American Behavioral Scientist
Volume 49 Number 7
March 2006 949-960
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10.1177/0002764205285174
http://abs.sagepub.com
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Sense Making and the Emergence of a New Form of Market Governance

The Case of the European Defense Industry

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The problem of sense making is particularly acute when established organizations face a sudden set of changes in their fields. This article offers some conceptual clarification of this issue in several ways in the context of profit-making firms. In these circumstances, managers need to worry about not just competitors but also governments, suppliers, and workers. Because of these complex interdependencies, the process of sense making is accompanied by a search process that may lead managers in directions that are a priori unpredictable. New sets of understandings about how to survive in a market often reflect political compromises between actors that create new cultural conceptions of action. Managers have to sometimes take what systems give in order instead of what they might prefer. The author illustrates these principles in the case of the reorganization of the European defense industry.

Keywords: *sense making; market governance; Europe; defense industry*

At the core of much organizational theory is the question of whether actors can change the course of their organizations to promote their organizations' survival. In the case of firms in markets, there is much evidence that when new markets emerge, the ability of managers to make these kinds of decisions is often overwhelmed by an unstable environment and their lack of resources (see Hannan & Carroll, 2001, for a statement of the ecological approach). Less attention has been paid to how managers in firms in stable market environments that suddenly become destabilized react. Most of our imagery about firms in a stable market is that managers who run firms will use their market power to prevail (Fligstein, 1996, 2001a; Perrow, 1986). Incumbents have a fixed way to understand what is going on, and they rely on a repertoire of readily available strategies to respond to challenges.

Author's Note: This article was prepared for a conference titled "New Public and Private Models of Management: Sense Making and Institutions," held at Skagen, Denmark, May 27-30, 2005. I would like to thank Frank Dobbin for his comments on an earlier draft of this article.

If staying the course does not work, it is possible for managers to change their thinking (Fligstein, 2001b). But making these changes is not straightforward. Managers must come to an analysis of what their "problem" is and create a "solution." This problem of sense making requires managers to change what "facts" they pay attention to and "frame" new courses of action in the context of rapidly changing market conditions. To do this, they must sometimes be flexible in their goals and take what the system gives (Fligstein, 2001b).

This article explores these issues in two ways. I provide a conceptual framework I developed earlier (Fligstein, 2001b) to understand how managers in firms in destabilized environments might react. Then, I use these principles to explore the case of the European defense industry. The defense industry is an unlikely site for observing a serious market crisis. At the core of the idea of state sovereignty is the notion that a government should be in control of both police and military power (Krasner, 1988). In Europe, historically, many of the largest defense companies have been owned by governments (Serfati, 2001). Military planners have wanted to have captive producers so that they are not beholden to foreign firms in times of war. But with the end of the cold war, European governments and defense producers faced a changed set of political and economic circumstances. This pushed them to begin undertaking a fundamental restructuring on a European-wide basis (Serfati, 2001).

This produced a trial-and-error process by which managers had to figure out what their governments would allow. One model was to let firms decide which products to pursue and which alliances and mergers to engage in. But most governments, despite their desire to rationalize the industry, prevented this from occurring for fear that all of their national defense capacity might end up in the hands of firms from other countries. The end result that managers created was a compromise forged from necessity. Government ownership of firms has been reduced, and there has also been substantial consolidation across the industry. But the three large multinational firms that have been formed are a consortium of the preexisting national firms. This new structure has "Europeanized" the defense industry by increasing the cooperation of firms across countries to produce for a single European and, indeed, world market. But the national identity of many of the firms has been preserved. Governments have some certainty that defense will not entirely slip away from the nation-state.

This story has several general implications for the issue of how existing industries might be reorganized as markets across societies become integrated. First, it suggests that managers must search for models that are legitimate as vehicles to take advantage of market changes. The discovery of these models often appears after the fact to make perfect sense. But such models have to take into account not just the crisis of an existing market but also constraints from governments, laws, and workers. New models are frequently compromises between competing interests that represent a culturally constructed political solution. It is this contingency of sense-making processes that I hope to make clear in this article.

