, those in the non-liberal (or managed or coordinated market) model, the commitments of stable shareholders and banks to long-term capital investments in large firms helps to foster a stable core of highly skilled employees with participation rights in company decisions – whether it be in terms of “enterprise constitutionalism” as in Germany or “enterprise communalism” as in Japan – that allows the so-called “flexible rigidities” in labour and long-termism in firm strategies, and therefore, comparative institutional advantage in incremental innovation.

[Table 3 about here]

What is noteworthy of the institutional complementarity found in “liberal” and “non-liberal” corporate governance is that they – in different ways – resulted in several decades of social compromise that ultimately supported its economic performance. This point becomes clearer when one investigates the process by which institutional complementarities are made. Jackson’s (2001) study is worthy of a lengthy discussion in this regard. The writer examines the parallel development of institutional arrangements governing capital and labour in “non-liberal” capitalist setting. Taking Germany and Japan as case studies, the writer demonstrates that “financial commitment” by capital was shaped by configuration of forces such as corporate law, the financial regulation, and competition policy (or market regulation), whilst “industrial citizenship” – at this point detached from institutions governing capital – was shaped by the organisation of state policies, managerial ideologies, and the labour movement. The argument that Jackson (2001) develops is that financial
commitment and industrial citizenship in both Germany and Japan underwent co-evolution, which ensured their ultimate compatibility and complementarity – a combination of which induced not only the development of skilled core workforce, but also several decades of unprecedented political and social peace.

This co-evolution involves “a complex series of continues, discontinuities, re-emergence of older institutions, and functional shifts of exiting institutions.” In the cases of Germany and Japan, in the absence of liberal civic and political rights in the late nineteenth century, liberal market institutions could not be developed through voluntaristic systems of contract. Authoritarian means were used to integrate private interests, either by co-opting opposition into political coalitions or subordinating private goals to the state. The strong interpenetration of state and society had consequence for corporate governance; the corporation was not viewed as a purely private association, but was subjected to a wide range of external social responsibilities, encompassing two elements: a strong public interest in the internal order of corporation (Gamble et al. 2000, cited in Jackson 2001:129) and a national interest in performance of corporation.

However, this outcome is far from guaranteed. For example, prior to Allied occupation, Germany and Japan remained very far from today’s stakeholder patterns of governance; labour participation was undemocratic given the absence of political citizenship rights for workers. Whilst neither Germany nor Japan fully adopted the Allied corporate governance institutions, the general legitimacy and position of capital owners within enterprise were weakened and strengthened the political power of labour. Jackson (2001) argues that the Allied influence helped to close contested alternative, i.e., socialism, while creating consensus to pursue class compromise within the framework of capitalist democracy. In short, it was with the help of external force applied by Allied occupation governments, which enabled the two countries to reconcile their non-liberal institutions with markets and democracy.

In moving from parallel development to co-evolution to complementarity, learning effect is imperative. Financial commitment gave managers the opportunity to learn to utilise industrial citizenship as a productive asset promoting competitiveness. Management accommodated industrial citizenship through company strategies that depend on lower levels of profitability, high rates of internal investment, and

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8 See Dore on Japan’s adoption of US institutions.
orientation toward growth – strategies not available under the strict capital constraints placed by market for corporate control. Monitoring was largely delegated to banks and to lesser extent, through employee voice. Reinforcement of these practices gave rise to consensus-oriented management. Also, industrial citizenship involved channelling employee interests and binding them to the interests of the company; for examples, the obligation of works councils to uphold the interests of the firm and maintain social peace or the high dependence of Japanese unions and workers on firm-specific skills.

It is worth underscoring at this point that institutional complementarities do not arise from conscious design (Höpner 2005), for the simple reason that economic actors are not always aware of the future benefits. For instance, German unions have long opposed the strong role of German banks, despite the latter being a complementary pillar to industrial citizenship.

Whilst the tightness of the link is debatable (see Hall and Gingerich for support of tight link, and Black et al. 2004 for refutation), most accept that there is a complementary link between the two that provides certain set of constraints and opportunities for managers in managing labour, i.e., varieties of corporate governance (Vistols 2001) (see table 3).

