CORPORATE GOVERNANCE, PATH DEPENDENCE AND NEO-INSTITUTIONALISM: BUSINESS HISTORY AND MODERN GERMANY

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ABSTRACT

Institutional theory has traditionally been concerned with the embeddedness of actors and organizations in national culture and institutions. The organizational outcome of this perspective is seen to be path dependence, organizational isomorphism and inertia. A consideration of lengthy episodes in Russia, Japan and Germany, representing the most propitious circumstances for institutional change, emphasizes the resistance of national institutions to “alien” innovations suited to different cultural and institutional environments.

On the other hand, recent developments in neo-institutional theory have identified the circumstances in which institutions *can* respond to changes in their external environments. Using a combination of neo-institutional and innovation diffusion theory, one important element of the alleged “Americanization” of German corporate governance is analyzed.

Research propositions are generated that will ultimately test the ability of these two schools of institutional theory to make accurate predictions.

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The juxtaposition of episodes of European corporate governance history with the derivation of propositions in relation to a governance innovation in modern Germany seems at first to constitute a hopelessly mismatched hybrid. Yet, in the subject of geography, the analysis of plate tectonics over millions of years informs the study of some new local volcanic eruption. New eruptions do depend on the attrition of continental plates along old fault lines and these eruptions can be just repetitions of an old patterns of volcanoes, earthquakes, etc. Alternatively, they can be significant new departures, as new faults and underlying movements reveal themselves.

The concern of this paper is international corporate governance, that has exhibited consistent national patterns that can be likened to continental plates, e.g. American market-based and Japanese voice-based governance. Governance systems compete in the market place but national differences have persisted over time. Attrition occurs between governance systems and “hotspots” arise where contradictions and frictions are strongest. The question arises whether these local eruptions follow old patterns or represent significant departures. It will be demonstrated that this leads ultimately to tests on old and new institutional theories.

This paper ultimately generates research propositions in relation to a key strategic decision in large German firms that represent a governance hotspot - the decision whether to adopt a governance innovation available for many decades in the USA, the executive stock option (ESO). These propositions are derived from traditional institutional theory, but the analysis of governance structures in general as key strategic variables, and of executive pay in particular, folds in neo-institutional theory and theories of innovation diffusion. The analysis also embraces the notion of national culture as a key influence on the adoption of governance innovations, though one that interacts with institutions and whose main influence is felt through the institutions that embody and in turn sustain national culture.

Traditional institutional theory has typically been concerned with path dependence at the analytical level of a given population or field of organizations (Greenwood & Hinings, 1996). In terms of selected national populations of firms, our first section considers consistent, or "isomorphic" patterns of corporate governance embedded (Granovetter, 1985) in populations of large firms, through the lens of traditional institutional theory.

Isomorphic institutions are, however, most vulnerable during episodes of turbulence, conquest and revolution (North, 1990), when the crusts that hold down governance eruptions are at their weakest. Furthermore, institutional reforms may have the best chance of success when powerful reformers, unconnected with local culture and institutions, are able to impose changes on a vulnerable society. This section briefly considers, therefore, three revolutionary episodes in the corporate history of Germany (1945-54), Japan (1946-1952) and Russia (1991-2001). It is important to select cases in the light of theoretical expectations (Eisenhardt, 1991), so these case-study episodes are chosen carefully to expose traditional institutional theory to the circumstances in which it is most vulnerable.

Of course, no business history of these episodes can constitute empirical testing, with so many different shifts in the prevailing environmental. Yet, in these most propitious of circumstances for coercive institutional change, the old "continental plates" of established governance templates seem to remain mostly intact, embedded in antecedent institutions buttressed by national culture (North, 1990).

This outcome informs a second section that is concerned with the circumstances in which governance changes and innovations *may* diffuse internationally in a process of convergence (Coffee, 1999). Here, neo-institutional theory is the chosen lens, and in this case, the level of analysis is that of different organizations at the same point in time, e.g. in different sectors of the economy. In our analysis, the focus is on those local firms that have global product strategies in common. The isomorphism found at a national level may have little relevance in this context (Dacin, Goodstein & Scott, 2002).

This theoretical discussion, essentially a dialectic between new theory and old (Seo & Creed, 2002), informs a third section that develops institutional theory to facilitate its final, and arguably most important, stage - empirical testing. It analyzes the design of executives' reward packages, a key strategic decision for large, leading firms. The context of this analysis is a German institutional environment previously hostile to such alien, market-based innovations over many decades (Noteboom, 1999). In this section, institutional theory is advanced through the derivation of important research propositions that recognise the *reality* of institutional stability and institutional change and not just their *appearance* (Greenwood, Suddaby & Hinings, 2002). These propositions are capable of subsequent development into testable hypotheses, as German data becomes available.

1. PATH DEPENDENCE DURING CRISIS

Corporate governance (CG) is the means by which senior managers are monitored, rewarded and penalised by shareholders and/or other stakeholders (Shleifer & Vishny, 1997) and the design of governance institutions represents one of the most important strategic decisions made by firms. CG takes two main forms (Noteboom, 1999). In the USA, in the UK and in most of the English-speaking world, *market-based* governance prevails, and managers constantly monitor share price movements, anxious about stock option gains, hostile takeovers and possible dismissal. Shareholders buy and sell stock but otherwise generally have no other significant role within the firm.

Elsewhere, however, dual-role relational investors prevail. In much of Asia, families are substantial owners as well as managers. In Germany and Japan, banks and other linked corporate investors share a degree of control over enterprise decisions, and in the case of

Germany, employee stakeholders also exercise their "voice" in CG, in a process that promotes consensus. In Russia, the State as relational investor retains significant stakes in many important firms and still exercises some degree of control, together with enterprise managers and other employees (Blasi, Kroumova & Kruse, 1997). In Germany, Japan and Russia, CG can be characterised as being *voice-based,* with relational shareholders engaged in multiple roles within the firm (Noteboom, 1999).

The isomorphism and underlying stability of these distinctive patterns of large firm CG in different countries has been attributed to national culture (Licht, 2001), and in Japan's case, CG is said to be a consequence of the influence of family values at all levels of society (Bhappu, 2000).

