Private Governance in International Affairs and the Erosion of Coordinated Market Economies in the European Union

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Private Governance in International Affairs and the Erosion of Coordinated Market Economies in the European Union

By

Andreas Nölke

Abstract

The variety of capitalism-perspective is particularly well suited for an assessment of the broader political and economic effects of transnational private governance, given its focus on the interaction between the diverse economic institutions that are regulating capitalist formations. The core notion here is “institutional complementarity,” i.e. “referring to situations in which the functionality of an institutional form is conditioned by other institutions” (Martin Höpner). Thus, substantial changes in one institution may have wide-ranging consequences for other institutions and, correspondingly, for the model as a whole. Within the “variety of capitalism” (VoC)-perspective, the most sophisticated and most frequently used frame of reference is the distinction between “Liberal Market Economies/LME” and “Coordinated Market Economies/CME,” with the first “Anglo-Saxon” model usually illustrated with the case of the U.S. and the latter “Rhenish” model with Germany (Peter Hall and David Soskice). Currently, we can observe that institutions that are strongly interlinked with the LME model are being transplanted into CME type economies by means of transnational private governance, particularly within the European Union. Examples include accounting standards, rating agencies and competition policy enforcement by law firms. Together, these recent activities tend to strongly undermine the institutional complementarities inherent in CMEs.

About the Author

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Preface

This paper was presented during a conference on “Germany in Global Economic Governance,” which took place at Cornell University on Feb. 22/23, 2008. It was organized by Stefan Schirm (Ruhr University of Bochum) and Hubert Zimmermann (Cornell). We would like to thank our sponsors, the DAAD (German Academic Exchange Service), the Department of Government, the University of Bochum, the Mario Einaudi Center for International Studies, the Institute for European Studies as well as Peter Katzenstein (Cornell), who served as commentator.

Germany, still the third or fourth largest global economy, has been particularly active in proposing a tighter regulation of international financial markets. We use Germany as an exemplary case of how medium-sized countries can shape global governance and how the political economy of countries with coordinated market economies conditions their global governance strategies as compared to so-called liberal market economies, such as the United States and the United Kingdom. With this focus, the project permits and initiates an overdue dialogue between the literatures on varieties of capitalism and on global governance, using global governance as the dependent variable. Another objective of the workshop was to address the dearth of country-specific case studies in research on global governance which often treats all states as essentially similar in their reaction to economic globalization.

Contributors were asked to look at various areas of global governance (such as hedge fund regulation, IMF reform, Basel II, pharmaceutical regulation, corporate governance, transgovernmental standard-setting, etc). All papers identified several levels shaping the German position: the subnational, the European and the global level. The German government, with varying success, engaged in strategic forum-shopping among these levels. A further characteristic was close cooperation between state and non-state actors. Overall, the extent of Germany's capacity to shape global governance is surprisingly large.
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Introduction

During the last years we have learned a lot about the workings of private governance in international affairs (Cutler, Haulfer and Porter 1999, Hall and Biersteker 2002). Still, normative issues have not received much attention. When covered, the most important normative concerns were the implications of transnational private governance on national sovereignty and the related question of democratic accountability. How to evaluate the socio-economic consequences of private rule making at the transnational level remains a difficult task. Most theoretical frameworks within political science and international relations are too state-centric for these questions; they predominantly focus on public policies. Furthermore, the focus of concepts within International Relations is usually on the mode of governance (i.e. public versus private, national versus international), and much less on its content. (e.g. neo-liberal versus social-democratic). This paper tries to develop an alternative framework by linking the discussion on private governance in international affairs with the debate on the “varieties of Capitalism” and its distinction between the ideal types of “Liberal Market Economies/LME” (usually illustrated with examples form the US) and “Coordinated Market Economies/CME” (usually illustrated with examples from Germany) within comparative political economy (Hall and Soskice 2001 a). The varieties of Capitalism (VoC) approach is particularly well suited for as assessment of the economic consequences of an increasing prominence of transnational

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1 This paper summarizes some research that I have conducted together with a number of collaborators within the Amsterdam Research Center for Corporate Governance Regulation (http://www.arccgor.nl/) during the last three years. It draws heavily on work together with James Perry, Arjan Vliegenthart and Angela Wigger whose inspiration is gratefully acknowledged. Thanks for generous funding are due to the Netherlands Organization for Scientific Research (NWO) within the ‘Shifts in Governance’ program. For the original research proposal see Nölke 2004. Earlier versions of the paper have been presented at the International Studies Association Workshop on “Accomplishments and Challenges in Research on Private Authority and Private Governance in International Affairs”, Chicago, February 27, 2007, at the Sixth Pan-European International Relations Conference, Turin, September 12-15, 2007 and at the workshop “Germany in Global Economic Governance” at Cornell University, Ithaca, February 22-23, 2008. I'm grateful to the participants for comments and suggestions, in particular to Claire Cutler, Hans Krause Hansen, Virginia Haufler, Robert Kaiser, Peter J. Katzenstein, Dieter Kerwer, Daniel Kinderman, Anna Leander, Chris May, Lena Partzsch, Tony Porter, Stefan Schirm, Or Raviv and Hubert Zimmermann.
private governance, given that it is deliberately based on a firm-centric conception of political economy, against the government-centric approaches that are dominating the field.

