Corporate Governance and Employees in Germany: Changing Linkages, Complementarities and Tensions[1]

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Introduction

In comparative debates, Germany is often viewed as a “stakeholder” model of corporate governance. Here two features contrast with market- or shareholder-oriented Anglo-American cases. First, the ownership of German companies is highly concentrated. Banks are argued to provide most long-term external corporate finance, act as stable shareholders and protect companies against hostile takeovers. These features support long-term capital investment and curtail managerial “short-termism” in response to volatile capital markets. Second, Germany has the most far reaching employee codetermination among OECD countries. Works councils enjoy extensive participation rights, and employees are also represented in the corporate boardroom. These institutions support long employment tenures and high skill patterns of work organization.

The literature presents two distinct views of the interactions between German investors and employees. The “varieties of capitalism” approach argues that patient capital and employee voice are seen as mutually reinforcing and complementary institutions contributing to German industrial success (Hall / Soskice 2001; Soskice 1999). Here, commitment by investors supports stable long-term employment, investment in worker training and cooperative industrial relations. Management is able to build long-term organizational capacities by drawing upon both patient long-term investment and the high-trust work organization. These institutional complementarities are seen as key institutional preconditions for the dynamic (X-) efficiency in lower volume, high quality product markets that require high skills (Streeck 1997b; 1992a).

Other approaches, notably within the “law and economics” literature, focus on how the role of employees impacts investors. Concentrated ownership and codetermination are again posited as complementary, but in the opposite sense. Codetermination is argued to hinder the emergence of dispersed ownership and shareholder-oriented corporate governance. Codetermination is argued to reinforce poor managerial accountability by dividing the supervisory board into factional benches, diluting the board’s overall powers and promoting collusion between management and employees (Pistor 1999). Mark Roe (1999, p.194) sees codetermination as increasing agency costs to shareholders, because “diffuse owners may be unable to create a blockholding balance of power that stockholders would prefer as a counterweight to the employee block." Consequently, codetermination reinforces the weakness of capital markets and lowers the number of widely held corporations.

These diverse interpretations stem from different underlying causal assumptions and imagery. Ownership structure may be seen as facilitating or constraining patterns of human resource management (HRM). Conversely, labor institutions can be viewed as an independent variable that impacts investors. Understanding how capital and labor <u>interact</u> depends strongly on what models are used to specify these relations.

This paper addresses these issues by examining German corporate governance within a sociological framework (Aguilera / Jackson 2003 forthcoming). Corporate governance involves various coalitions between capital, labor and management (Cyert / March 1963; Aoki 1986). But these coalitions are shaped by their embeddedness within institutional settings that tend to be nationally distinct—including corporate law, accounting rules, financial regulation, pension finance and industrial relations. Institutions shape the social and political processes by which actors` interests are defined ("socially constructed"), aggregated, and represented. While politics play a central role in building institutions (Fligstein 1990; Roy 1997; Donnelly et al. 2001), institutional configurations exert joint effects that may have strengths and weaknesses for different types of economic behavior (Aoki 2001).

Section 1 examines the basic features of post-war German corporate governance and human resource management as they existed through the late 1980s. Section 2 examines the institutional linkages between these features. Section 3 outlines the changes in corporate ownership and finance in Germany during the 1990s, in particular the declining role of banks and emerging market for corporate control. These changes are related to observed changes in employment and industrial relations, particularly focusing on issues of remuneration and codetermination. The conclusion argues that linkages do exist between corporate governance and human resource management, although the literature often overestimates the extent to which national business systems display an overall coherent and system-like character.

1 German Corporate Governance in Comparative Context

The German "model" defies easy categorization as an insider,[2] employee-oriented or stakeholder-oriented corporate governance. We use the broad term nonliberal to describe governance mechanisms that limit the role of markets as mediating mechanisms for both capital and labor (Jackson 2002b). Both factors of production are institutionalized based on organizational commitment and voice within governance coalitions. In this regard, Germany is rather similar to countries like Japan and distinct from liberal market-oriented economies such as the U.S. or Britain. But Germany has its own specificities. For example, unlike Japan, German firms are subject to stringent legal regulation of its internal governance structures and external regulation through corporatist associations.

This institutional logic can be described as a "constitutional" model of the firm where the voice of labor and capital is as a matter of public interest and supported through politics (Donnelly et al. 2001). Unlike a purely private association, corporations have features of a social institution that assigns non-contractual status rights and obligations to its members independent of their will and exchange value in the market. Governance involves both externalization of private interests onto corporatist associations, as well as internalization of societal interests within the firm. Outside the firm, governance is interwoven with industry-wide collective bargaining, membership in employers associations and chambers of commerce and industry, and obligations to train according the public standards in the apprenticeship system. Within the firm, decision making is densely regulated through a two-tier board system that legally separates management and shareholder control, as well as opens the supervisory board to employee representatives (See **Figure I**). Voice is shaped by strong legal institutionalization of public identities and class interests.