However, national institutions embody, promote and defend national culture (Roe, 1993, 1997; Bebchuk and Roe, 1998), and top officers in large companies everywhere are embedded in social structures that link actors, influence and legislation (Davis and Thompson, 1995). Thus, banking and tax laws in the USA discourage relational investments by banks in industrial firms, and encourage them in Germany and Japan (Roe, 1997). Anti-takeover devices have been gradually eroded by shareholder activism in the USA (Davis & Thompson, 1995), while dual-board governance is allowed to obstruct takeovers in Germany. In this case, national culture and institutions become inextricably intertwined in their impact on CG.

FIGURE 1 ABOUT HERE

Figure 1 reports for the five countries under consideration the three main national cultural attributes (Hofstede, 1997) that may influence governance institutions. Although Hofstede's cultural dimensions have been widely criticised elsewhere, (e.g. Schwartz, 1994), they suffice here for the purpose of informing specific research propositions. A low-high spectrum can be seen to run generally from left to right in Figure 1, with the familiar low collectivism, low uncertainty avoidance, low power-distance tolerance of the USA and UK contrasting with national culture in Russia, Germany and Japan, to be addressed separately below. These characteristics are may now be considered in relation to the general shape of governance institutions.

FIGURE 2 ABOUT HERE

Figure 2 is developed from Licht (2001) and traces the implications of low, US/UK levels of power-distance tolerance, collectivism and uncertainty avoidance for particular elements of CG. For example, the open disclosure of company information to outsiders protection is demanded by highly individualistic shareholders with low power-distance tolerance in relation to executives, and low uncertainty avoidance makes shareholders and executives willing to accept the risks involved in open disclosure. It would be easy to produce equivalent Figures and commentaries for Russia, Japan and Germany, and a similar Figure is provided later at Figure 3 in relation to another governance element, executive pay in Germany and in the USA/UK.

With legal, fiscal, social, political and economic institutions embedded in the distinctive national cultures of the USA and UK, one can understand the resistance of prevailing governance structures to proposed reforms that purport to advance collectivism, hierarchical control by executives, or insurance against risks for stakeholders. In these circumstances, interest groups from all sides tend to defend the *status quo* (Davis & Thompson, 1995).

Thus, UK governance has been resistant to EU attempts to impose works councils on large UK firms to advance employee participation and collectivism. By way of contrast, in the case of Germany, higher levels of collectivism and uncertainty avoidance manifest themselves in voice-based governance institutions that are said to comprise a community, or *Gemeinschaft* of stakeholders (Schneider-Lenné 1992). With moderate levels of collectivism, trust is an important feature of German firms, where incumbent employees and managers form coalitions and each party foregoes individual opportunities for short term gain in favor of longer term collective gains (Pistor, 1998).

This means for example that banks and employees, fearing the uncertainty of takeover and liquidation, are strongly represented on upper-tier, supervisory boards, and encourage the accumulation of labor and financial reserves by firms (Macey and Miller, 1997). EU efforts to construct a takeover code that would force German firms to permit takeovers according to the democratic wishes of individual shareholders have been blocked.

Although traditional governance patterns are deeply embedded in local culture and institutions and have tended to withstand proposed reforms, however, certain historical episodes of upheaval (Newman, 2000) may comprise the most propitious circumstances for CG change. Business history (Aldridge, 1999) and case-studies over long periods (Greenwood & Hinings, 1996) have been advocated for applications of institutional theory, and in this context, archival data may be used to develop cases that investigate the introduction of governance reforms that inevitably clash with prevailing national culture and institutions. Although Williamson (2000: 597) asserts as an economic institutionalist that "…insular societies often take measures to protect themselves against 'alien values'…", isolated examples of the survival of “alien” governance reforms have been found, but in most cases, successful transplants followed very long periods of French or British colonization (Berkowitz, Pistor & Richard 2000).

Transplants are alleged to have the most chance of survival as a result of “conquest or revolution” (North, 1990: 89). In the case of economic institutions, Williamson observes that (2000: 598), “…occupations (following World War II), perceived threats (the Meiji Restoration), breakdowns (Eastern Europe and the former Soviet Union), a military coup (Chile) or a financial crisis (New Zealand) – will, however, occasionally produce a sharp break from established procedures. Rare windows of opportunity to effect broad reforms are thereby opened.”

In this spirit, therefore, in order to examine the possibility of transplanted institutional change in the most propitious circumstances, three historical episodes from Germany, Japan and Russia are briefly considered. The vulnerability of these three societies during the chosen episodes, with an external reforming power not embedded in local culture and institutions, may have been expected to promote institutional change. In each case, however, the path dependency and inertia predicted by conventional institutional theory substantially stands unrefuted, as governance structures still resisted convergence on internationally isomorphic forms. Each case is now considered, with the Russian case developed at greater length than those for Japan and Germany, as the secondary literature is less well-developed for contemporary Russia.

Russia (1991-2001) is first considered as a case-study in which pressures for Anglo-American governance reforms were strong but of course a political and economic revolution was not accompanied by military occupation. Nevertheless, massive Russian debts with western States, private financial institutions and public institutions meant that Russia was virtually "held captive" by the World Bank and International Monetary Fund. The approval of these institutions, widely seen as being essentially controlled by the US government, was needed for governance reform packages. In consequence, a team from the US Agency for International Development advised the Russian cabinet minister charged with privatization, a major plank of governance reforms (Blasi, Kroumova and Kruse, 1997).

These reforms were staged from 1991 in the context of national institutions founded on, and mutually supporting, a national culture of high tolerance of power distance, moderately high levels of collectivism and high uncertainty avoidance, see Figure 1. These cultural attributes favour the preservation of local institutions that protect jobs in the context of high levels of distrust of distant, though powerful, authority. It will be argued for the majority of Russian manufacturing industry that the voice-based influence of the State and of enterprise incumbents have survived attempts to impose US-style market-based governance on hostile local institutions and culture.

Before 1991, Russian industrial CG may be characterised as State bureaucracy, and not just during the period after the Revolution of 1917. The first attempts at industrialisation in Russia were made by Peter the Great before 1725 in the form of State factories that requisitioned serf workers and managers for their operation. Licensed private operators were to supply consumer goods to meet State procurements at fixed prices (Pipes, 1995: 209). State railways, State banks and State-licensed monopolies prevailed until the end of the nineteenth century. Foreign investors gradually gained access to the oil industry and some manufacturing but by 1905, "… any company in Russia could have their authority to operate withdrawn by the administration at will", (Crisp, 1976: 183). The national emergency created by WW1 was an excuse to formalise State regulatory controls, and State Councils were formed, again for product procurement at fixed prices (Gatrell, 1986: 185).