The case study provides evidence for how national firms maintain national identities despite forces pushing them to join a more international marketplace. This provoca-

tive result may help to explain one of the persistent puzzles of the global economy in the past 20 years: If markets are growing more integrated, why have national capitalisms persisted (Berger & Dore, 1996; Boyer, 1996; Guillen, 2001; Whitley, 1999)? The answer from the case study is that national governments have different attitudes toward their largest national corporations. Some, such as the United States and Great Britain, are prepared to let them be sold and reorganized by the highest bidder. Others, such as France, Italy, and Germany, work to maintain the identities of their firms for political reasons. This result is consistent with the literature that stresses the continued importance of governments and national economic elites in the organization of national and international markets (Boyer, 1996; Crouch & Streeck, 1997; Hall & Soskice, 2001).

Some Conceptual Tools

A sociological theory of markets begins by recognizing that the social processes that occur at the beginning of markets may differ from those that characterize stable markets (Fligstein, 1996). In new markets, there exists no established hierarchy of firms and no accepted principles to define and control competition. Managers are more on their own and subject to the forces of competition. In stable markets, incumbent firms use their strategies and deploy their resources on a period-to-period basis to reinforce their position in the market order. There are always some crises caused by temporary downturns in the market or competitive challenges by existing market players. But dominant players can successfully fight off challengers.

Markets are usually destabilized by some form of extreme crisis. This crisis can be caused by governments (either intentionally or unintentionally), a severe market downturn, or the emergence of new firms that are outsiders that claim to have a new way to structure the business. It is this situation that reintroduces fluidity into market arrangements and allows for a shakeup of existing market players and the possibility for a new set of rules to emerge to structure market activity.

In this situation, managers have to come to an understanding of what is happening. Their first response will be to attempt to defend the old order, frequently by turning to the government for protection. But if this fails and their existence is threatened, will they consider changing their course of action? The problem of sense making begins with an analysis of the problem and then a search for what to do. Actors must come to an interpretation of the crisis and propose some solution or new frame (Fligstein, 2001b; Lounsbury & Glynn, 2001; Rao, Monin, & Durand, 2003). One source of a new course of action might be following other firms that are perceived to have analyzed the problem correctly. But managers must be able to gain support of important external constituencies (governments but also customers, workers, and suppliers) if they are to make change.

The Case of the European Defense Industry

I want to use these conceptual tools to make sense of the reorganization of the European defense industry. Circa 1985, the European defense industry was fragmented. There were a large number of small defense firms specializing in one kind of weapon system that were totally dependent on their governments for business. In many countries, firms were owned by their governments. The coming of the European single market and the end of the cold war created two crises for defense firms. The single market opened up the possibility for firms to consider competing in each other's domestic markets. The governments agreed to open up national procurement, and this meant that firms could potentially bid for contracts in other societies. The end of the cold war meant that governments around the world were reducing their consumption of armaments of all kinds. In the relatively small markets of Germany, France, Great Britain, Spain, Italy, and Sweden, the continued existence of already small national firms was clearly at risk.

Managers in existing European firms and national governments had to figure out how to the decline in the demand for arms while maintaining the ability to continue to produce weapon systems. Three models of consolidation were considered (Serfati, 2001). Governments could try to consolidate their national defense industries into a single national champion to supply mainly the national market. The problem with this strategy was that the national market still remained too small to sustain one large diversified firm. It would also lead to markets across Europe remaining fragmented along national lines as all governments would protect their markets, and firms would have little opportunity to sell more abroad.

A second strategy that was proposed and, for a couple of years, seemed possible was for governments to cooperate and decide that their firms would specialize in different weapons systems. So, all of the tanks would be made by one country, the fighter planes by another, and cruise missiles by a third. The problem here was that it was difficult for this to happen. Governments would have to decide which markets to specialize in and then agree with one another about how to do this. Firms, many of which were privately held, would have to decide to comply. This would require a lot of coordination between governments and firms under conditions where both sides had highly divergent interests.