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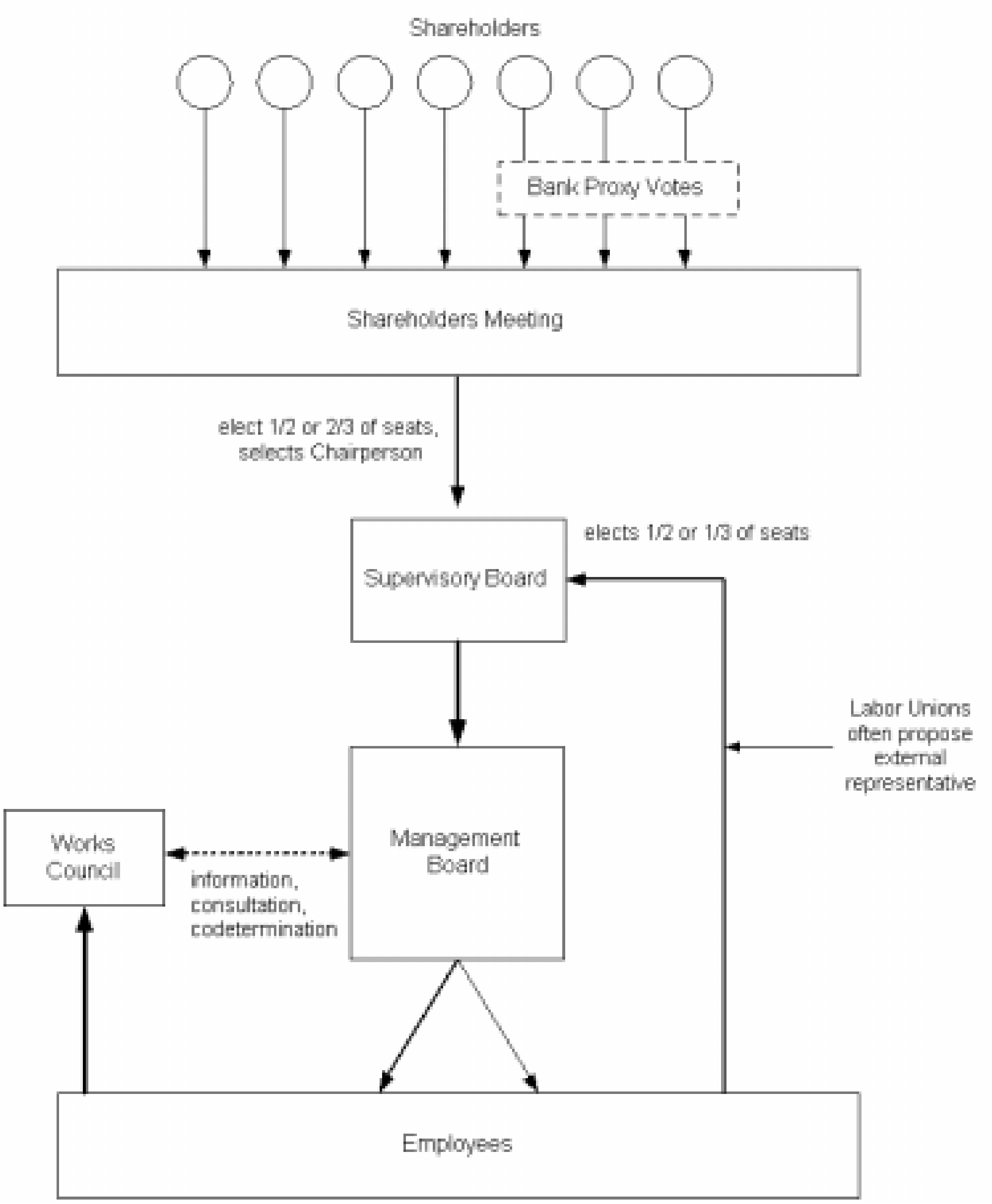
[2] For example, the characterization of Germany as an insider model would overlook the importance of "outside" interests such as industrial unions and employers associations that promote broader class interests. Moreover, the publicly guaranteed nature of codetermination rights do not fit well with the notion of an insider model.

Figure I



In this section, we examine the more specifically the role of investors, employees and management in turn. Our emphasis is on the relationship between institutional features and the high organizational commitment (limited role of markets) within German firms.

1.1 Corporate Ownership, Finance and Monitoring

Corporate ownership in Germany has three well known features: high concentration, the predominance of strategic ownership ties among corporations ("coordinated capitalism") and the importance of banks in external finance and monitoring. Open markets for corporate control are largely absent and banks play the central monitoring role among investors.

First, ownership concentration is high in Germany and minority shareholders play a limited role (Höpner / Jackson 2001). In 1998, the proportion of dispersed ownership averaged only 26 per cent among the 100 largest German companies. 18 per cent was held by families, 14 per cent by the state, 17 per cent by foreign investors, and 14 per cent by other companies and banks. This ownership structure did not change much in the last 20 years. A high proportion of large firms remain unlisted private companies, while the number and market capitalization of listed corporations are low in international comparison.