From regulation it was a small step in 1916 to the pre-Revolutionary branch ministries, *glavki*. Already, according to Blackwell (1970: 61), "… by the end of 1916, a degree of state control of industry unprecedented in Russian history had been attained", and (p70), "…seventy *glavki* were run by boards consisting in many cases of the old factory managers and technicians, but including a preponderance of trade union members, workers' representatives and party officials. In turn, the *glavki* appointed similarly composed boards, as well as directors and inspectors, for local plants." Of course, the *glavki* were later (in the 1930s) to become a significant feature of Stalin's central planning.

In the case of Russia, a different kind of dual economy to the large firm/small firm dichotomy in Japan and Germany, noted below, was to emerge, with the manufacturing sector (minus high-tech firms usually associated with the military-industrial complex) being allowed to develop a CG framework quite distinct from that in primary sectors, banking groups, utilities and in high-tech firms.

In a manufacturing sector characterised by obsolete technologies, bloated workforces, and employees' anxieties concerning downsizing after privatization, the political clout of employees in State enterprises was perceived to constitute an effective veto on reforms. They desired a privatization program that did *not* permit US-style outside shareholdings and hostile takeover threats, and so the Russian government and US agencies, anxious to achieve privatization that would be quick and irreversible, reluctantly agreed to voucher distributions that effectively gifted controlling stakes in firms to incumbent managers and employees (Boycko, Shleifer and Vishny, 1993). The outcome was "employee-owned, manager controlled" firms (Earle and Estrin, 1996), generally without share listings and therefore safe from takeover.

While the US-dominated international financial institutions understood that this outcome was quite different from US-style capitalism, they expected that outside investors would ultimately be able to acquire shares and replace ineffective managers. Years later, however, employee-owned, manager-controlled firms continue to be the dominant governance feature of this sector (Estrin and Wright, 1999), and in practice, incumbents were able to avoid capital market listings for their firms and to obstruct over-the-counter stock sales to outsiders by controlling access to share registers (OECD, 1999). Of course incumbents have been unable to provide investable funds for enterprise restructuring, but some import protection for domestic markets has enabled many firms to survive. Above all, a peculiarly Russian form of relational governance has evolved, with dual-role shareholders comprising managers and other employees.

In the rest of Russia's industrial economy, primary producers (metals, oil, gas, etc), banking groups, utilities (e.g. telecoms) and high-tech firms were excluded from the centralized privatization program. In these sectors, the disengagement of the State bureaucracy has often been incomplete. In 1995, a Russian government anxious to raise funds before a Presidential election arranged for Russian banks to hold large amounts of shares in 28 of Russia's large, "blue chip" companies in a loans-for-shares arrangement [Blasi *et al.*, 1997: 74], to culminate in open auctions in 1996, intended to accommodate foreign bidders. In practice, however, only 12 companies were auctioned (some to the banks themselves) and banks held on to the shares as security for loans never to be repaid. These holdings ultimately formed the basis for Russian Financial-Industrial Groups.

The outcomes of these and other *ad hoc* cash auctions for some of Russia's best companies were very unsatisfactory, and the State continued to influence their activities through its personal contacts with industry and their links with the media and banks. For example, Boris Berezovsky was in charge of LogoVAZ, a conglomerate focused around car distribution while he was deputy secretary of the Security Council, with access to files on politicians and businessmen. In many cases the State held on to a "golden" share guaranteeing continued State control, and with Surgutneftgaz, the company's incumbent pension fund (under the control of enterprise managers) was allowed to win the auction. In the case of Norilsk Nickel, the auction was organised by Oneximbank, which itself won the contest with a bid of $170.1m when the reserve price was $170m. (Indeed, the whole loans-for–shares scheme was designed by Minister of Finance Vladimir Potanin, who was also chairman of Oneximbank, though he nominally resigned upon joining the government.) With Russian regional telecom monopolies, the State held on to large packets of shares through its Svyazinvest holding company, United Energy Systems is substantially the old Ministry of Power Generation.

Other cases of State-dominated governance that bear little resemblance to US-style capital markets may be cited. In the case of Gazprom, the Russian gas monopolist with oil interests, together valued at around eight percent of Russia's GDP, the Russian Federation still holds 38% of shares. The Chairman of Gazprom is Rem Vyakhirev, who was First Deputy Minister of the FSU for the gas industry 1986-1991, and the government's representative on the Gazprom board was former Russian Prime Minister, Viktor Chernomyrdin.

In the "commanding heights" of Russian industry comprising these "blue chip" companies, it is difficult to quantify any continuing State influence since many of their private owners have strong personal links with the government, and many large groups of companies still incorporate the old ministerial structures they were supposed to replace. In quantitative terms, despite the privatization of most manufacturing (i.e. loss-making) firms, "the Ministry of State Property still remains a majority shareholder in over 12,000 SOEs and a minority shareholder in over 3,800 companies with no coherent set of goals to exercise ownership rights. Assets are managed mostly via state boards composed of 2,000 members of ministries and agencies" [OECD, 1999: 5].

Again in contrast with US-style CG, besides formal State ownership and board representation, echoes of the old State structures survive. For example, the world crisis early in 2000 in the supply of the precious metal palladium was attributed to the bureaucratic procedures necessary for Russian exports of palladium. The metal is produced by Norilsk Nickel, stocked by the Central Bank of Russia and by Gokhram, the State Precious Metals Agency, while export quotas and licences are issued by the President's Office and by Almaz, the exporting arm of the Ministry of Finance.

The participation of foreigners in privatisation auctions was in practice seriously restricted, but even where genuine outsiders have succeeded in obtaining shares, their ownership rights have often been severely weakened by insiders [OECD, 1999]. Outsiders' stakes have been diluted by new holding structures [Maddy and Ickes, 1998] and by new share issues authorized by company meetings organized with insufficient notice. There have also been serious deficiencies in Russian accounting standards and in the disclosure of information to outsiders, and enterprises have often been stripped of their best assets by incumbents in a number of ways. These include transfer pricing that appropriates value away from subsidiaries and their outside investors to a manager-controlled holding structure (OECD, 1999).