Finally, governments could pursue a market-driven solution. They could allow firms to decide which lines of business to be in and which firms to buy. The problem here was that governments were ambivalent about losing control over defense production. They have spent much of the past 20 years deciding how far they are willing to go in this direction. This has been compounded by the fact that the French government continued to own much of its defense industry, making it harder for any consolidation to occur.

None of these models was totally viable, and the result was a hybrid model that combined features of all three models. Governments remained intimately involved in the consolidation of firms and were never totally willing to let firms decide with whom

to partner. Indeed, the defining feature of what was possible was the more general attitude of each of the main governments toward protecting national champions. The British government was most in favor of market solutions and least in favor of trying to produce a single national champion. Not surprisingly, British firms were frequent takeover targets, and the British did not initially allow its two largest military producers to merge for fear of creating a monopoly. The German government used a version of supporting a single national champion by allowing most of the German industry to be merged into Daimler-Chrysler, thereby preserving German control over the German industry. The French government's policy shifted between more market-oriented solutions and trying to create national champions. In the end, the French government has a large ownership share in two of the three largest defense firms in Europe.

Managers of the firms in different countries had to take into account what their governments said they might allow and, in the last instance, what they actually let happen. Because of this constraint, managers realized it was easier to cooperate with one another through the use of joint ventures rather than engaging in mergers. When they managed to buy out a firm from another society, they frequently left the firm intact and ran it as a separate company. Although there has been cross-national consolidation into three large groups (British Aerospace, EADS, and Thales), enough of the original national firms still survive that governments have the sense that their national firms and industries have not disappeared. The overall effect is a cross-national industry where three large consortia of firms cooperate to divide up the national markets. There is a single market for defense products in Europe, albeit one that keeps intact the national firms that produced separate products (European Commission, 2003; Serfati, 2001).

It is useful to describe how managers ended up with this form of consolidation. Even before the end of the cold war, there was discussion about possible consolidation in the European defense industry. The European market had too many small players, and some consolidation was likely. In 1988, GEC (a British-owned armaments manufacturer) and Siemens (a large diversified German firm) tried to buy Plessy (United Kingdom), a maker of military electronics. Alain Gomez, president of Thomson (France), said, "The Plessy bid is the start of a big shake-out in European defense firms" (*Business Week*, November 28, 1988, p. 50). At another large French firm, Matra, a senior official commented that "this is a sign that there will be a major restructuring of the European defense industry. Everybody has to have a European strategy" (*Business Week*, November 28, 1988, p. 50).

Players began to line up to take over other firms. Daimler Benz (later Daimler-Chrysler), a German firm, began to buy up mostly German companies with the approval of the German government. These included AEG, Dornier Aerospace, Krauss-Maffei, and, in 1988, Messerschmidt (*Financial Times*, July 13, 1988, p. 22). This gave them a presence in many defense fields, including a large participation in Airbus, the commercial aircraft manufacturer. The French firm (partially government owned) Thomson-CSF began to go on a merger binge with companies from a number of different countries. They bought Link-Miles (United Kingdom), a stake in Pilkington electronics (United Kingdom), and three businesses from Philips (the

Netherlands). The two largest British firms, GEC and British Aerospace (hereafter BAe), were also active in the merger market. But despite many attempts at consolidation, the pace of mergers slowed during the 1990s.

The U.S. Department of Defense gave the international defense industry a huge jolt when it began to encourage mergers of its principal suppliers. By 1996, the bulk of the American arms producers were absorbed into four firms: Hughes-Raytheon, Lockheed Martin, Boeing, and Northup Grumman. In 1997, Lockheed and Northup were merged. This presented the European firms and governments with a real challenge. The large American firms would not only dominate the American market but would be huge players in the global market for weapons. The only way for European firms to compete was for them to consolidate as well.

There was one huge problem for firms trying to merge to compete across Europe. Article 296 of the Treaty of Rome (the treaty that founded the European Union [EU]) gave the governments total control over defense and security issues and allowed them to ignore single market rules when it came to defense issues. This meant that the EU had no legal basis to open up a market in defense (European Commission, 2003, p. 8). The governments vacillated between being in favor of defense consolidation and being against it, depending on what merger was being proposed, what firms were involved, and who was in power in each of the member states. The Thatcher government, for example, was sometimes caught between its free market ideology, which would have pushed it toward supporting consolidation of the industry without regard to national origins of firms, and its desire to preserve British sovereignty by protecting national champions. Generally, because Britain had an active market for takeovers, many British firms were takeover targets. The French government owned a large amount of its defense industry. As a result, one of the main themes of the period of consolidation was that managers in privately owned firms were skeptical about entering into agreements with French firms.