Second, ownership is closely related to strategic interests of other organizations. Pyramidal conglomerate holding companies (<u>Konzern</u>) and dense bank-industry networks are both important (Beyer 1998). Sociologically, these ownership stakes involve high levels of <u>commitment</u> to particular enterprises, unlike the more diversified and liquid trading of U.S. institutional investors (Jackson 2000). And whereas Anglo-American institutional investors are oriented to financial gains from share-price appreciation and dividends, corporations and banks tend to pursue <u>strategic organizational interests</u> in promoting cooperation between firms and generating relationship-specific rents. Dense intercorporate networks suppress markets for corporate control and create incentives for voice rather than exit.

Third, German universal banks have played a central monitoring role. Banks are closely linked to business through credit, large equity stakes, the exercise of proxy votes, and supervisory board representation (Edwards / Fischer 1994). Given different preferences of shareholders and creditors, strong banks weaken the position of minority shareholders. Bank monitoring is an element of relational financing[3] where debt and equity are commingled. These multiplex relations alleviate agency conflicts between owners and creditors, as well as diminish information asymmetries. External corporate finance is dominated by bank loans and complements a strong capacity for internal finance in the absence of shareholder pressure (Corbett / Jenkinson 1996; Borio 1990).

This pattern of ownership and control developed in close relation to several regulatory institutions. First, corporate law mandates two-tier boards that facilitate the representation of large shareholders. Second, voting rights deviate from the one share-one vote principle through multiple voting rights and voting caps. Small shareholders were also represented by banks who voted the shares held in their custodial bank deposits. Third, capital market regulations and accounting rules tend to weaken the position of minority shareholders and market mechanisms. For example, the German accounting rules are creditor-oriented and are considered to lack the same transparency as found in International Accounting Standards (IAS) or the General Accepted Accounting Standards (US-GAAP).

1.2 Employment, Industrial Relations and Work Organization

Employee voice is institutionalized through the legal institution of codetermination at the level of the Supervisory Board and the works councils.[4] Works councils have extensive rights to information, consultation, and codetermination on matters relevant to employment. The works council is legally bound to represent the employees as a whole, maintain social peace, and promote the welfare of the enterprise and its employees. Employee representatives on the Supervisory Board provide a counterweight to shareholders in the appointment of management, as well as involving employees in monitoring of strategic business

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[3] On relational financing, see Aoki and Dinc (1997, p.3). Empirical studies find that bank ownership reduces the sensitivity of investment to liquidity constraints, thus supporting the view of high financial commitment by banks (Elston / Albach 1995).

[4] Works councils at the level of the plant represent all workers. Meanwhile, codetermination also extends to the Supervisory Board, where employees are represented with between 1/3 and 1/2 of the seats.

decisions. The appointment of a labor director to the management board by the employees reinforced the consensus nature of decision making within the board.

Employment relations are characterized by a "decommodification" of labor. Employment tenures are long and exhibit a low downward elasticity over the business cycle (See **TABLE 1**). Unlike Japan , stable employment is not primarily generated through long-term incentives of internal promotion patterns and firm-specific skills. The returns to firm seniority in Germany are quite low.[5] And while employees tend to be highly skilled, training takes place within a multi-employer and quasi-public system of occupational training.[6] These skills are portable and related to broad occupations rather than firm-specific. These features reinforce each other, since strong occupational identities gravitate against generalist careers and elaborate internal promotion. The hierarchical span of control is flat, and the occupational qualifications of supervisors tend to overlap with subordinates.

Stabile employment relates to several institutional features. First, employees often lack incentives to change firms because wage differentials across firms, industries, and regions are relatively low due to industry-wide collective bargaining. Inter-industry wage differentials are significantly lower than Japan or the U.S.[7] Likewise, earnings differentials by firm size in manufacturing are very low relative to Japan or the U.S. (Jackson 1996). Second, a central goal of works councils is to stabilize core employment. Legal protection against dismissals increases pressure for internal adjustment rather than external numerical adjustment. Works councils resist short-term layoffs and mandate internal redeployment through training and transfers. Without their approval, dismissals are rendered null under German employment law. Employers are thereby forced to first resort to "benevolent" methods of employment

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5 DiPrete and McManus (1995) find large differences between the U.S. and Germany in the returns to tenure while controlling for industry and occupation.

6 Germany has a distinctive system of vocational training in roughly 400 nationally certified occupations. Training is subject to corporatist administration by employers associations, labor unions and state agencies (Hilbert et al. 1990). Apprenticeships combine elements of school-based and company-based instruction. In 1991, 72% of the West German labor force had completed apprenticeship training (BiBB 1993, p.16).

7 Inter-industry wage differentials are nearly twice as large in U.S. even when controlling for differences human capital variables (Bellmann / Möller 1995, p.152; Schettkat 1992, p.36-37).

such as natural attrition, early retirement, transfers, etc. before involuntary dismissals. Works councils support such adjustment by negotiating “employment pacts” involving measures to increase the productivity and flexibility of the workforce.

From the perspective of management, a key to stable employment are skills and training. Strong occupationally-based skills contribute to functional flexibility in the workplace, which can to some extent substitute for recruitment on the external labor market. The German training system organizes occupations into categories of overlapping skills that create a wide “substitution corridor” between occupations (Sengenberger 1987).[8] Polyvancy creates a high capacity of internal adjustment to changes in technology and products.