The outcome for genuine outside investors, therefore, is a capital market quite different from that in the US. Nevertheless, in 2001 the Russian Trading System (RTS) boasted 60 regularly traded stocks, and 27 of them have American Depository Receipt (ADR) quotations in New York, as a means of "…escaping the weakness of their home country's institutions" (Black, 2000). Despite the barriers to free float in Russia, however, only four of these ADR stocks in 2001 traded at a substantial premium on the US market, indicating substantially lower shareholder risks and trading costs than on the Moscow RTS market. However, in firms privatized in the central program, outside ownership has apparently increased gradually, from around 20% in 1994 to 39% in 1997 (Estrin and Wright, 1999: 409).

Other signs suggest, however, that outsiders are still facing cultural and institutional barriers set up by enterprise incumbents. For example, although there are 60 regularly traded stocks on the RTS, this number is down from over 220 in early-1998, and included only three companies from manufacturing industry. The bulk of traded stocks came from primary extractive industries, banking, telecoms and electricity utilities. Furthermore, it is rare for any company to have more than 20% of its shares in "free float" and available for purchase, and this is quite typical of countries characterised by relational shareholders, i.e. most countries outside the USA and UK (Blasi *et al.,* 1997: 153). Although 27 companies had ADRs late in 2001, all of these were at level 1, involving just the same information disclosure in New York as in Moscow. (Two years earlier, two Russian companies had full, level 3 ADRs involving full information disclosure to US GAAP standards.) After the collapse in Russian share prices in August 1998, four of the Russian ADRs on the US market had prices below ten cents, and were essentially dormant. Outsiders' minority shareholder rights continue to be abused. For example, in late 1999, British Petroleum was invited to tender for the purchase of Chernognyeft, a subsidiary oil company of Sidanco (TNK) that it already substantially owned.

What are the theoretical implications of all this Russian business history? Although enormous changes have been achieved since 1991, it seems that privatizations achieved before 1997 had a limited impact. Modern Russian CG arguably still bears less resemblance to US capitalism and more to the default mode provided by historical antecedents, where a State bureaucracy and enterprise incumbents had substantial voices in the context of high levels of uncertainty avoidance and moderately high collectivism that are characteristic of Russian national culture, and embedded in her institutions. Americanization has been stoutly resisted.

Although the US government had a powerful influence of Russia's reforms after 1991, of course no military occupation was involved. Perhaps, therefore, it should not be surprising that top officers in the Russian government and in key industrial firms were able to obstruct and in some cases reverse the intentions of the reformers. In this context, therefore, a consideration of Japan and Germany after WW2 provides cases with more powerful outside reformers and more vulnerable indigenous institutions, thus favoring the absorption of "alien" reforms and the refutation of traditional institutional theory.

Japan (1946-1952) probably falls between Russia (1991-2001, see above) and Germany (1945-54, see below) in terms of the seriousness of crisis and the presence of an external governmental power behind reforms. In Japan's case, the Supreme Command for the Allied Powers (SCAP, effectively under the control of the US government) did not formally replace Japan's civilian government, but was able to use more informal channels to impose its will. SCAP communicated with the indigenous Japanese government through a Central Liaison

Office, transmitting instructions and reporting back on implementation. In some cases, SCAP issued directives, but in practice the Japanese could dilute US instructions and delay implementation (Schaller, 1985).

Japan’s resistance to governance reform must be understood in the context of institutions founded on a national culture, with high uncertainty avoidance and moderately high levels of both collectivism and power-distance tolerance as dominant traits (Hofstede, 1997), see Figure 1. Indirect influence through an established Japanese parliament made it easy for top officers in Japanese government and industry to frustrate and reverse US-style, exit-based CG reforms. The consensus-style decision-making implied by moderately high collectivism, together with high levels of uncertainty avoidance, constituted major barriers to establishing US-style capital market disciplines. As with Germany and Russia, high uncertainty avoidance supports CG institutions that help to preserve employment levels. In the case of Japan, however, relational investors and managers in large firms often collude to protect employees, using a paternalistic style rather than consensus. Apart from these exceptions, it is no surprise to learn that Japan resembles Germany. Indeed, Japan modelled its corporate laws on Germany after the Meiji restoration of 1868.

Like pre-WW2 Germany, CG in pre-war Japan featured the ownership and control of large firms by families, but in Japan, family *zaibatsu* comprised pyramidic stock holdings in diversified groups, each embracing banks that were to become a prominent post-war phenomenon. The “fifty-six families versus seventy-two million people” (Hadley, 1979: 23) developed close links with government (Hadley, 1970: 4) helping to promote legal institutions that reinforced this structure. Family members often served in government, particularly in the Ministry of Munitions, that subsequently became the Ministry of Commerce in 1945, and after 1949, the influential Ministry for International Trade and Industry (MITI).

Zaibatsu family holdings evolved from the master-servant culture of feudalism that had only relatively recently been overthrown in Japan. In the villages, people had formed communities, joining forces to plant rice and distribute water. “The landlords and the village head were the unquestioned authorities who would exploit the tenant but not actually expel him or let him down completely when he faced hard times.” (Hirschmeier and Yui, 1981: 204)

This culture viewed western competitive firms as alien, but *zaibatsu* firms were made palatable by characterising themselves as family groups attracting traditional loyalties. As today, Japan developed an extreme form of dualism, with large firms supported by a large informal sector with tiny workshops and frequently day-labor systems. In the large firms in the 1920s, however, males who were skilled or office workers enjoyed the now-familiar features of permanent employment and seniority wages (Hirschmeier and Yui, 1981: 205).

In the first two *zaibatsu* firms, Mitsui was organized around a bank from the outset, and Mitsubishi, beginning as a shipping firm, gave prominence to its banking activities after 1880.

Upon assumption of direct rule over Japan, the US military government concerned with removing the perceived causes of war, designated 83 of the old holding companies that constituted the *zaibatsu* for liquidation. However, an indigenous Japanese plan, called the Yasuda Plan after the *zaibatsu* family member who authored it with the approval of the other “Big Four” *zaibatsu* firms (Mitsui, Mitsubishi and Sumitomo), recommended that the holding companies themselves should volunteer for dissolution and detail the means of doing this. Stock was to be sold by a Holding Company Liquidation Commission (Schaller, 1985).