The core argument of this paper is that many prominent cases of private governance in international affairs are strongly affiliated with the LME model, based on the powerful role of Anglo-Saxon coordination service firms. Given the increasing importance of these firms within international affairs, this development threatens to erode the comparative advantages of those economies that are associated with the CME model. The core notion here is “institutional complementarity,” i.e. “referring to situations in which the functionality of an institutional form is conditioned by other institutions” (Höpner 2005). Thus, substantial changes in one institution may have wide-ranging consequences for other institutions and, correspondingly, for the model as a whole. This would not only be to the disadvantage of Germany (and other “Rhenish” countries) and their socio-economic systems that, inter alia, include a powerful rule for organized labour and fairly egalitarian systems of income distribution, but arguably also to the overall welfare of capitalist societies:

To the extent that national or other institutional specificities serve as niches allowing firms and economies to develop competitive new products and processes, their disappearance must diminish the aggregate entrepreneurial creativity and vitality of capitalism as a system. It is furthermore highly unlikely that any one approach to running a capitalist economy will monopolize all the virtues – which would seem to offer good Popperian, or even Hayekian, reasons for seeking to preserve the innovative potential inherent in a healthy level of ‘socio-diversity’ within global capitalism (Crouch/Streeck 1997: 15).

In order to further the argument of the ongoing erosion of CME-type economies by the transnational private governance of coordination service firms, the paper will first juxtapose the most important economic institutions within the LME-CME dichotomy (section 2). The core of the paper consists of three case studies on the influence of Anglo-Saxon coordination service firms on core economic institutions within LME economies, namely those of rating agencies on bank-based corporate finance (section 3), accounting firms on stakeholder-oriented corporate governance (section 4) and law firms and the erosion of traditional forms of innovation transfer within competition policy (section 5). The conclusion places these developments into the broader context; the struggle over the
pre-dominant variety of capitalism within the European Union. Here is a crucial linkage between the mode and content of regulation. In this case, the mode of private governance has been a welcome option for the European Commission to overcome the opposition against more political attacks on coordinated capitalism that has been caused by public EU-regulation. Whereas public regulation has only led to uneasy compromises, as witnessed for the Takeover Directive, the European Works Council Directive or the European Company Statute Directive, private regulation has been more successful to further the LME model by deliberately choosing a less politicized, expert-based constellation.

The Classification of Capitalisms According to the ‘Varieties of Capitalism’-theory: CME versus LME

The most widely used and comprehensive version of the Varieties of Capitalism-model is still the one developed by Hall and Soskice (2001b). Although there are a number of alternatives (e.g. Whitley 1999, Coates 2000, Amable 2003, Schmidt 2003), most authors still prefer to depart from the juxtaposition of the ideal types of Coordinated Market Economies and Liberal Market Economies. Beside offering a rather balanced and comprehensive framework, one of the most important advantages of this typology is its parsimony (Jackson and Deeg 2006: 31-32): while the two ideal types clearly are unable to give full justice to the intricacies of, e.g., British, French or Italian capitalism, they still grasp the most important differences between “Anglo-Saxon” and “Rhenish” economies.

The main theoretical task of the CME/LME juxtaposition is to explain the marked differences in the competitive advantages of advanced capitalist economies. These advantages are most easily demonstrated by focusing on the different types of innovation processes that are central to the two production systems (Hall and Soskice 2001b: 38–44). CMEs have a premium on incremental innovation which is particularly important for the production of capital goods such as machine tools, company equipments, consumer durables, engines, and specialized transport equipment, where “the problem is to maintain the high quality of an established product line, to devise incremental improvements to it.
that attract consumer loyalty, and to secure continuous improvements in the production process in order to improve quality control and hold down costs’ (ibid, p. 39). LMEs, in contrast, focus on radical innovation, which is important in fast-moving technology sectors (e.g. biotechnology or software development), and in the provision of complex system-based products and services (e.g. telecommunication or defense systems).

The basic hypothesis of the Varieties of Capitalism approach is that the inherent institutional complementarities of the two different types of market economies are able to explain these specific innovation patterns. Furthermore, each element of the two ideal types has strong institutional complementarities with other elements of the same model, and differs clearly from the functional equivalent of the other model. Usually, five interdependent elements can be highlighted (Hall/Soskice 2001b: 17-33, see also Jackson and Deeg 2006: 11-20), namely (1) the financial system, i.e. the primary means to raise investments, (2) corporate governance, i.e. the internal structure of the firm, (3) the pattern of industrial relations, (4) the education and training system and (5) the preferred mode for the transfer of innovations within the economy.