It is useful to consider some of the machinations that played out and eventually resulted in the formation of three large companies: BAe, Thales, and EADS, the three defense giants in Europe. In 1994, Thomson-CSF (France) bought the defense electronics businesses of Thorn-EMI (United Kingdom), continuing its pattern of picking up smaller firms or else pieces of firms from other countries. Other firms pursued the tactic of cooperating with partners from other countries by either merging existing operations into new subsidiaries or creating wholly new subsidiaries for specific projects. In 1996, BAe and Matra (France) agreed to merge their missile businesses and form a jointly owned subsidiary for that business. In that same year, four European companies—GEC, Daimler Benz, Alena (Italy), and Saab (Sweden)—formed a new company, Eurofighter, to build a new fighter for European governments. GEC and Thomson agreed to create a new company, Thomson Marconi Sonar, out of assets they both already had. GEC also had arrangements with Matra to build satellites and Siemens to work on telecommunications.

The European governments began to think more seriously about coordinating their defense procurement and to consider allowing the industry to rationalize through mergers. The United Kingdom, Italy, France, and Germany created a European Arma-

ments Agency to coordinate the production of arms systems that were to be bought by all European governments. In 1998, European governments decided to push defense consolidation forward. The countries with the six largest arms producers agreed to remove official obstacles to ownership and transfers of sensitive technologies. They directed the EU Commission to produce a document to produce rules for a single market in defense goods.

The French government went back and forth about what it wanted. On one hand, France appeared to want to protect French firms by maintaining public ownership. In 1996, it convinced Serge Dassault to allow his firm to be bought out by Aerospatiale, a firm owned by the French government. The French government appeared to be building national champions at the time that the British and German governments were more committed to creating more efficient, privately held competitors. In 1998, the French government did eventually agree to begin to privatize its holdings in Thomson-CSF and Aerospatiale. But executives in BAe and Daimler-Benz were skeptical that they were serious (*Financial Times*, July 6, 1998, p. 3).

The *Financial Times* summed the dilemma as follows:

> Yet while companies have itchy trigger fingers, government procurement policies across Europe have not shifted sufficiently to give the industry a clear target at which to aim. France still seems to regard the idea of competitive procurement as a quaint Anglo-Saxon obsession; Germany says it wants more defense work to be allocated competitively, but has yet to make all the tough decisions to back that up; Britain still ponders the philosophical niceties of a perfectly competitive defense market in a manifestly political arena. None of these countries has yet made the hard compromises which would make a single European defense equipment market a reality. (February 22, 1996, p. 21)

These problems did not go away in the subsequent years. In 1996, the president of Thomson, Alain Gomez, tried to open negotiations with GEC to merge the firms. The French government did not approve of that and sacked Gomez. It began to privatize Thomson by offering the company instead to Alcatel and the Lagardere Group, which owned Matra. GEC opened talks with Martin Marietta, an American firm (*Sunday Times*, April 13, 1997). These talks eventually fell through, and GEC began to discuss a merger with BAe (*Herald-Glasgow*, July 7, 1997). The British government decided to oppose this merger because of its anticompetitive effects. When this happened, discussions began to create the largest cross-border defense merger of all: a merger between BAe, Aerospatiale-Dassault, and Daimler Benz, which were the main partners in the Airbus consortium. The problem with this merger was that the French government had a 100% stake in Aerospatiale and a 50% stake in Dassault (*London Times*, July 10, 1997). BAe and Daimler Benz wanted the French government to reduce its interest in the newly merged firms, whereas the French government wanted to maintain control.