**Analysing change**

**Pressures for change – a critical juncture?**

Although it is clear that there are significant differences between the UK and Germany in the institutions involved in corporate governance, a key question is how enduring these differences are within the context of “globalisation”. In the early 1990s as the stakeholder models in Germany and Japan ran into their own set of competitive problems, claims that the shareholder model would have to be adopted in these countries if they wanted their industries to remain competitive in world markets began to have strong appeal. Setting aside what should be done, there have been significant pressures for change, particularly since the early 1990s:

First, there has been a greater liberalisation of international capital markets and readiness of ‘national’ capital to seek the most profitable opportunities for both assessing and investing capital wherever this may be in the world. This has entailed the modernisation of capital markets in countries that have not previously had large
capital markets. Such modernisation has introduced new actors to those markets (i.e., investment funds) and has established enhanced legitimacy for and wide acceptance of their primary goal – shareholder value. This, in turn, has put pressures on listed firms to restructure their operations with fund managers’ expectations; e.g., there have been strong pressures to reduce diversity and concentrate on what is considered core business, for failure to de-diversity is sanctioned by the so-called conglomerate discount on the share prices of such firms.

Second, competition in product markets has intensified. It has made it important to attain sufficient size and market influence to prevail against international competitors and this has exerted pressure for capital concentration, through merger and acquisition. This, in turn, sometimes precipitated listing on stock markets, e.g., majority family ownership, listed a proportion of its shares in 1996. Competitiveness on international markets also has been shaped by product innovation. The increased speed of innovation and the greatly enhanced cost of research and development to achieve it have created further pressures for capital concentration and reliance on the stock market to achieve it.

Third, there has been a growing cultural or ideological orientation of shareholder value. The U.S. has been extremely effective in exporting its institutions through education (MBA programmes), consultancy and accounting firms, and international organisations (IMF, world banks, OECD). The management practices of measuring performance through application of precise financial indicators, premised on the concept of shareholder value, now have become legitimate (international) practice. They are regarded as modern management practices, the adoption of which enhances managerial reputation.

**Institutional change in German corporate governance:**

Regarding change in corporate governance, Germany is an interesting (and controversial) case because the pressures for change have caused direct confrontation with the existing system. The most important legal changes in Germany in the past few years in the area of corporate governance have been in the areas of (1) company law and (2) financial regulation (Vistols 2001).

To elaborate, the first significant reform of company law in over 20 years was effected through the Law for Control and Transparency in Large Companies (taking effect in
1998), which modified the Joint Stock Company Law of 1965. The first significant point is that the reform effort was motivated much more by corporate scandals rather than the desire to adopt Anglo-American corporate principles. The law was an initiative of the Kohl government as a political response to a number of major failures of supervisory board oversight. Thus the most significant provisions of the law was to strengthen the supervisory board vis-à-vis management, for example in allowing the supervisory board to choose and independently meet with the firm hired to audit company accounts. The law also modified the personal liability of corporate directors to try to make lawsuits a more credible mechanism for ensuring accountability of board members for their decisions. The law also authorised the use of stock options for managers and share buy-back programmes to allow German companies to adopt ‘typical’ Anglo-American practices on incentives.

The reforms above were complemented by a set of laws reforming financial regulation (Second and Third Laws for the Promotion of Financial Markets). Germany took important steps in the 1990s (through the Second and Third Laws for the Promotion of Financial Markets) to introduce some Anglo-American style institutions into its financial markets. Second Law (from 1991) established oversight of securities markets through the German version of the U.S. Securities Exchange Commission (Bundesaufsichtsамmt fur Wertpapierhandel) and imposed insider-trading prohibitions. This is after more than a decade of opposing pressure for the U.S. to substitute corporatist regulatory mechanisms with American-style financial reform. The Third Law (passed in 1997) liberalised restrictions on mutual funds and venture capital companies and allows more liberal listing requirements to try to encourage more German and foreign companies to list on the German stock exchange.

At the same time, what is most significant about the Law for Control and Transparency in Large Companies reform is how many fundamental aspects of German company law were not changed. As pointed out by Vistols (2001), neither the dual board system nor the principle of employee board representation was ever seriously questioned. The basic principle of the Joint Stock Company Law of 1965 – i.e., that neither shareholders, top managers, nor employees should exert unilateral control in the company – remains intact.