(1) The primary means of raising capital for investment in the LME system are bonds and equities to be issued on international capital markets. In CMEs, domestic bank lending plays a much bigger role, together with retained earnings. The two different modes of corporate finance clearly differ regarding the importance of current returns and of publicly available information. Companies in LME economies are strongly dependent on publicly available information and on current earnings for their terms of investments. Dispersed and rather fluid investors need this information in order to value the quality of bonds and shares. In CME, the importance of balance sheet criteria is less prominent, since investors have alternative sources of information, either as owners (family enterprises or concentrated capital) or based on long-term business (banking) relationships, together with diverse channels for reputational monitoring such as business associations.
(2) Correspondingly, the **corporate governance** systems in the two models differ starkly. The LME model focuses on outsider control by dispersed owners, based on active markets for corporate control (mergers and acquisitions, including hostile takeovers). Managers enjoy a considerable freedom of maneuver, being controlled via incentives that are strongly geared towards share prices, e.g. via share options. The CME model, in contrast, has rather strong disincentives for hostile takeovers, and is primarily based on the insider control by major shareholders (blockholders). Managers have to find the consensus of their supervisory boards for major decisions and therefore have to involve blockholders and representatives of workers.

(3) Generally, the **relationship between business and labor** is far more consensual within the CME model, based on a corporatist system of industrial relations including industry-level wage bargaining and powerful company-level works councils (or even worker representation in supervisory boards as in the German *Mitbestimmung*). This is a necessity for production strategies that are based on continuous improvements in product lines and production processes, based on highly skilled labor. Management needs motivated labor to keep productivity high, whereas labor needs protection against lay-offs to invest into company-specific skills. The LME pattern of industrial relations, in contrast, relies heavily on the market as coordinating mechanism. Management has full autonomy to hire and fire based on highly fluid labor markets. Staff, in return, has few incentives to invest in company-specific skills and instead focus on general skills transferable across firms.

(4) **Education and training systems** in CMEs are geared towards the provision of skilled workers with highly industrial or company-specific skills. Correspondingly, business invests strongly into the human capital of its staff, e.g. based on a comprehensive apprenticeship system and a strong focus on vocational training. Powerful employer associations prevent free riding of individual firms on the training effort of others. Given the fluidity of labor markets in LME, in contrast, there are only very limited incentives to invest in industry- or company specific skills. Companies would not be able to benefit from their investments, because workers might be lured away from
competitors, whereas workers depend on acquiring skills that can be used in many different locations. Correspondingly, the education system is geared towards the provision of general skills.

(5) All capitalist varieties rely on the speedy **transfer of innovations** throughout the economy. Within Liberal Market Economies, this transfer most frequently takes place by hiring qualified staff from other companies, or buying the whole company that has made this particular innovation. Both options are supported by a rather fluid labor law and active markets for corporate control. In Coordinated Market Economies, this option is not readily available, given long-term labor contracts and protection against hostile take-overs. Instead, innovations are transferred by a host of inter-company relationships, including business associations or joint ventures, and frequently supported by public funds. This specific innovation system complements very well with sector-wide training schemes that focus on industry-specific skills.

In sum, the two models differ in the basic mechanisms for the solution of coordination problems within national economies. In Liberal Market Economies, the most important form of coordination are competitive market arrangements and formal contracts. In Coordinated Market Economies, non-market forms of coordination such as inter-firm networks and national or sectoral associations play a crucial role (Hall and Soskice 2001b: 8, 33-36).

While LME and CME-type economies can safely co-exist – and this co-existence may even be considered as healthy – we witness an increasing number of clashes between some of the underlying institutions within the European Union. More and more, these economic issue areas are being regulated by the common institutional framework of the Single Market. Only one of the five core institutional areas outlined above so far has largely remained unaffected of unifying EU regulations, i.e. the **education and training** systems. Although the recent Bologna process has lead to considerable EU inroads in the field of higher education, education and training systems have clearly remained a core prerogative of the Member States of the Union. A second institutional area has witnessed
a major clash between the economic systems of the Member States, i.e. the relationship between capital and labour. Here, the Commission tried to introduce regulations that threatened to undermine core institutions of CME economies, such as the German system of co-determination. However, massive political opposition by the affected governments has led to a number of uneasy compromises that leave the national institutions largely intact, such as the European Works Council Directive or the European Company Statute Directive (Cernat 2004). In the three remaining domains, however, we witness the emergence of EU regulations that are clearly favouring the LME model. In case of corporate finance, Anglo-Saxon rating agencies have become an important part of EU banking regulation. The provision of company information for listed firms, a crucial element of corporate governance regulation within the EU, is now regulated by International Accounting Standards that are strongly influenced by the Big Four accounting companies and LME practices. Finally, the regulation of EU competition policy, a crucial regulatory framework for the transfer of innovations between companies has recently witnessed a fundamental change that has very much empowered Anglo-Saxon law companies and can be interpreted as a shift towards a LME framework.

In the following three sections, I will demonstrate for each of these three types of coordination service firms how they are embedded within the LME model, how their authority recently has been extended (most notably by the European Union) to affect CME-type economies, and how they might contribute to the erosion of core institutions within the latter.