When the French Socialist government came to power in 1997, it pulled away from selling off its stake in Aerospatiale and Dassault. Indeed, it appeared as if the French Socialist government was intent upon creating a single national champion by pushing

Thomson, Aerospatiale, and Dassault into a single firm (*Financial Times*, September 27, 1997, p. 2). The negotiations over how to structure the Airbus consortium bogged down.

Privately held firms continued to buy parts of one another to push forward consolidation. Daimler Benz and BAe bought the defense business of Siemens in 1998 (*Wall Street Journal*, January 15, 1998, p. 18). GEC created a joint venture with Alena (Italy) to produce radar and guided missiles (*Financial Times*, March 18, 1998, p. 6). GKN (United Kingdom) merged its helicopter unit with Agusta (Italy) to create the world's second largest helicopter company (*Financial Times*, April 6, 1998, p. 6). In 1998, the French government began to backtrack on privatizing defense firms. It agreed to sell some of Aerospatiale's assets to Matra, the main company of Lagerdere (*Guardian*, July 24, 1998, p. 21). At the same time, the French government resumed talks to create a large European merger between Aerospatiale, BAe, and Daimler-Benz's defense business (*Financial Times*, July 24, 1998, p. 21).

Once again, these negotiations broke down. In November, the French government insisted that it wanted to keep a "golden" share that would prevent the company from a hostile takeover. BAe and Daimler refused to grant the French government that power and decided to go ahead on their own and create the European Aerospace and Defense Company (EADC; *Financial Times*, November 8, 1998, p. 2). In retaliation, the French government began to discuss pushing Aerospatiale entirely into the hands of Matra. A large number of mergers were under discussion. Racal (United Kingdom) began conversations with Thomson-CSF, and GEC continued discussions with Thomson as well. It appeared as if the whole industry was about to experience a wave of consolidation with or without the consent of governments. But the BAe and Daimler merger hit a roadblock. BAe wanted controlling interest in the new company. The German government and Daimler balked at this. Talks cooled. Then GEC decided to sell off its defense business entirely. It put its defense unit for sale, and BAe was immediately interested. So were Thomson and Daimler. This further cooled relations between BAe and Daimler (*London Times*, January 15, 1999, p. 10). In the end, the British government approved the merger of BAe and the defense assets of GEC, a merger that it had previously opposed on antitrust grounds.

Ironically, although it initially appeared as if the French were trying to create a national champion in a single firm, it was, in the end, the British who created a large British enterprise that consisted of the two largest British defense companies. But this analysis of what happened is not entirely accurate. GEC had a large number of joint ventures and subsidiaries with both French and Italian firms. BAe took over the GEC stakes in Matra-Marconi (France) as well as joint ventures with Alena (Italy) and Daimler. It is more accurate to see BAe as a British-led firm with French, Italian, and, to a lesser extent, German firms as part of its group.

Daimler began to consider a merger with Aerospatiale-Matra. It began to execute its vision of a European Aerospace and Defense Company by buying Casa, its Spanish partner in Airbus (*London Times*, June 29, 1999, p. 26). Eventually, it came together with Aerospatiale to form EADS, which produced not only armaments but also the Airbus (*Financial Times*, July 24, 2000, p. 2). Thomson-CSF reentered the picture by

Figure 1
Some Major Ownership Relationships Between European Defense Contractors, 2003

French government
EADS
Airbus
Daimler
Eurofighter
Dassault Aviation
Dassault Ind.
MBDA
Panaria
Thomson-Dasa
BAe
Alena Marconi
Finemecchia (Italy)
Saab
Alena
Thomson Marconi
Eurosam
Racal
Thales
Alcatel
French government

Source: Ernst and Young (2002).
Note: Arrows indicate direction of ownership. BAe = British Aeronautics; EADS = European Aeronautic Defense and Space.

proposing a merger with Racal (United Kingdom; *Financial Times*, January 5, 2000, p. 22). It too began a series of mergers and renamed itself Thales.