Decommodification is also found in issues of payment schemes and wages. Payment systems are linked to both centralized collective bargaining and the firm-level works councils. Collective agreements set minimum rates with high thresholds, as well as outlining basic provisions and premium pay (e.g. overtime, shift work rates and holidays) for each grade of employees. In manufacturing, most collective rates are time rates for each grade. Payment-by-results, such as piecework, are also common but do not result in much individual variation in wages. Collective agreements specify criteria for firms to categorize jobs into standardized grades: job evaluation methods, including detailed weightings for skill, knowledge, responsibility, and factors in the work environment (dust, gases, noise, vibration, etc.). Works councils play an important role in monitoring the implementation of industry-wide agreements at the company level.

Remuneration patterns have several notable features relevant to corporate governance. First, the scope for firm-level variation of wages and working conditions is considerably reduced by industry-wide bargaining. Large and successful

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8 For example, apprenticeships in German metalworking occupations last 3.5 years. 6 occupations share an identical basic training the first year . In the second year, these occupations split into 3 "groups" that share an additional half year of training. The next half year is spent in training in 6 broadly defined occupations. Finally, the last 1.5 years are spent within one of 17 specializations. Unions have pursued a strategy of lengthening and broadening occupational training, thereby drastically reducing the total number of occupations over the last decades (Jackson 1993).

companies often pay a wage premium above the level of collective agreements.[9] But their scope remains limited. Second, individual variability of pay is also reduced. Given union commitment to principles of equal pay for equal work, firm seniority plays little or no formal role in the determination of individual pay (hence, the flatter age-earnings profile). Employees are graded largely according to their qualifications. Works councils help assure that only workers with particular qualifications get access to certain jobs and prevent skilled workers form being classified into unskilled jobs.[10] Third, income inequality is generally low given the flat wage structure and relatively high wages. Income differentials between top management and production employees are thus compressed relative to Anglo-Saxon countries.

Industrial relations are characterized by strong employee voice through codetermination within the firm, as well as multi-employer collective bargaining that regulate wages and working conditions on an industry-wide basis. Employee influence thus has dual channels: employees represent their interests as producers in a particular enterprise through codetermination and their broader class-wide interests through collective bargaining. Works councils are closely involved in issues of work organization, working conditions, etc. Moreover, works councils also have functions as a long arm of the industrial unions by monitoring the implementation of collective agreements and occupational training.

Centralized, industry-level collective bargaining imposes comparatively uniform wages across firms and limits dispersion across industries. German unions pursue solidaristic wage policies that seek to actively narrow the earnings gap or promote uniform wage increases for all groups. Employers associations may discipline their members who pay too far above the premium. Standardized wage structures across firms eliminate or at least attenuate wage competition in the national market.

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[9] See Bellmann (1995) on the determinants and levels of wage agreements above the collective rates.

[10] The link between pay grading and qualification is not direct (e.g. everyone with this qualification must earn a standard salary) but is steered through the system of jobs.

Work organization in industry is characterized by high functional flexibility and incremental patterns of innovation. These features are closely linked to the characteristics of employment relations and industrial relations discussed above. German firms face high and uniform wages imposed by centralized collective bargaining, making wage differentials between low level unskilled workers and skilled workers small (Jackson 1996). Uniform wage increases mitigate the effects of supply and demand on the relative earnings at each skill level and create incentives for the substitution of skilled for unskilled labor. As Streeck (1992a, p.32) argues, "A high and even wage level also makes employers more willing to invest in training and re-training as a way of matching workers' productivity to the externally fixed, high costs of labour." Firms accommodate high wages by migrating into "high end" markets where competition is based on quality rather than price. This productivity whip is only functional as a constraint to the extent that high and flexible occupational skills are also present and contribute to the X-efficiency of work organization.

1.3 Management

German managers contend with strong voice from concentrated owners and banks, as well as employees and unions. Given this pluralistic set of interests, management face dual pressures for both long-term profit maximization and employee utility (Aoki 1988). These dual pressures are somewhat attenuated by a highly consensus-oriented management culture. Interests must be negotiated in shifting coalitions that involve patterns of horse trading, issue linking and package deals between different groups of management. This consensus orientation is supported by several institutional features making up the social world of German management:

- Management careers tend to follow functional specializations, even within the management board. Educational backgrounds in science and engineering dominate the highest positions. Managers remained tied closely to their occupation (*Beruf*), and thus conspicuously lack a generalist orientation. The strong tendency for technical functions to be incorporated into the management hierarchy limits the relative importance of financial economics (Lane 1993).

- Managerial authority tends to be rooted in technical competence rather than supervisory or business-related skills. "Management" is not so strongly set apart from other occupational groups in either educational background or forms of compensation. This productivist ethos of the business organization acts as an integrating mechanism, with strong focus on incremental technical innovation, quality standards and build-up of long-term market share .

- The legal principle of collegiality in the management board gravitates against strong dominance of the President, and balance financial considerations with other management functions such as operations and personnel.

- Moderately high rates of internal promotion and long management tenures help stabilize the long-term relations that top managers enjoy with their suppliers, customers, other corporations, banks and works councils. The limited role of the external labor market also favors the orientation toward long-term profits instead of short-term success.