Rating Agencies and the Erosion of Bank-based Corporate Finance

The authority of rating agencies is a product, and a core element, of an ongoing process of the disintermediation of finance that diminishes the role of commercial banks in the provision of capital (cf. King and Sinclair 2001: 5-8). LME and CME economies differ heavily regarding the degree of financial disintermediation – whereas this process is very much advanced in LMEs, within CMEs banks still retain a very prominent role for company

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2 This section of the paper draws on Nölke and Perry 2007.
finance. Banks traditionally function as financial intermediaries in that they bring together the users and suppliers of financial resources. Alternatively, suppliers and users can also come to an agreement without the intermediation of banks (i.e. via capital markets), thereby avoiding the overhead costs involved. However, this process of disintermediation creates an information problem for investors, since they have to carry the risk of default repayments themselves. This is when rating agencies come in, because they take over the task of collecting dispersed information on the financial situation of borrowers and condensing it into a single measure, a standardised metric (a “rating”), which is then used as a benchmark for other market actors.

Although there has been intensified competition and an increasing number of players in the credit rating sector since the 1990s, two major Anglo-Saxon agencies – Moody’s Investor Service (Moody’s) and Standard & Poor’s (S&P) – continue to dominate the market. Other agencies occupy niche markets, such as Fitch Ratings for municipal and financial institutions. The dominant role of Moody’s and S&P is not limited to the US, and it is their transnational authority over European and Asian market actors that has caused the most controversy (King and Sinclair 2001: 12). This controversy has been intensified by the Basle II capital adequacy proposals which mandate specific risk metrics which are to be provided by the leading rating agencies (cf. King and Sinclair 2001: 17-25). The justification for these proposals is that banking insolvencies have frequently been shown not to be limited to a bank’s country of origin, but rather to have spilled-over to impact the financial systems of other countries. Still, given the level of competition in the banking sector and the mercantilist behaviour of many governments, banks have long had a strong incentive to take greater risks than might be considered optimal. While the first Capital Adequacy Accord in 1988 (Basle I) addressed some of these issues, a second accord (Basle II) currently is in its final round of ratification and has already been adopted by the European Union. Rating agencies play a core role in Basle II, because less sophisticated banks are obliged to calculate the amount of capital to be held against the risk of credit default based on external ratings. Private authority here becomes enmeshed in a public-private system of multi-level governance.
Credit rating agencies exercise their authority in two ways (cf. King and Sinclair 2001: 4): First and foremost, they shape the behaviour of market participants by limiting their thinking to a range of legitimate possibilities. Secondly, they can occasionally exercise an explicit veto over certain options by using a ratings downgrade. Rating agencies have received most attention for their evaluation of public institutions, because this assessment forms one of the most obvious cases transnational private authority has a direct impact on public actors (cf. Hillebrand 2001, Sinclair 2003: 151-155), although the principal task of rating agencies is to assess the “quality of other companies” debts. It is here that rating agencies exercise their authority over other private actors, since most companies cannot afford a low ranking and will therefore consider changing their behaviour to suit the preferences of a rating agency. The authority of rating agencies over the basic organization of capitalist economies should therefore not be underestimated. Even if a company that is issuing a bond does not agree with a particular assessment, it has to take account of other market actors who will be acting upon that particular rating (King and Sinclair 2001:11). Given the public character of rating up/downgrades, the impact of these agencies is far more infrastructural than the confidential assessment of banks in a system of intermediated finance as typical for CME economies. Correspondingly, rating agencies can be considered a core element of the LME model of ‘financialised capitalism’ in which the owners of liquid capital and their investment analysts occupy a powerful position (Sinclair 1999: 158).

Insofar as the epistemic authority of rating agencies favours the LME system of disintermediated finance, it is not politically neutral, but rather actively favours a specific socio-economic model which is very much in line with the short-term investment horizon of the Anglo-Saxon approach (Sinclair 1994: 149). Third-party enforcement of credit rating has a long history in the US and some other Western countries (cf. Kerwer 2001, King and Sinclair 2001: 14-17), but has now gone global. These most recent developments have not only been criticized due to the practical problems involved, but also because they may further undermine the Rhenish model, in this case especially the financing structure of many “Mittelstand” companies, one of the backbones of Rhenish capitalism (and of CME-type economies in more general). Currently, German small and medium sized business feel this
threat very strongly because of the limited availability of internally generated funds and their strong reliance on long-term loan financing for investment. Basle II and the increasing role of rating agencies will make this financing model even more difficult since highly indebted companies will face a steep increase in credit costs due to their ‘problematic’ risk profile under Basle II. In effect, many of these companies are being forced to mobilize funding by going public or selling themselves to private equity funds, often referred to by critics in especially continental Europe as locusts. This may, in turn, lead to the familiar “… pressures of ‘short-termism’ that plague American and British companies – pressure from shareholders to maximize dividends by concentrating on quarterly results and short-range return on investment variables” (Sally 1995: 69), and to a more conflictive relationship with the representatives of labour. An increasing role of rating agencies, therefore, may threaten the very basis of the Rhenish capitalist model because its elements are highly interdependent and may not be easily transferred and exchanged.