By 2004, three large consortia of European defense firms emerged: EADS, which was made up of Aerospatiale, Daussault, the assets of Daimler-Benz, and the assets of

CASA; BAe, which had bought the military assets of GEC, Marconi, Saab, and a number of other British companies; and Thales, which was made up of assets from Thompson, Racal, and bits of several Italian companies. In the media, these firms are often described as a British-French-Italian consortium (Thales), a French-British-German-Spanish consortium (European Aeronautic Defense and Space [EADS]), and a British-Scandinavian consortium (BAe). The truth, however, is more complex. Figure 1 shows that these three consortia have many connections to one another. BAe and EADS, for example, share ownership over Airbus, the civilian airframe manufacturer, and MBDA, a joint venture that makes missiles. Thales and BAe share ownership over Thomson-Marconi, a large producer of radar and other military goods. Finally, Thales and EADS share ownership over Daussault and Thomson Dasa. The French government continues to own shares in Thales and EADS, even though, over time, it has wound down its position. It still maintains a "golden share" in each of the firms, meaning that a takeover of those firms cannot go forward without approval of the French government. In essence, the cross-ownership patterns within and across the three firms are very dense.

Conclusion

The transformation of the European defense industry since 1985 is an interesting site to observe how managers confronted by radically changing market conditions work to find new ways to preserve their firms. I have shown that the reorganization of the industry was precipitated by the shrinking of the market for defense goods in the wake of the end of the cold war. Had European defense corporations been left to their own devices without the influence of governments, they likely would have created a small number of European-wide corporations that were privately held and competed directly with one another. Instead, because of the continuing influence of European governments, a much looser structural reorganization took place. The three firms that emerged do not compete strenuously for the business of European governments. Europe is left with three large consortia that cooperate and own many ventures jointly. The identities of many of the firms remain intact. There also remains substantial ownership of two of those firms by the French government. This reorganization reflects a distinct compromise between the managers of firms who tried to undertake direct mergers and governments that were concerned to maintain some control over their ability to produce armaments.

There are three main lessons to take away from this case study. First, the process of discovering new ways to organize existing markets relies heavily on managers finding ways to solve their problems that will manage to please not just shareholders but also relevant stakeholders (i.e., governments, customers, and workers). Finding these solutions is not straightforward and often requires trial-and-error processes. Second, it is often the case that the solutions that eventually appear reflect political compromises—compromises between the various parties involved in having some authority over the decision-making process. This means that it may sometimes be difficult a priori to fig-

ure out how things might turn out. The ability of managers to push forward their vision depends on their relative power over other parties. Third, governments are always likely to be players in the reorganization of existing markets. This is because such markets rely on governments for many things, from rules governing the market to the government's role as consumer and regulator of the market. Indeed, many market reorganization projects start with the intended and intended actions of governments.

This case study has implications for the debate over the future of national capitalist models. On the one side of the debate are scholars who believe that globalization will undermine national models and the ability of governments to protect national firms (Cable, 1995; Castells, 1996; Strange, 1996). On the other side is the persistent result that any time people look carefully at the various forms of national capitalisms, they discover that the national models have great resilience (Berger & Dore, 1996; Crouch & Streeck, 1997; Hall & Soskice, 2001). This case study suggests at least one reason why national models appear to persist. Some governments have chosen different policies on whether to protect national firms or allow hostile takeovers (Roe, 2003). Where governments continue to protect national firms, there is going to be little convergence in the identity of firms and the way that they function.

The reorganization of any industry is going to take place under the rules of each national government. Some governments may decide to protect national champions by continuing to own shares of those firms and direct industrial policies. Others may decide to leave the matter entirely to managers. Although the European defense industry has been reorganized, it has done so through the lens of the policies of European governments—policies that are applied to national firms. So, the British government is prepared to see its firms bought out and run according to market principles, whereas the French prefer to maintain some control. The German government has been somewhere in the middle, preferring German firms to be private but also preferring them to remain in German hands. The result is some cross-border mergers but also consortium and alliances that preserve the national identity of firms.

Managers who face difficult economic conditions must make sense not just of what their competitors are doing but also of what their governments are prepared to accept. The case of defense contractors has one unique feature that may color the generality of our results. The main customer for their product is governments, which are also the main actors that are interested in regulating the market. Although this certainly heightens the role of government in this particular case, it is an empirical question as to the degree to which this occurs across industries and places as markets integrate across regions and the world.

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