Unsurprisingly, only 16 (not 83) holding companies were in fact liquidated. A brief interlude of US-style capital markets was, however, achieved, reinforced by an Anti Trust Act that forbade corporations (including banks) from holding industrial shares (Berglöf and Perotti, 1994). Consequently, by 1949, 69.1% of all industrial shares were held by individuals (Scher, 1997: 65) and the Commercial Code for Illinois was adopted, requiring minority shareholder protection, a Securities Exchange Commission (SEC) on the US model, standards of information disclosure and independent accountancy bodies (Cooke and Kikuya, 1992). In addition, a Glass-Steagall Act imposed by the US authorities was designed to weaken the power of banks in industry by requiring the separation of commercial and investment banks (Roe, 1993: 1930).

Besides capital market reform, the US also attempted to promote employee voice as a barrier to any re-emergence of concentrated shareholdings, giving preferential treatment to employees' purchases of shares in the liquidation of holding companies. However, trade union militancy in the form of a proposed national strike in 1947, together with US fears concerning the spread of communism, caused a switch in policy that allowed docile enterprise unions to emerge, and any prospect of German-style employee voice in CG disappeared.

US-style capital markets also did not last long. Japanese regulators effectively forced savings into the banks and they began to accumulate industrial shares (Roe, 1993:1930). Just three months after the US handover of governmental power back to the Japanese in May 1952, the SEC was abolished, along with many shareholder rights. AGMs quickly became exercises in tokenism, and *keiretsu* began to coalesce around banks and trading companies, rather than around the old family holding companies. Indeed, three of the old ("Big Four") *zaibatsu* (Sumitomo, Mitsui and Mitsubishi) were allowed to re-emerge as *keiretsu,* and the Yasuda bank-based *zaibatsu* simply changed its name to Fuji. Stable cross-holdings, cross-directorships and Presidents' Clubs replaced the family holdings as the coordinating mechanisms of the new conglomerates. By 1991, Sheard (1994: 333) estimated that 91% of listed industrial stock was tied up in interlocks.

As with Russia, the question arises, what is the theoretical relevance of this Japanese business history? It is clear that a form of relational CG emerged in large firms after the US departure that was consistent with Japanese cultural and institutional antecedents, and not very dissimilar from pre-war structures. For example, the “new”, bank-based structure of *keiretsu* groups was an echo of the earlier *zaibatsu.* Stable shareholdings in industrial firms by banks as relational investors facilitated the permanent employment and seniority wages of modern firms, but these were also used earlier by *zaibatsu* as an incremental variation of feudal village culture.

Americanization was again resisted, as in Russia. Institutional embeddedness and path dependence were the distinct outcomes for large Japanese firms after WW2, though, as in Germany, see below, an important small and medium-sized business sector continued to operate virtually unaffected by occupation.

In the case of *Germany (1945-54)*, occupying military governments faced even less local resistance to reforms and had unprecedented power to impose governance changes during the most severe national crisis. While more indirect methods were used in Japan after WW2, see above, in W. Germany the Allies opted for direct military rule in 1945, through a central Control Council (CC) employing large numbers of bureaucrats in four zones, e.g. 20,000 British civil servants in the British sector alone (Turner, 1989). The British and US zones of occupation subsequently combined into a Control Commission for Germany (CCG) that was effectively under US control from Frankfurt after 1947.

In the face of a German culture of low tolerance of power-distance and moderately high levels of uncertainty avoidance and collectivism (Figure 1), a number of early attempts, motivated by US demands for de-Nazification, were made after WW2 to introduce US-style, market-based CG into Germany, to replace the old system of voice-based CG that involved family, bank and inter-firm ownership and control.

For example, vigorous attempts were made to disperse the blocks of shares held by families, banks, suppliers and competitors (through cartels) etc and to break the strong links between industrial firms and the State. Over one thousand cartels were broken up, family-held shares were sequestered and new share issues involved maximum holdings and loans for employees and small shareholders to acquire shares (Stolper, 1967). Nation-wide banks were restricted, on the model of State banks in the USA, to single *Länder*, with limits on their holdings of industrial shares (Kindleberger, 1984)

These attempts to deconstruct voice-based *Gemeinschaft* and facilitate the construction of market-based CG in Germany (with associated high stock liquidity, takeovers, stock-based pay for executives and open information disclosure) foundered, however, on the rocks of existing national institutions and a national culture that underpinned them. In the early years of the occupation, this was a result of informal German pressures on the military governments that gradually became more formal, with the creation of the Federation of German Industry (BDI) in 1949.

Under informal German pressure, the CC and CCG were responsible for regulations that provided the cornerstone of "new", voice-based CG in Germany, with significant elements of employee control. *Mitbestimmung* (co-determination) was gradually introduced from 1945, with supervisory boards in the coal and steel firms, and was the subject of CCG legislation in 1949 (CCG Monthly Report, 1949). The CC enacted a regulation in 1946 requiring large firms to arrange works councils in each plant (Official Gazette, 1946).

However, works councils already existed in many German firms immediately after reunification in 1871, they re-surfaced during the flirtation with Communism in 1918, and were prominent in Hitler's German Labor Front (Bureau of Business Research, 1969). Similarly, Supervisory Boards were a feature of Hitler's Corporation Law of 1937, and certainly many large German companies already had dual board governance in the nineteenth century (Charkham, 1995). Effectively, the post-WW2 dual boards and works councils were only minor modifications of pre-war relational structures.

Under influence from German pressure groups, the voice-promoting cornerstones of modern German CG were introduced after WW2, with the support of the US military government anxious to dilute the power of dynasties associated with Nazism. At the same time, its early attempts to dissolve networks were gradually reversed to a large degree. For example, the largest three national banks (Deutsche, Commerz and Dresdner) were slowly re-united. They began to collect places on the supervisory boards of industrial firms again and, even without the ownership of controlling blocks of shares, banks learned how to control firms through bearer stocks deposited with them (Kindleberger, 1984). Many family firms managed to reinstate their founding families, e.g. Alfried Krupp replaced his purged father as Chairman. By 1970, three of the old steel firms (Krupp, Thyssen and Klöckner) had re-formed. The BDI opposed deconcentration and by 1970 large blockholdings were again the norm in large German firms, as competitors and suppliers accumulated firms in related firms. Even today, few modern German firms employ international or US accounting conventions and stock liquidity is low, even in DAX30 firms (Franks & Mayer, 1997).