Accounting Firms and the Erosion of Stakeholder-oriented Corporate Governance 3

As coordination service firms, the accountants occupy an especially privileged position since they alone have the authority and legitimacy to validate the accounting information provided by corporations in their financial statements. Without such validation (auditing), the corporations cannot fulfil their statutory obligation to publish annual financial statements. Accounting information is an essential element of corporate governance around which production and distribution are organised in a market-based economy. The measures of profit, wealth and value provided in companies’ annual financial statements are the primary means by which society is able to compare the efficiency of different production techniques. This is true in both the public and private sector. In the former, national government statistics on economic growth, and also on the contribution of various industrial sectors to that growth, draw substantially on accounting numbers produced at the firm-level. Such statistics inform policy decisions not only in corporate governance, but also in other policy arenas such as education and trade. In the private sector investors allocate financial resources on the basis of accounting information which they receive both directly and via

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3 This section of the paper draws on Perry and Nölke 2006 as well as Nölke and Perry 2007.
intermediaries who process and analyse the data for specific purposes. Among these intermediaries are not only the specialised financial news media, but also the rating agencies discussed in the previous section that rely on financial statements for comparable data describing the performance and solvency of the companies whose creditworthiness they are assessing.

Important for the authority of accounting companies as coordination service firms is the widespread adoption of international accounting standards, as developed by the private International Accounting Standards Board (IASB). Traditionally, accounting standards were developed on the national level, under the supervision of national governments. However, international economic integration and the disintermediation of finance have led to increasing demands for the harmonization of national standards. The assessment of the quality of stocks traded on international capital markets relies on accounting: international financial investors not only need transparent company accounts in order to make their resource allocations on a sound basis, but also standardisation of such information in order to compare their investment options in different countries without major difficulties. In the absence of international harmonisation of accounting standards, financial investors have shown a clear preference for the shares of firms audited by the global accounting firms, i.e. the Big Four (Strange 1996: 137). In the system of bank-intermediated finance, prevalent within LME-type economies, internationally harmonized accounting standards were less important, partially because of the domestic focus of many banks, but also because banks frequently had alternative ways of assessing the financial situation of their major clients due to their insider status (e.g. as blockholders).

Internationally harmonized accounting standards are also important for the legitimacy resource base of the whole profession, because it increasingly becomes obvious that different national standards lead to dramatically different results for the same company, thereby threatening to call the reliability of accounting information into question, and with it the authority of the profession. Following failed intergovernmental efforts to harmonise EU accounting standards, the European Commission decided to adopt IASB standards for all exchange-listed corporations in the EU from 2005, taking the total
coverage to ninety-two countries (Tweedie and Seidenstein 2005). The United States has not adopted IASB standards, instead retaining those set by the Financial Accounting Standards Board (FASB). However, the IASB and FASB have been engaged in a long-term convergence project since 2002 (the “Norwalk Agreement”) and the two organisations are now developing many standards jointly by default.

The ongoing process of international accounting harmonization can be seen to have strengthened the position of the Big Four accounting firms in several respects. First it has reduced the threat that divergent national standards and the corresponding differences in company earnings posed to the authority of their main product (audited financial statements). Second, harmonisation also gives the Big Four even greater scale advantages in capturing national markets that were hitherto regulated by local standards. Unsurprisingly, therefore, the Big Four are the major source of funding for the International Accounting Standards Committee Foundation, a non-profit Delaware corporation which is the parent body of the IASB, and which funds and directs the work schedule of the standard setter. The Big Four accounting firms also occupy key positions on the IASB’s committees and working groups, as do many financial-sector actors, which may go some way to explaining the content as well as the form of regulation (Perry and Nölke 2006).

The development of powerful transnational private authority in the form of accounting firms was already highlighted by Susan Strange in her seminal study on the “Retreat of the State” (1996, chapter 10). Strange focused on the extreme concentration of the market for accounting services, where the biggest six firms (referred to as the “Big Six”) had market shares of more than 95 per cent in the most important national markets, thereby giving them considerable structural power. In the meantime, concentration within the sector has progressed even further, with the Big Six have becoming the Big Four (PriceWaterhouseCoopers, KPMG, Deloite & Touche, and Ernst & Young). A study by the US General Accounting Office (2003, cited by Porter 2005: 6) revealed that these four firms audit over 78 percent of US public companies, virtually 100 percent of major listed companies in the UK, over 80 percent in Japan and 90 percent in the Netherlands. This
heavy concentration within the accounting industry is, inter alia, being supported by the ongoing process for the development of international accounting standards, as highlighted above. At the same time, the powerful role of the Big Four together with the current harmonization of international accounting standards intensify the structural impact of this type of coordination service firms.