Similarly, although financial reforms have led to more liquid and transparent stock exchange for the largest German companies (particularly the largest thirty companies
contained in the DAX, German stock exchange), what is perhaps more significant about these laws is the elements of continuity that remain. The vast majority of German companies are in fact not listed on the stock exchange (in fact, the German stock market remains undercapitalised in comparison to some of the advanced economies), remain embedded in “relational networks” including their local banks, and continue to receive their external finance mainly in the form of bank loans. Furthermore, although a slight trend in investment in favour of stocks can be noted, in fact no steps have been taken to radically change the distribution of ownership of financial assets or the distribution of these assets between different categories. In short, although financial markets have been somewhat liberalised, the increase in the relative importance of the types of institutional investors dominant in the UK, i.e., pension funds and mutual funds, are limited. The influence of foreign investment funds - the most insistent claimants for shareholder value – has been significant in only a small proportion of cases – about 10 percent of large listed companies.

**Change in the logic?**

How is the institutional change and resilience described above to be evaluated, especially taking into consideration the malleable nature of institutional complementarity? As discussed above, the task requires demarcating a “point” in which incremental change can turn into fundamental change over time. If the last serious “liberal” pressures in non-liberal societies came in the form of post-war American occupation (certainly in Germany and Japan), today it comes in the form of globalisation. The above pressures are genuine, and rarely does one deny that there has been a certain degree of spill-over effect of changes in corporate governance, that is, trends toward capital market liberalisation and de-regulation of labour relations. However, the commonly held position of the writers of varieties of capitalism has been continued divergence, despite the observable changes. Take for example German co-determination, which is oft considered to be a battleground for convergence-divergence debate; it remains resilient to change, and they argue that despite the observable changes in German corporate governance, co-determination is highly unlikely to disappear in any foreseeable future.

Yet, as the proponents for convergence – albeit relatively small in number – are keen to point out, focusing on persistence may miss the fact co-determination may have become largely a “ghost institution” with little practical function other than symbolic (Whittall, forthcoming). More interestingly (and subtly), as Jackson (2003) himself
suggests, co-determination may be undergoing a transformation from a general legal right of industrial citizenship into an economically expedient device to improve a firms’ competitiveness, differently organised in different workplaces to fit specific technological and market requirements and based more on contractual arrangements than on the traditional, public constitution of the workplace. It would be difficult to dispute Streeck and Yamamura’s (2005:43) comment, referring to the above, that “an institutional analysis that fails to recognise such transformation as a major change, a change that affects the operation of the institution of co-determination in a fundamental way, misses the essence of what it observes.”

Are such changes reflected in the discourse of the actors? Core and powerful economic actors have begun to identify their own interests with those of capital market actors and to actively promote internal change. In short, all these external pressures, have not simply been imposed on unwilling firms in the case of Germany. These changes have been supported mainly by the large private German banks (particularly the Deutsche Bank and the Dresdner Bank), who have become pessimistic about the chances of achieving high profits through traditional corporate lending, and now wish to compete with the U.S. and U.K. investment banks for more capital market-based income such as underwriting, asset management, derivatives, and trading on own account. This small but powerful group of private banks clearly do see the U.S. as “the model” for financial regulation and have pushed for financial reform to try to increase the significance of capital markets (and thus market-related business) in their “home territory”, and political actors – of both left and right - have given them legislative support amidst social tension and conflict.

Conclusion

As a means of devising a way in which to assess change in institutional change that goes beyond thick descriptions of incidences of change and resilience, this chapter stressed the need to examine change in institutional complementarity. To this end, it has argued for the need to examine the relationship between capital markets and labour relations as two key institutional arrangements governing capital and labour. It then pointed to the importance of corporate governance as a realm where the two interact, followed by a discussion on the mechanisms by which capital market and labour relations interact in the sphere of corporate governance in both “liberal” and “non-liberal” settings (using the model presented by Gospel and Pendleton 2003, 2005). However, in order to do so, it required examining how the two different sets of
institutional arrangements developed and gradually co-evolved to ultimately reach complementarity. In the process, using Germany as case study, this paper pointed to the importance of critical junctures and the hegemonic discourse that reflects the underlying social and political settlements of institutional complementarity.
References