Again, what are the theoretical implications of this German business history? In Germany, it would appear that moderately high levels of collectivism (implying the wide participation of stakeholders in CG), and moderately high levels of uncertainty avoidance together produced a community of stakeholders unwilling to expose itself to the discipline of volatile stock market prices. Arguably, German national culture, and the legal, social and political institutions that underpin that culture, reasserted itself after attempts by the US military government to establish directly-enforced elements of US-style, exit-based governance. This outcome reflects the institutional embeddedness and path dependence already noted in the Russian and Japanese episodes reviewed above.

2. NEO-INSTITUTIONALISM AND GOVERNANCE EVOLUTION

The previous section demonstrated, at a national level within three quite different countries and cases, that isomorphic governance institutions withstood alien transplants in circumstances of extreme crisis. The convergence of governance institutions (Coffee, 1999) emphatically did not occur in the most propitious of circumstances, as imposed governance reforms (Aldridge, 1999) foundered on hostile national culture and institutions. In the language of innovation theory (Mowery and Rosenberg, 1993) governance innovations can be demand-induced and/or supply (or knowledge)-driven. In the three cases, on the demand-side, serious economic crisis could have been expected to induce governance reforms. On the supply-side, the strengths of Anglo-American governance innovations were already widely transmitted and appreciated.

However, Rogers (1995) clearly demonstrated the importance of national culture to innovation adoption, and the local absorptive capacity (Zahra and George, 2002) for “alien” structures was quite low. Prevailing governance forms in the three episodes chosen above continued to conform closely with institutionally-prescribed templates inherited from the past (Davis and Thompson, 1994).

To this point, therefore, institutional theory has been depicted not as a theory of organizational change but as an explanation of the isomorphic similarity and stability of nationally established organizational arrangements. Yet institutional change *does* occur periodically, and the rest of this section will be concerned with a consideration of the circumstances conducive to institutional change. This leads to a final section that tests the power of institutional theory to explain and predict actual changes in the German economy since 1990.

The focus of neo-institutional theory is not on the single State nor the single organization but rather on different organizations or sectors within the State (Greenwood and Hinings, 1996), and the purpose of this focus is to take theories of organizational change beyond ideas of inertia and persistence (Greenwood and Hinings, (1996). Also, the emphasis here is on induced rather than coercively imposed change (Aldridge, 1999).

Institutional change tends to occur when external contingencies change (DiMaggio and Powell 1983; Aldridge, 1999). Oliver (1992) identified three main drivers of institutional change: *functional* pressures arising from perceived performance shortcomings, *political* pressures from shifts in the interest and underlying power distributions that have underpinned existing institutions, and *social* pressures from fragmented interest groups with discordant views. The influence of each of these drivers is undoubtedly related to resource dependency (Pfeffer and Salancik, 1978) and Greenwood and Hinings (1996) propose that researchers track the effects of changes in crucial market pressures on power dependencies within and between organizations.

In these circumstances, equilibrium can be punctuated (Tushman and Romanelli, 1985) by the absorption of governance innovations, depending on the tightness of coupling across institutional sectors (Greenwood and Hinings, 1996) and thus compliance with existing templates. Top officers in government and in large industrial firms play a crucial role here, embedded in social structures that link actors and influence legislation (Davis and Thompson, 1994). For example, senior executives may drive change after participating in international executive labor markets, and some firms may need to develop global product strategies to compete on world markets for goods and services (Davis and Thompson, 1994). Executive influence on institutions may be strongest when strategies are capital-intensive, i.e. when external financial capital is the resource upon which firms are most dependent, and where local supplies are inadequate. New laws (e.g. changes in takeover legislation, corporate taxation) may now be influenced by senior executives (Davis and Thompson, 1994), facilitating convergence on previously alien structures.

These circumstances for institutional change processes are consistent with the limited convergence experienced in S. Korea (Mishaupt, 1998) and Taiwan (Seo and Creed, 2002), where established isomorphism conflicted with divergent executive interests. In the case of modern Germany, it is argued that large industrial firms with significant exporting levels and/or facing import competition felt obliged as a divergent sector to attract American financial capital. As suppliers of the dominant resource upon which firms depended, American investors were able to insist upon institutional change, involving changes in laws influencing the liquidity of company stock, and upon revisions in the incentive packages offered to executives.

An analysis of governance in modern Germany, in particular the reward packages of senior executives is, therefore, the focus of a final section, which crucially considers the relevance of the analysis to the development of institutional theory itself.

3. MODERN GERMAN GOVERNANCE AND INSTITUTIONAL THEORY: SOME PROPOSITIONS

On the face of it, Americanization and the convergence on of the German economy on the US model progressed rapidly and spontaneously in the 1990s. This apparently contrasts with the fate of the imposed reforms after WW2.

Traditionally, in large German firms, managers (and especially the *Vorstandssprecher* and *Vorstandsvorsitzender,* who correspond broadly with Chief Executive Officers, CEOs) have been controlled mainly through the voice-based participation of other stakeholders in decisions: banks and employees impose their influence through the upper-tier board (*Aufsichtsrat*) and shareholders are usually tied to the firm in the long term. This all suits the German national culture of moderately high levels of uncertainty avoidance and collectivism.

As in Russia and Japan, share price has been fairly unimportant in disciplining managers, and in 1990, total German stock market capitalization was only 23% of GDP, with few hostile takeovers to discipline managers (Bernhardt, 2000). Share prices can have had only a weak impact on managerial decisions and firms are quite secretive in the matter of disclosing company information to the public.

But by 1997, total German stock market capitalization had risen to 40% of GDP (Megginson, 2000), and therefore share price movements are now likely to play a stronger role in the discipline and motivation of senior managers. However, this 40% was still well short of market capitalization in the USA (144% of GDP) and the UK (155%). In the USA and UK, information disclosure is relatively open and executives are strongly disciplined by share price movements. Share price reductions increase the threat of takeover and executive dismissal and also influence executives' total rewards. Nevertheless, with rising share liquidity, German CG in general, and important corporate strategies concerning executives' rewards in particular, may be *converging* on the American model (Coffee, 1999).