Central to the IASB’s new standards is the move from historic cost to fair value accounting (Nölke and Perry 2006). Historic cost accounting values assets at the cost of acquisition whereas fair value accounting uses current market prices (if no such market exists, a model is used to arrive at a simulated market price). The move from historic cost to fair value reduces the discretion of management in valuing assets, especially for assets with active markets. It also compresses the future into the present in a manner which is both volatile and which changes the reference point for understanding both the value, and the workings, of a company. An asset is valued by buyers and sellers based on the present value of the future expected profits which will arise from owning it. With historic-cost accounting, this process impacts the asset’s accounting value only once, when it is acquired. The result is that the asset is thereafter seen more for its productive capacity, and less for its acquisition/disposal value. Under fair value-accounting the re-evaluation of an asset’s worth is an almost continuous process. As such, the current use of the asset has to be regularly justified in terms of its current market value. Fair value accounting therefore gives external forces (i.e. influential financial market actors) more leverage with which to set the parameters for economic decision making within the firm, a practice which is in line with the corporate governance relationship between shareholders and managers in the LME variety of capitalism.

Accounting standards are an integral foundation of a particular variety of capitalism. Thus, the rather conservative, creditor-oriented accounting standards in Germany (the Handelsgesetzbuch/HGB) complement the strong role of the German banks during the development of the CME variety of capitalism in which the HGB was designed. For example, the German accounting standards which enabled the building substantial ‘hidden’ reserves by German companies should be seen as an expression of the priority
German banks gave to ensuring the safety of their long-term lending to enterprises. In contrast, IASB financial statements now employ so-called fair value accounting (the IASB’s preferred measurement technique for new accounting standards), giving shareholders the wherewithal to demand that every corporate asset is put to its most profitable use, as judged by market benchmarks (Barlev and Haddad 2003). In defining what constitutes a profitable use, shareholders are likely to adopt a much shorter-term perspective than managers so IASB standards can be expected to make conservative (Rhenish) financial planning rather more difficult, and thereby serve to discourage the longer-term business strategies which depend upon it.

More trouble for the Rhenish model has recently surfaced in the context of the International Accounting Standards Board’s IAS32. By reclassifying the internal capital (Eigenkapital) as borrowed capital, many small- and medium scale enterprises become heavily indebted (in accounting terms). Together with Basle II, this could strongly increase their credit risk premium (see Frankfurter Allgemeine Zeitung 28 November 2005, p.20)

It should be stressed however that accounting standards are not the root cause of such changes and pressures – rather they are a complimentary factor alongside others such as the deregulation of the financial sector, and the corresponding rise of shareholder value from a management consultant’s tool to a corporate governance paradigm. Nevertheless, IASB accounting standards are playing a key role in institutionalising changes in the structure of capitalism. As in the case of credit rating, regulation based on the LME variety of capitalism and on a powerful role for Anglo-Saxon coordination service firms is contributing to an erosion of the CME variety. It is probably the realisation of this fact, which recently led to the foundation by major German companies of a German committee for accounting standards (Deutsches Rechnungslegungs Standards Committee/DRSC), with the specific purpose of wielding greater influence in the IASB’s policy network. So far the DRSC has not been very successful, as evidenced by its comprehensive reorganization after only a short period of operation.
Law Firms, Competition Policy and the Erosion of Traditional Forms of Innovation Transfer

In order to understand the implications of the recent fundamental shift within EU competition policy for the variety of capitalisms within the European Union, we first have to clarify the different principles and enforcement practices underpinning competition policy within the CME and LME models, as illustrated with examples from Germany and the US. While the traditional EU system of competition policy was very much in line with CME (German) institutions, the recent shift has introduced major elements of the LME (US) model and may threaten traditional forms of innovation transfer within CME-type economies. A crucial ingredient of this recent shift is the empowerment of Anglo-Saxon law firms that play an important role within the private enforcement of competition policy within the US.

Underlying the spirit of the CME model is the perception that capitalism needs to be organized and economic power controlled (Albert, 1993: 117-9; Streeck, 1997: 37). Markets are not perfectly self-regulatory, but jeopardized by “market failures,” such as the abuse of excessive market power, restrictive business practices and collusive agreements between corporate actors. Public market intervention in the form of competition control is conceived as necessary for the preservation of an open and free economic life, and in a wider sense also for pluralistic democracy. Hence, the state should provide for a pro-active and strong institutional framework that safeguards market players from the anarchy of free markets, creating a “thoroughly and continuously policed competition order” (Budzinski, 2003: 15). Rather than privileging certain interests above others, the competitive order should serve the economic wellbeing of a broad variety of socio-economic constituencies. Some forms of inter-firm collaboration may be acceptable (or even desirable), in particular if these serve the diffusion of technology within the economy (Hall and Soskice, 2001b: 26). This multi-goal and long-term orientation provides a philosophical framework for a balanced interventionist strategy in the administration of anti-competitive conduct, representing a regulatory analogue of the more generic “Rhenish model” of social market economy.

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4 This section of the paper draws on Wigger and Nölke 2007.
Although the overall influence of German ordo-liberal scholars in other economic regulatory policies has waned since the 1960s, it continued to have a remarkable stronghold in EU competition policy (cf. Budzinski, 2003; Hölscher and Stephan, 2004). The ordo-liberal idea of public market intervention is reflected in the fact that EU competition laws were designed to serve primarily the long-term goal of the European integration project, also including wider socio-economic policy purposes, such as the occasional alleviation of employment problems of certain sectors or regions and the restructuring of “sick” industries (Jarman-Williams, 2001). SMEs received special protection from fierce competition through subsidized loans, R&D support and financial guarantees (Motta, 2004: 16).