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<th>Political-historical Approach</th>
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<td>Rational-choice institutionalism</td>
<td>Historical institutionalism</td>
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<tr>
<td>System coordination &amp; logic</td>
<td>Focus on coherence, and economic efficiency as the key logic</td>
<td>Acknowledges incoherence, and even contradictions, and social legitimacy and political stability as the key logic</td>
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<tr>
<td>System change</td>
<td>Views IC as a strongest mechanism of institutional reproduction (resilience); and therefore, institutionally deterministic</td>
<td>Open to the possibility of loose and malleable complementarity; potential for “innovative” actors to make path-altering change</td>
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<td>View of the firm</td>
<td>Corporate governance</td>
<td>Key issues of interest</td>
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<td><strong>Separation of ownership and control; Principal-agent problem and alignment of incentives.</strong></td>
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| **Firm as a “social institution”, which cannot adequately be characterised through the language of ownership or contract** | **Shareholder as merely owners of shares, as opposed to owners of the ‘firm’** | **The role and perceived need for corporate law – the optimality of free contracting or corporate governance arrangements** | **Employees are not members of the firm, but outsiders with rights strictly delimited by contract; To accord more rights than specified by the contract, e.g., via employment law, is intrusion.** |
| **(1) Benign managerialism** | **Stakeholder value governed by managerial discretion** | **Sceptical of satisfactory re-balancing of interests is through regulation – too complex a task for intervention by way of general rules** | **Rejection of hierarchy that places owners and managers above employees; Employees should only accept functions within the contract; Firm is not different from a market, and therefore no moral/social obligations** |
| **(2)** | **Stakeholder value** | **Sceptical of the benign managerial; Emphasises on the need for institutions, organisational norms or laws that ensures varied interests to be incorporated in decision-making** | **The role of management is to balance the interests of the parties that are directly involved in the business, including employees (but also suppliers and customers) as well as shareholders** |

### Table 2. Conceptualisation of the Firm and Corporate Governance by Major Disciplines

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<th>Financial economics &amp; management studies</th>
<th>Legal studies &amp; institutional economics</th>
<th>Comparative political economy*</th>
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<tr>
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<td>Ownership model (property analysis)</td>
<td>Firm as a “social institution”, which cannot adequately be characterised through the language of ownership or contract</td>
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<td>Nexus of contracts (contracting site for various groups)</td>
<td>(1) Benign managerialism</td>
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<td>(2) <strong>Stakeholder value</strong></td>
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<td><strong>Stakeholder value governed by stakeholder</strong></td>
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Critique

Shareholders do not own the firm, for a company – as a legal entity – cannot be owned in the legal sense. Furthermore, the company is more complex and its effects more far-reaching than the usual subjects of property rights, so the case for shareholder value by virtue of their supposed status as owners is erroneous.

Severely reductionist character of the nexus of contracts model, in which the company as an organisation is effectively eliminated. For instance, regarding company as no more than the sum of its contractual components involves a misrepresentation of the social reality of workplace relations.

First, social institution model that regard all affected groups as having equal claims to participation in organisation seem incapable of providing a blueprint for a workable form of business enterprise; second, social institution model is incompatible with effective managerial accountability. The organisation’s objectives would to a greater or lesser extent be indeterminate if the stakeholder model were implemented, and therefore it would be impossible to devise clear standards against which management performance could be judged.

On varieties of corporate governance – why do varieties exist?

Varieties of national corporate governance through a typology that distinguishes between “market and outsider” and “relational and insider” systems. However, the logic of property rights would dictate that “market and outsider”

Differences in the development of legal tradition – common law vs. civil law (the LLSV perspective). However, the contractarian theorists support the notion of a single “ideal-type” of corporate law, which emerges as an end-product of an evolutionary process that inevitably and “naturally” converges on a US-style pattern

Differences in the national trajectories of development, e.g., in the period of the great depression that followed WW1, domestic banks and the government closed down capital markets in countries like Germany and Japan which lead to bank-, family-, state-owned corporate governance.