The design of executives' reward packages represents a key strategic decision to be made in relation to CG (Shleifer and Vishny, 1997), but US-style reward packages, relying significantly on equity-related elements, of course rely on a general environment of US-style CG. This involves stock prices fluctuating on liquid markets, and extensive information disclosure to outside individual shareholders. This environment in turn corresponds with the low levels of uncertainty avoidance and the high levels of individualism that are distinctive features of American national culture, see Figure 1 and the first column of Figure 2.

Specifically, Executive Stock Options (ESOs) are a major influence on the decisions of CEOs in the USA. Although CEOs are in powerful positions, they are subject (almost exclusively) to the discipline of the firm's share price. Perhaps for this reason, average US CEO salary in firms with sales of $500m or more averaged $1,932th in 2000 (Towers Perrin, 2002). Of this, only $530th was in base salary with the rest made up of bonus, benefits and ESOs, mostly the latter. ESOs in the US are mostly '"plain vanilla", i.e. without performance conditions, and executives automatically benefit if share price rises. Typical of an individualistic culture, average CEO total rewards in large US firms in 2000 were on average 531-times the average wages of hourly employee.

At the other end of the spectrum, however, stand large German firms, with consensus-based decision-taking leading to an egalitarian sharing of the power and wealth of the CEO with others. CEO power is subject to all kinds of pressure from stakeholders such as employees and banks, mostly through upper-tier Boards. A typical German large-firm CEO salary in 2000 was only $230th, plus $225th in bonus, etc (Towers Perrin, 2002). ESOs were rare until recently. Total CEO pay was on average only 11-times average wages, and disclosure levels required by German accounting standards have been low. For example, under German accounting rule 285/9 of the HGB (German Commercial Code), firms must disclose only aggregate pay for Executive Board members in total, with nothing on the mix of rewards or on the pay of individual directors.

But this situation is said to be changing as governance reforms are induced, taking advantage of American pay innovations. German firms in sectors that are adopting global product strategies, resource-dependent upon financial capital in amounts too large for “friendly” German providers of funds, are being forced into the arms of US investors. US investors look for executive pay packages in German firms that will attract and retain senior managers capable of pushing through a global strategy, and they demand high levels of disclosure of these packages. German tax laws have now been changed to remove the disincentives for share sales by long-term, relational investors like banks, so the shares of large firms are becoming generally more liquid, a necessary condition for ESOs as effective incentives. In 1998 the German Stock Company Law (*Aktiengesetz*) was changed to make ESOs easier, without the need for convertible bonds. Before this, ESOs at Deutsche Bank and Daimler Benz (in 1996) had attracted criticism.

Press reports suggest that, since the 1998 Aktiengesetz, most large German companies have been “Americanized” in terms of one important governance strategy for firms: executive pay packages. By 2001, all DAX 30 companies reported at least the existence of ESOs in AGM notices to their shareholders. This all suggests rapid convergence on American CG in terms of the important institution of executive pay, and appears to fly in the face of German culture. It also appears to be consistent with neo-institutional theory that predicts the ability of institutions to change to adjust to circumstances.

FIGURE 3 ABOUT HERE

But are there are fundamental contradictions between US-style executive pay and relational governance in large German companies, creating a dialectic (Seo and Creed, 2002)? Figure 3 shows that, despite some relaxation of the legal institutions that underpin German national culture, ESOs imply a philosophy of individualism, are essentially inegalitarian, and create uncertainties for executives with uncertain future rewards and for shareholders faced with uncertain future executive labor costs. Above all, they increase the power of executives to control their own reward packages through the possible manipulation of performance conditions, exercise prices and the timing of announcements in a way that is inconsistent with Germany’s low tolerance of power-distance. This latter cultural attribute is shared with the USA and UK, but here collectivism and uncertainty avoidance is also low.

It seems important, therefore, to investigate at a deeper level the apparent innovation of German ESOs, to develop research propositions that recognise the *reality* of institutional stability and institutional change and not just their *appearance* (Greenwood, Suddaby & Hinings, 2002). Such research propositions should ultimately be developed into hypotheses for empirical testing, contributing significantly to the development of institutional theory.

We assume for the moment that traditional institutional theory, with its emphasis on embeddedness, isomorphism and inertia, *is* appropriate for the analysis German CG. This approach is justified by (a) previous experience with path-dependent German CG and a lack of real convergence, even under US military occupation, 1945-54 (Buck and Tull, 2000), and (b) previous evidence on general human resource strategies in German firms - of which executive pay strategies are a subset - that emphasize their embeddedness in antecedent German culture and institutions (Ferner, 1997).

If traditional institutional theory is provisionally accepted for the moment, it could be expected that American-style ESOs may be manipulated by German firms to produce a path-dependent instrument that, in its details, is more consistent with long-term relational CG based on voice rather than stock market exit. Therefore, five propositions are advanced on the presumption that German CG will *resist* Americanization.

For example, while German ESOs may be considered consistent with Americanization, with German firms as communities of stakeholders favouring egalitarian outcomes, significant variations in the extent to which ESO schemes cascade down through the organization may be proposed. Thus:

P1. ESOs in German firms may be expected to be more egalitarian, extending to a larger numbers of senior managers and other employees than equivalent schemes in the USA and UK.

Similarly, a community of stakeholders imposing tight, collective “voice” control of managerial decisions may be uncomfortable with the wide variations in the dispersion of income and wealth that ESOs imply. Despite any more extensive coverage of schemes in terms of their wider membership, German ESO schemes may still be expected to offer lower rewards in total. Therefore:

P2. German ESO schemes may be predicted to involve smaller proportions of firms' total issued capital under option in ESO schemes than in the USA and UK.

With relatively low tolerance of power-distance in Germany, besides a concern to extend less valuable ESO schemes (P2) to wider constituencies of employees (P1), influential stakeholders may want to ensure that ESO-based rewards are "earned" by managers. This could create a "win/win" situation whereby all the firm's stakeholders collectively benefit from improved performance. In turn, this could involve more numerous and tighter performance conditions rather than "soft" ESO schemes, designed by executives to suit their own pockets. Two propositions are therefore generated:

P3. With low levels of executive power in Germany subject to a degree of collective control, the attachment of quantitatively more performance conditions to ESO awards can be predicted compared with the USA and UK.