- Managerial compensation traditionally avoided high power incentives such as stock options.

2 Institutional Linkages, Complementarities and Tensions

How do these institutional features of German corporate governance interact? What linkages exist between corporate ownership and control, on one hand, and the role of employees, on the other?

Institutions in different domains may be viewed as complementary when one institution becomes more viable in combination with specific other institutions. Complementarities do not imply economic efficiency, but a process of mutual reinforcement. For example, the welfare effects of an institution A may increase in combination with institution B, but not with institution C. But interdependence may also create tensions because institutions imply conflicting principles of rationality (Lepsius 1990). For example, codetermination may be seen as diluting ownership rights and thus destabilizing particular patterns of organization. The issue of institutional complementarity should not be confused with a principle of self-similarity across domains. For example, codetermination may be a beneficial countervailing element to owner control. More generally, contradictory organizing principles may be a source of requisite variety for organizations, as well as provide for flexible and beneficial recombination of practices (Stark 2001).

Here an important methodological issue is arises. Specifying complementary relationships requires the elaboration of theoretical models linking economic functions across institutional domains. And yet, corporate governance influences multiple dimensions of economic activity. Organizational goals should often be seen as the outcome of governance processes, rather than organizational goals as determining the choice of governance institutions. This inherent selectivity of economic models may account for a pronounced tendency in the literature to see institutions as being very tightly coupled and exerting strong causal influence as complementary elements of a system.

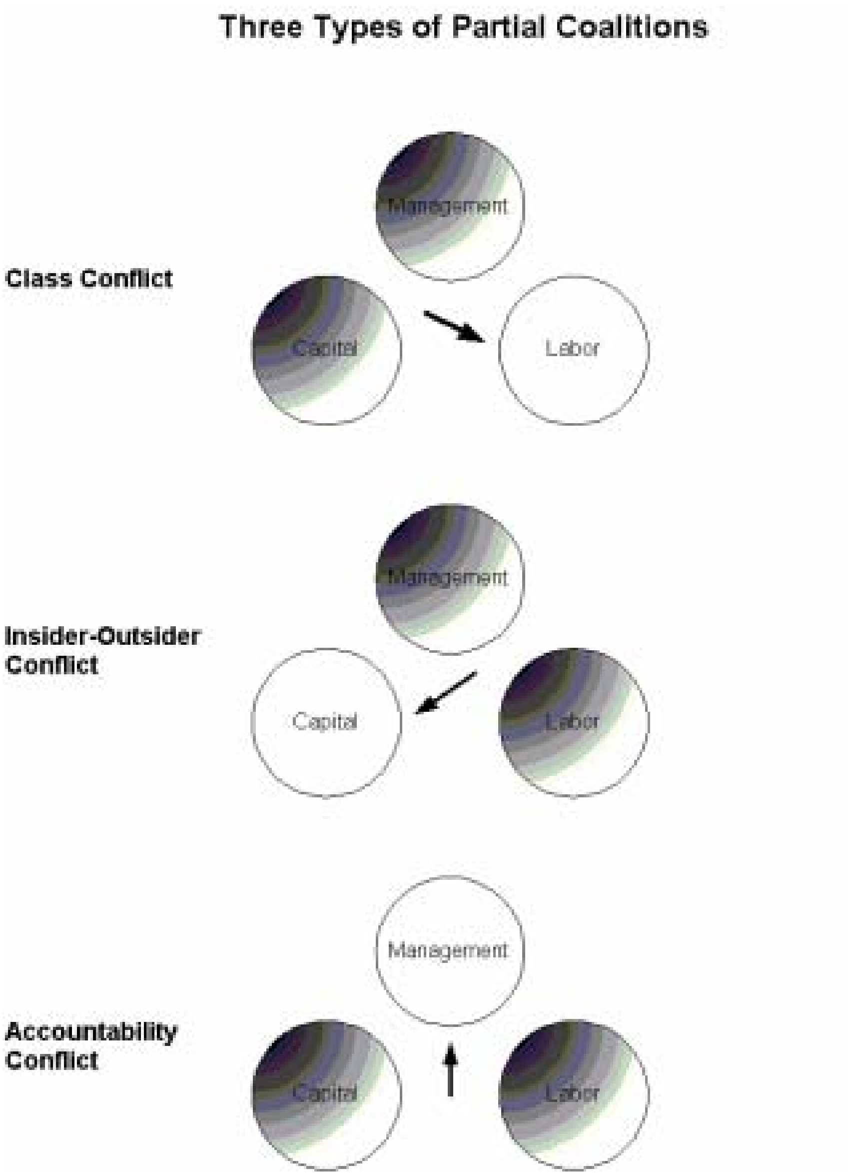
Rather than presenting an economic model, we analyze these relationships as governance coalitions from a sociological standpoint. Whether stakeholder interests exist in positive- or negative sum relation depends upon the issue area at hand, as well as the institutional definition and anchoring of control rights. By making interest constellations into a variable, three ideal-typical patterns can be observed: class conflicts, insider-outsider conflicts, and accountability conflicts.