Conversely, the maxims of the Chicago School have had a strong influence on the US antitrust system of the last decades, the archetypical example of an LME-type economy. According to this paradigm’s central tenet, public market intervention is intrinsically at odds with a free market ideology. As a monetarist response to Keynesianism, Chicago scholars propagated the deregulation and liberalization of markets (Budzinski, 2003: 9). Structural interventions should be the exception, or then be restricted to the minimum necessary, since markets largely regulate themselves. The ultimate determining factor for assessing anticompetitive conduct should be consumer welfare maximization, underpinned by rigorous economic modeling based on neo-classical price theory – a cornerstone of the Chicago School (Fox, 1997: 340). The single goal orientation with regard to mere price reductions for consumers is reverberated in a short-term view on economic efficiency, another important yardstick of the Chicago theorem. Following from a commitment to “survival of the fittest” logic, it propagates a permissive attitude towards “size” as long as prices remain competitive and “economics of scale” can be achieved. Consequently, not the concentration of market power as such, but collusive agreements with clear negative effects on consumer welfare, cartels and other restrictive business practices should constitute the focal point of competition control. Long-term
economic concerns, such as the diffusion of technological innovation through inter-firm collaboration, do not play an important role in the LME variety of competition control (Hall and Soskice, 2001b: 31).

Not only the basic **guidelines** governing competition law differ considerably between the CME and LME models (as outlined above), but also the **enforcement practices**. Again, these differences can best be understood in the different institutional arrangements of the variety of capitalisms. The distinction between LME versus the CME way of enforcement follows in broad lines the contours of the classification of common versus civil law made by scholars of comparative law.

The common law tradition underpins the institutional setup of Anglo-Saxon competition authorities (cf. Gerber, 1998). Competition law enforcement is a case-orientated endeavor in which courts constitute the ultimate resort of stopping anticompetitive conduct. In what is generally referred to as the court model or the “bifurcated judicial model” (cf. Trebilcock and Iacobucci, 2002), the antitrust agency is merely equipped with investigatory powers. For instance, in the US, the leading example of a common law scheme, the enforcement agencies, the Federal Trade Commission and the Department of Justice, cannot block anticompetitive conduct by themselves, but likewise to private plaintiffs have to litigate all cases before the courts. However, more than 90% of all formal US antitrust actions are brought to the courts by private litigators (Kemper, 2004: 9; Wils, 2003: 477). The strong role of private enforcement in antitrust prosecution is due to a range of systemic features in the US model that make it particularly attractive to initiate legal proceedings against corporations, such as damage compensation, class actions, contingency fees, criminal prosecution and leniency schemes: A successful plaintiff in the US can be awarded not only the costs of suing (expert fees and attorney’s fees), but up to three-times the damage suffered (treble damages). Moreover, plaintiffs can group together and sue collectively (class actions) and professional litigators may offer contingency fees or sell their legal services under a “no-cure-no-pay” condition. In combination with criminal sanctions (imprisonment of CEOs), and leniency schemes (immunity from prosecution to those who first confess having participated in a collusive
agreement), there is much incentive to bring antitrust infringements to the US courts. Consequently, the regulation of business conduct relies significantly on an *ex post* enforcement by private plaintiffs, rendering the U.S. common law tradition a market-oriented model with “private attorney generals.” The basic objectives of competition policy and the mode of enforcement are closely intertwined. Both parts of the LME model rely on the critical notion that public market intervention should be kept as limited as possible. Moreover, both assume that collusive behavior should be prosecuted merely on the basis that other market actors have clearly been negatively affected. The focus on only one decisional criterion upon which anticompetitive conduct is judged necessarily follows from the litigation-oriented approach – otherwise the discretionary power of the courts would be too excessive. There is no place for long-term concerns, neither in policy paradigms, nor during their enforcement through private litigants that are primarily motivated by short-term profits.

In Continental Europe the civil law tradition is more prominent. Although judicial precedence does play some role in the interpretation of competition laws, enforcement is merely a “clause-centric” approach (Hwang, 2004: 114), bound to general and abstract legislation, complemented by more detailed regulatory frameworks. In civil law countries, specialized competition authorities, rather than courts, are the main decision-makers – a model that has been termed the “integrated agency model” (cf. Trebilcock and Iacobucci, 2002), or the administrative control model. Competition authorities tend to be equipped with far-reaching discretionary powers when addressing and administering anticompetitive business conduct. Regimes of *ex ante* authorization according to which corporate actors notify planned agreements to competition authorities are common not only for mergers, but also for commercial agreements. Due to the bureaucratic character, *ex post* enforcement by courts and private litigants is far less important. Courts are merely involved in case corporate actors appeal against the decisions taken by competition authorities. Again, competition policy principles and the mode of their enforcement are closely interrelated with the basic institutions of CME-type economies. The ordo-liberal legacy of “comprehensive” competition control is reflected in the institutionalization of powerful public enforcement agencies with wide-ranging
competencies, allowing for the “ordering” of the economy according to a broader political view. Only public agencies can be entrusted to balance the multiple goals of antitrust policies within the CME model, including the promotion of the transfer of innovations by inter-firm collaboration.