P4. Following P3, the use of qualitatively more demanding German performance indicators can be proposed compared with the USA and UK.

German shareholders are broadly relational, with only small proportions of total shares in free float. Such long term shareholdings, and the voice-based governance they facilitate, are likely to promote long term relations with senior managers. Specifically, executives' reward packages are also to exhibit longer term characteristics.

P5. CG in Germany will produce ESO schemes of longer duration, with longer qualification periods imposed before option exercise, and longer holding periods for shares after option exercise, than in the USA and UK.

It can be seen that these five propositions implicitly favor traditional institutional theory and the adoption of an American pay innovation such as the ESO by large German firms in a way that, in its detail, does not constitute substantial Americanization.

However, the development of concrete hypotheses from these propositions and the conduct of empirical tests must await the fuller disclosure of pay information by German firms, and, of course, fuller disclosure is itself an indicator of Americanization. Disclosure levels are increasing slightly in German firms. For example, of the 43 DAX 100 firms declaring at least the existence of ESOs by 2002 in shareholder AGM invitations, only 11 companies disclose details of ESO schemes because they have voluntarily adopted US "Generally Accepted Accounting Principles" (GAAP) accounts. A further 10 companies provide information on executive pay in their proxy statements to the US Stock Exchange Commission as a result of their Level 2 or 3 American Depository Receipts (ADR) listings. With some firms using GAAP *and* ADRs, even fairly rudimentary ESO information is only available for 14 of the 43 large German firms disclosing the existence of ESOs.

4. DISCUSSION

What conclusions can be drawn from this predominantly historical analysis for policy and theory-building?

In relation to policy, it seems clear that no one form of CG, certainly not US-style, market-based CG, is appropriate in all contingencies. In particular, national culture and antecedent institutions are important contingencies, different CG structures bring their own strengths and weaknesses in different circumstances, and it may be an illusion that governments can “pick and mix” the optimum CG package.

In relation to theory, the analysis of three historical episodes in Germany, Japan and Russia confirms the resilience of national cultures and institutions to imposed Americanization, even at vulnerable stages of their history. From this perspective, therefore, researchers within the governance-strategy-performance paradigm, especially in transition economies (e.g. Thomas and Waring, 1999; Filatotchev, Buck and Filatotchev, 2000) should not be surprised at the statistical insignificance of many of their regression coefficients. Change is emphatically path dependent, and key actors have low absorptive capacity and an inability to unlearn embedded routines and templates quickly.

However, neo-institutional theory does contemplate the contingencies that promote institutional change, and SOME spontaneous governance changes have become evident since 1990 in Russia, Japan and Germany. Institutional change may be cosmetic rather than real, however, and these changes represent a new opportunity for institutional theory, offering progress toward the final stage of social science, and the most important stage for Popperians, that of empirical testing. If hypotheses developed from the above propositions remain unrefuted after empirical testing, traditional institutional theory will be supported, and German ESOs will be identified as a governance hotspot that leaves unchanged the nature of governance tectonics in the form of distinctive continental plates. In this case, ESOs in Germany may turn out to be a path-dependent extension of established German institutions and culture.

The possibility of genuine institutional change is real. Apparent cases of convergent institutional change in relation to business strategies besides ESOs such as takeovers and equity-based executive pay should, however, be analyzed in depth before their equivalence across national cultures is assumed. If convergence in governance forms is found, the intriguing possibility arises that convergence on market-based governance may be just a special case of the predicted convergence in the structure of transactions in general, as economic systems mature (Peng, 2002).

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FIGURE 1 DIMENSIONS OF NATIONAL CULTURE

	USA/UK	GERMANY	JAPAN	RUSSIA
Collectivism	Low (9/11)	Moderate (33)	Moderate (54)	Moderate (55)
Uncertainty Avoidance	Low (46/35)	Moderate (65)	High (92)	High (80)
Power Distance Tolerance	Low (40/35)	Low (35)	Moderate (54)	High (88)

Notes: the ratings are based on national rankings obtained from Hofstede, 1997, pages 26, 53, 113; Elenkov, 1998, p. 139. The raw Hofstede/Elenkov scores are shown in parentheses. Note however that the Hofstede/Elenkov scores for individualism were subtracted from 100 to give a score for collectivism.

FIGURE 2 US/UK CULTURE DIMENSIONS AND GOVERNANCE STRATEGIES

	Information Disclosure	Shareholder Rights	Insider Trading	Takeovers
Low Collectivism (High Individualism)	Individual outside shareholders expect transparency, no suppression of information.	Equal treatment of each individual shareholder in terms of votes per share, minority protection..	Broadly permitted (with exceptions) to encourage information disclosure to all individuals.	Allowed but minority shareholders protected by takeover codes.
Low Uncertainty Avoidance	Transparency. Open release of good and bad news.	General laissez faire emphasis by shareholders relatively unafraid of losses.	Allowed despite windfall gains for executives.	Generally allowed despite unforeseen gains/losses for incumbent shareholders and employees.
Low Tolerance of Power Distance	Transparency. Top officers not allowed to conceal bad news.	Equal. No stock pyramids or dual class shares.	Allowed but subject to rules to prevent abuse by executives for private gains.	Allowed, but controls on poison pills/shark repellents deployed by executives to protect themselves.

Note: author's own Figure, loosely developed from Licht (2001).

FIGURE 3 EXECUTIVE PAY AND NATIONAL CULTURE

	US/UK	GERMANY	
Low Collectivism (High Individualism)	Toleration of wide differences in individual rewards. Weak controls on executive pay.	Moderate intolerance of wide differences in individual rewards. Moderately strong controls on executive pay.	Moderate Collectivism (Moderate Individualism)
Low Uncertainty Avoidance	Executives accept volatile rewards. Shareholders accept the volatile costs of executive rewards. Weak controls on executive pay.	Executives moderately unwilling to accept volatile rewards. Shareholders moderately unwilling to bear the costs of volatile executive rewards. Moderately strong controls on executive pay.	Moderate Uncertainty Avoidance
Low Tolerance of Power Distance	Shareholders unwilling to tolerate executives designing their own pay packages. Strong controls on executive pay.	Shareholders unwilling to tolerate executives designing their own pay packages. Strong controls on executive pay.	Low Tolerance of Power Distance