- **Class conflict** manifest when shareholders and management have similar interests vis-a-vis employees, particularly regarding distributional issues such as wages or selected personnel and social issues.

- **Insider-outsider conflicts** may arise when employees and management have similar interests vis-a-vis shareholders. This is often assumed in agency theory, such as when insiders favor internal diversification („empire building“) or may block efforts at restructuring. Another salient issue here relates to takeover defenses, which may be favored by corporate insiders at the expense of outside shareholders.

- **Accountability conflicts** may arise when shareholders and employees align their interests vis-a-vis management. For example, both groups may favor measures to improve corporate transparency and disclosure. Information on company performance or transparent definition of profits may be used by both groups as a tool to control management, even when they oppose each other on how corporate surplus should distributed. Similar constellations may also appear around issues of risk management or in preventing perverse incentives in managerial compensation.

Figure 2



2.1 Class Conflict

Class conflict must be contextualized through a consideration of what interests dominant owners pursue and how these interests impinge upon the distributional outcomes for labor (and vice-versa). We argue that several features of ownership were historically important reducing class conflicts in Germany and facilitating mutually agreeable distributive outcomes:

- (1) Intercorporate and family ownership bind capital to the long-term fate of the firm, and stress long-term strategic interests of the firm over short-term pressure for financial results;
- (2) Lower stock market capitalization stabilized a competitive rate of return to capital while placing fewer constraints on the share of value-added going to labor;
- (3) Protections from hostile takeovers guard against "breaches of trust" that would otherwise endanger cooperative industrial relations, stable employment and incremental innovation and learning in work organization.

Despite common views that shareholders are neglected, marginal returns to shareholders in Germany were quite favorable in comparative terms[11]and gave investors little incentive to exit. Comparisons of German and British corporations (Höpner / Jackson 2001) have shown that shareholder returns are quite similar at the margin when measured in price-earnings ratios or dividend yields. Yet top British corporations averaged over double the market value of the German corporations. German shareholders thus received competitive rates of return as long as market capitalization remains low, i.e. ownership remains concentrated among existing stable shareholders. And as a consequence of higher market valuations, British corporations produce higher operative rates of return (19.2% EBIT to sales compared to 9.4%) to sustain similar returns to capital. Meanwhile, top German corporations employ twice the number of employees (138,000 vs. 61,000 employees) and generate higher turnover (38 million Euro compared to 22 million).

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[11] The real rate of return on the national stock market index averaged 10.2% in Germany and 7.8% in the U.S. between 1950 and 1989 [Jackson, 2001 #463].

Given the absence of strong distributive constraints from the capital market, German firms retain the option of pursuing business strategies other than maximizing return on equity (Ide 1998): firms can pursue higher market shares through strategies of forward-pricing; firms can spend more on capital investments and / or R&D; firms can absorb higher raw materials costs; firms can concentrate on market segments offering lower returns but having large market size and relatively low risk; firms can absorb higher la2bor costs, thus avoiding layoffs more easily during cyclical downturns and thereby protecting employee morale and firm-specific human capital. These distributional options helped firms to accommodate employment rigidities, high wages, and strong employee voice as corporations specialized in strategies of "diversified quality production" (Streeck 1992b).

It is worth noting that this distributive pattern is unlikely to be sustainable under an open market for corporate control. Here, the lower market to book values (price–book ratio, PBR) create high takeover premium and make firms vulnerable to predator firms with higher market valuation. Thus, De Jong (1996) argues that the absence of takeovers is a central prerequisite for the high share of value-added going to employees in Germany.

2.2 Insider / Outsider Conflicts

Under conditions of rapid economic growth, conflicts between insiders and outsiders were not predominant in Germany. Labor unions were able to achieve high equality of wages, while high growth secured employment. In this sense, German labor markets were characterized by remarkably little "dualism" as found in the U.S. or Japan.

[to be completed]

--do employees contribute to the agency costs of ownership (insider / outsider)?

--multiplexity of ownership with strategic interests help reduces insider / outsider dilemma

--class-wide vs. firm specific labor interests

2.3 Accountability Conflicts

Issues of accountability are perhaps the hardest to access in terms of an objective set of outcomes. While post-war Germany has had its share of corporate scandals and tails of managerial excess, the stability of the financial system has remained quite stable until recently.

Germany has received much criticism in terms of transparency and information disclosure. Conversely, private information is often thought to be an important part of German governance. For example, universal banks were thought to have extensive access to private information through their multiplex relationships as creditor, owner and board member. Moreover, banks achieved excellent economies of scope through comparable information from competitors and other firms throughout the sector. Another element concerns employee representatives. The Supervisory Board members sent from the works councils bring detailed knowledge about the actual operations in different divisions and often have extensive consultation with management within the economic committees of the works councils. Taken together, these sources of private information exchange may improve corporate accountability in the absence of more public information disclosure.