Against this background, the 2004 reform of EU antitrust regulation and enforcement is the most radical shift in the history of European competition policy. It came in the form of a package of both substantial and procedural changes. One of the core components consists of replacing the more than 40 year-old Regulation 17/62 with Regulation 1/2003. This measure abolished the long-standing administrative notification regime under which companies could have ensured in advance by the European Commission that a planned commercial agreement did not fall into the category of a cartel or other restrictive business practices prohibited under Article 81 (TEC). As the business community cannot rely anymore on the sanction-free notification procedure, but has to assess by itself whether a planned deal infringes with the law or not, the main burden of antitrust enforcement has now been shifted to the private sector. Companies are not only expected to ‘police’ themselves, but also their competitors, distributors and suppliers by bringing infringements of Article 81 to the courts, usually based on the expert advice by transnational law firms. Thus, the new regime introduces greater reliance on private ‘market intelligence’ in spotting anti-competitive practices and less market supervision and intervention by public authorities. This constitutes a considerable step of convergence towards the US model, which for commercial agreements never had a similar notification regime in place. Although the reform does not (yet) touch upon national enforcement practices, the conversion towards the Anglo-Saxon common law competition enforcement model is likely to be driven a step further by the introduction of stronger incentives for private plaintiffs to litigate. Commissioner Kroes is quite overt in this respect by stating that “[…] the comprehensive enforcement of the competition rules is not yet complete – not enough use is made of the courts.” (Kroes, 2005). Hence, the decision for increased private enforcement is likely to paving the way for further legal modifications on the national level, such as the introduction of an explicit system of damage relief for private plaintiffs, leniency schemes, and the possibility for class
actions. The Commission believes that once a system of damage relief is introduced also on the Member State level, private parties will go much further in bringing actions to the courts than competition authorities (Monti, 2004). Although private plaintiffs have neither invaded the European nor the national courts with legal actions in competition matters since Regulation 1/2003 has come into effect, it is likely to open up a Pandora’s Box of further legal modifications that bring the European (CME) model of competition law enforcement one crucial step closer to the US-style (LME) competition culture.

Finally, the sweeping reform in one of the core pillars of European competition control not only contains a shift in the mode of regulation (from public to private enforcement), but also in the substance of regulation (from ordo-liberalism to the Chicago School). By facilitating private litigation, much more importance is now given to short-term consumer welfare considerations, which underpins the application of a single measure for anticompetitive conduct that can be entrusted to courts and private litigants. The move away from the public multi-goal perspective towards the narrow efficiency concern radically breaks with the European tradition of pursuing broader goals in competition law enforcement (e.g. the protection of competitors from the concentrated power of dominant companies, or the safeguarding of innovation transfer by inter-company agreements). The 2004 competition reform entails a shift away from the previous administrative and legalistic approach towards increased use of economic reasoning as a focal point for decision-making, which constitutes another crucial point of convergence towards the Chicago model (cf. Hwang, 2004). Increasingly, rigorous economic analyses underpin the assessments of restrictive business practices (e.g. extensive empirical and econometric assessments on product markets and market shares, simulation models and price calculations, damage analyses). In combination with private self-enforcement and facilitated court access, however, large parts of the burden of judging anti-competitive conduct on the basis of economic evidence will have to be carried by private companies, in particular specialized transnational law firms of Anglo-Saxon origin.
Conclusion: Coordination Service Firms and the Battle of Capitalisms in the European Union

In sum, we can observe that institutions that are strongly interlinked with the LME model are being transplanted into CME-type economies by the means of transnational private governance, particularly within the European Union. Examples include accounting standards, rating agencies and competition policy enforcement by law firms. Together, these recent activities tend to strongly undermine the institutional complementarities inherent in CMEs.

The privatization of certain facets of EU business regulation has gained ground through a depoliticized, professions-based interest constellation that disregards more eminent political features of this form of economic organization (Dewing and Russell, 2004: 300). It should not surprise that attempts by the EU to introduce Anglo-Saxon standards in the form of public regulations, such as the European Works Council Directive, the European Company Statute Directive and the 13th Takeover Directive, have led to somewhat uneasy compromises, given the high visibility of these issues and the corresponding political controversy (Cernat, 2004). In contrast, the private-authority based regulations discussed in this article have led to a clear decision in favour of the Anglo-Saxon model. While more explicit political attacks on the basic institutions of Rhenish capitalism are not (yet) feasible, the enhanced role of private actors in EU regulation provides an excellent opportunity for the erosion of these institutions – “through the backdoor.”

Seen in perspective, we thus link content and mode of governance, since its private transnational character has made the mobilization of a meaningful opposition by labor, small- and medium-sized enterprises or representations of the Rhenish variety of capitalism as a whole far more difficult. Particularly from the perspective of international organizations such as the European Commission, regulation via transnational private governance may thus be an attractive option to circumvent a political opposition that would be more powerful in case of public inter-governmental regulation.
References