Maps the typology of “market and outsider” and “relational and insider” onto (wider historical and institutional contexts of) typology of capitalist model, i.e., liberal market and coordinated market models, respectively.
system is the "ideal-type" of corporate governance (suited for large firms in today's economy). Therefore, it has strong notion of modernisation approach.


Note: * For the comparative political economy perspective, Parkinson (2003) outlines three positions, i.e., benign managerialism, stakeholder value, and the political model (or the "firm as private government" – a variant of the stakeholder position that contends stakeholder groups who are particularly affected by corporate decisions should receive the equivalent of political rights which ensure that their views are represented). In this paper, the third is omitted given that the political model has little empirical reality and applicability.
### Table 3. Varieties of Corporate Governance and VoC

<table>
<thead>
<tr>
<th>Corporate Governance Systems</th>
<th>More marketised system (U.S. and U.K)</th>
<th>Less marketised system (Germany and Japan)</th>
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</thead>
<tbody>
<tr>
<td><strong>1. The balance of support given by management for the interests of capital and labour</strong></td>
<td>Emphasis on shareholder primacy has negative effect on labour because the capacity of firms to achieve real increase in returns is limited. In other words, shareholder value shifts the distribution of claims against the firm but does not increase the surplus generated by firms. Hence, moves to enhance shareholder value will often be accompanied by measures to reduce workforces (though workers who remain may benefit from pay increase and/or accept work intensification). Therefore, push for weaker statutory protection for labour</td>
<td>Emphasis on stakeholder value means that direct representation of both financiers and labour in management provides a more even balance between the two interests (Germany), or the prevailing norms require that managers are not seen to act against the interests of labour (Japan)</td>
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<tr>
<td><strong>2. The time-frame of managerial decision-making</strong></td>
<td>The managers of large funds, such as mutual or pension funds, are assessed on short-term performance, and this feeds through to pressure on managers, via market signals, to maximise short-term returns. The potential to exit and sell reinforces short-termism. Firms are less willing to invest in longer-term intangible activities such as training and related forms of human resource development.</td>
<td>The closer integration of financiers into the firm, via equity ownership or long-term debt, facilitates a long-term perspective by firms. These arrangements then feed through to managerial policies.</td>
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<td><strong>3. The nature of business strategy</strong></td>
<td>The pursuit of financial maximisation. The importance of financial returns (coupled with the cost of short-term capital) encourage radical product innovation by facilitating flotations and spin-offs of high-growth firms, as in the information technology and biomedical industries. The product market strategies have implications for management decision making in relation to employment patterns</td>
<td>The pursuit of product market share. German manufacturing firms have sought to secure competitive advantage by producing relatively complex products involving complex production processes. Competitive advantage is maintained via incremental process innovation in production. Together these have allowed German firms to pursue market share in particular manufacturing</td>
</tr>
<tr>
<td>4. The importance ascribed to financial factors in decision-making</td>
<td>and workforce training. Promote internal measures of firm performance which are primarily financial in nature. The emphasis is on financial returns from equity markets percolates down through firms to influence many aspects of managerial behaviour.</td>
<td>sectors. The converse arguments would apply.</td>
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<tr>
<td>5. The approach to securing managerial and employee commitment</td>
<td>The dominance of market-based transactions encourages (along with the absence of close relationship) the use of market-type devices to secure commitment and discourage employee institutions which may confuse their commitments. Variable pay and stock options tend to be used in an attempt to deal with the agency or commitment problem at both higher and lower levels of the firm. Simultaneously, these measures shift risk from capital to labour.</td>
<td>The converse arguments would apply.</td>
</tr>
<tr>
<td>6. The degree of cooperation with other firms</td>
<td>The converse arguments would apply.</td>
<td>Interlocking ownership, coupled with direct involvement in governance, may facilitate more coordination among firms, e.g., vocational training system (Germany), where employers cooperate to develop general and occupational skills. Similarly, ownership coordination also appears to be consistent with multi-employer collective bargaining, where firms are prepared to cooperate in the fixing of aspects of wages and conditions.</td>
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Sources: Gospel and Pendleton (2005), with author’s additions.
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