Similar debates surround board effectiveness in Germany. Supervisory boards are often criticized for being too large, poorly informed and hence too inactive in monitoring. Another stream of criticism concerns codetermination and the possibility of factionalism within the board leading to ineffectiveness. Yet the two-tier board system does provide for the clear separation of management and monitoring functions now advocated world-wide. Also boards have a large number of outsiders, although much debate remains as to whether they are effectively independent or whether their strategic relationships provide detrimental conflicts of interest. These debates cannot be discussed further here. However, no quantitative evidence exists to show that German firms are slower to remove poorly performing management than U.S. boards

3 Changing Institutional Interactions since the 1990s

As described above, German corporate governance proved to be a relatively stable "model" during much of the post-war period. Institutional complementarities fostered stable distributional compromises to reduce class conflict, while insider-outsider and accountability conflicts were held in check. But since the mid- 1990s, German corporate governance has come under considerable pressure for change. Economic pressures of internationalization and political pressures for liberalization promoted a growing role of capital markets. "Shareholder-value" became widely discussion as a new paradigm of management with greater focus on stock price, core competence, transparency and investor relations activities. Debate ensued as to whether Germany would (or should) converge on a liberal U.S.-style system of corporate governance that reflected international standards for investor protection.

How will the trend toward shareholder- or market-oriented corporate governance impact human resource management and institutions of employee representation? The existing literature posits a tight fit between capital market institutions and labor institutions, but presents divergent hypotheses. Strong institutional complementarities may gravitate against change and allow only gradual "path-dependent" evolution. For example, codetermination would be expected to prevent the emergence of dispersed ownership and active capital markets. Yet institutional complementarities also suggest that changes in one set of institutions will lead to changes in the other linked sets of institutions. Here change would ripple through the system and lead the German model to collapse like a house of cards. Move toward market-oriented capital would require a "fitting" set of market-oriented labor institutions characterized by stronger external labor markets, numerical flexibility, variable pay, and fewer vested rights to participate in managerial decisions.

This section examines how changes in capital market pressures are impacting German HRM and industrial relations. We begin by reviewing some selected empirical findings from our own work on the changes in corporate ownership and monitoring during the 1990s (Jackson 2002b; Höpner 2002; Höpner / Jackson 2001). The subsequent changes examine the role of employees in greater detail.

3.1 Changes in Corporate Ownership and Management

Since the mid-1990s, a number of important changes in corporate ownership and monitoring have become apparent. Here we highlight a few features: the rise of new institutional investors, the erosion of monitoring by banks, and the emergence of a market for corporate control. These trends are most pronounced among large internationally-oriented corporations.

Furthermore, the monitoring capacity of German banks has been substantially eroded by the change toward more "marketized" ownership and capital market rules, leading many leading of the core private banks to move away from "house bank" relationships and enter into the Anglo-American dominated field of investment banking. The declining stability of the German corporate network and weakening of legal protections from shareholder pressure have led to the emergence of a market for corporate control, albeit on a limited scale.

First, the most noticeable change in corporate ownership in the 1990s is the rise of institutional investors and the internationalization of stock ownership. Data on the aggregate ownership of listed shares in Germany (see **TABLE 2**) show a rise among foreign investors, who are predominately Anglo-American institutional investors such as pension funds and mutual funds. Furthermore, domestic investment funds are growing. These groups are concentrated among large corporations: at Veba (e.on) 75%, Bayer 68%, SAP 55%, BASF 73%, Schering 74%, Thyssen 78%, or Bilfinger+Berger 55% of all shares were owned by institutional investors (Höpner 2001). In 1999, British and American funds alone help 40 per cent of Mannesmann shares, 31 per cent of DaimlerChrysler, and 27.5 per cent of Deutsche Telekom.[12]

These changes in the identity of owners have led to new types of pressures from investors. New institutional investors pursue financial interests through their investments, thus favoring profitability over growth and shorter time horizons. Institutions also have a strong preference for liquidity ("exit" rather than voice) and generally refrain from active intervention in the fate of particular firms. Empirical

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[12] Handelsblatt, 8.11.1999

studies show that institutional investors only rarely attempt to influence management (Steiger 2000)[Price Waterhouse / ZEW, 1998 #4739: 5; Engelhard, 1998 #4752]. Their corporate governance capacity lies in professionalizing information-gathering and investment strategy (exit). Therefore, stock prices are becoming more responsive to management decisions and more volatile. Their investor “activism” targets the promotion of general practices of “good governance,” but rarely translates into strategic interest in corporate control.

The stability and concentration of ownership is conversely Looking again at **TABLE 2** shows that the growing proportion of institutional investors went with a declining shares among individuals, the government and other non-financial corporations. While growing “institutionalization” increases concentration, a parallel to a trend exists toward de-concentration of ownership and unwinding of tightly linked corporate networks. Privatization of government enterprises is one important factor. However, the overall density of corporate networks in Germany is declining (Windolf 2000). This development will likely since the “*Eichel-Plan*” abolished tax on the profits of sales of share blocks (Höpner 2000).

Second, monitoring by banks is substantially eroding for several reasons. Bank credits to large corporations have substantially declined, as these corporations have become largely self-financing (under conditions of slow economic growth) or have new alternative modes of finance (Jackson 2002a). Several large private banks have undertaken a strategic reorientation toward Anglo-American style investment banking. The move from the *Hausbank* to investment bank paradigm contradicts their willingness to play a major role in the monitoring of industrial companies {Höpner, 2001 #576; Beyer, 2001 #4781; Deeg, 2001 #585}, because a close relationship to industrial companies would weaken their reputation among international customers of financial services. The withdrawal of banks from active monitoring is evident in the declining number of Supervisory Board chairs held by bankers among large corporations (Höpner 2001). The *Deutsche Bank* is leading this trend, and has reduced its supervisory board chairs by nearly half. A last point concerns the direct ownership stakes of banks. Also, banks investment portfolio has become more market-oriented and less focused on stable relationships. As bank board members decline, a rapidly proportion of supervisory boards are headed by ex-managers from inside.

Third, the barriers to hostile takeovers have significantly eroded and led the emergence of a market for corporate control on a limited scale. The takeover of Mannesmann by the British Vodafone in early 2000 was a watershed case illustrating the extent of change in Germany. Contrasting Mannesmann with other takeover attempts targeting German companies in the 1990s shows the erosion of barriers against hostile takeovers (Höpner / Jackson 2001):

- As large banks change from the *Hausbank* paradigm to the investment bank paradigm, banks are giving up their role as guardians against hostile takeovers. For example, *Krupp*'s takeover attempt for *Thyssen* in 1997 was the first case where the Deutsche Bank supported a takeover attempt.

- The corporate law reform (the *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* or *KonTraG)* (1998) forbid voting rights restrictions; these restrictions were one of the most important of Continental's defensive actions against the takeover attempt of the Italian tire company Pirelli. Additionally, the *Kapitalaufnahmeerleichterungsgesetz* (KapAEG) (1998) made the economic worth of corporations more transparent.

- Codetermination does not act as a strong barrier to hostile takeovers any longer. Comparing the cases of *Thyssen* (1997) and *Mannesmann* (1999 / 2000), one can see that unions have changed their political attitude towards hostile takeovers: from fundamental opposition against "predator capitalism" in 1997 to a pragmatic acceptance of hostile takeovers as an inevitable instrument of economic behavior in 2001.

In conjunction with the changing role of shareholders and monitoring, German management boards are also undergoing extensive change toward a greater finance orientation and away from the traditional science and engineering focus. This shift is symptomatic not only of shareholder demands, but the internationalization of managerial labor markets and the growing encounter of German junior management with Anglo-American management cultures. Information has been collected on the careers of all 90 top managers who were chief executives in the 40 biggest listed industrial corporations in the 1990s.[13] A few findings on the development of the career and education features of top managers in the 1990s can be summarized.

- A strong trend exists towards professionalization. The share of chief executives without higher educational training declined from just under 14 per cent to zero per cent in 1998 and 1999.

- The share of top managers who went through the German apprenticeship system is in decline (from 30 per cent in 1990 to 15 per cent in 1999).

- Most remarkably, the role of the external labor market is clearly rising. In 1990, 17 per cent of the observed top managers were recruited from outside; in 1999, the percentage rose to more than 35 per cent. The role of in-house careers is declining.

- The percentage of top executives who can be classified as financial experts[14] is rising. 39 per cent of chief executives have studied economics, 24 per cent have trained as lawyers, and 32 per cent have studied natural science or technical subjects.[15] Comparing these data with information on the 1970s [Poensgen, 1982 #4780] suggests a strong decline in the role of natural science and technical subjects.

- The average time in office among top managers is in dramatic decline, from more than 13 years in 1965 to less than 7 years in 1996. Please note that only completed times in office were quoted, so the line should have no “natural” tendency of decline.

These changes in the “social world” of top managers help explain why shareholder value strategies enjoy high reputation among managers. The changing social background and career incentives for management influences their perception of corporate goals . The emergence of a highly competitive labor market for managers requires the application of measurable performance criteria such as CFROI, EVA™ and – of course and objectively comparable – share price development. At the same

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[14] Top managers who once worked for the financial division of any company were classified as financial experts.

[15] These data were weighted for the duration of the time in office.

time, the willingness of supervisory boards to fire top managers is on the increase. In the 1990s, several chief executives were forced to retire from office because of bad performance and the resulting crises of confidence in the supervisory board, for example Horst W. Urban (*Continental*), Anton Schneider (*Deutz*), Bernd Pischetsrieder (*BMW*), Heinz Schimmelbusch and Heinrich Binder (*Metallgesellschaft*), Bernhard Walter (*Dresdner Bank*), Dieter Vogel (*ThyssenKrupp*). Beyond that, the increased importance of financial economics in education and career favors the willingness to utilize financial indicators.[16]

In sum, new investor pressures and changing management have had strong consequences for the strategies of large German corporations and the relations among stakeholders—these changes can be expressed as a rise of a shareholder-value paradigm (Jürgens 2000; Vitols 2000; Streeck 2001). In the early 1990s, the conglomerate VEBA was one of the first companies that sought to raise the importance of financial interests of shareholders within corporate policy. In the mid-1990s, numerous other companies such as Bayer or BASF or Siemens followed suit.

Shareholder value policy (henceforth SV) aims primarily at making the market cost of capital the hurdle for corporate investment. In order to meet the minimum return to capital, SV aims at the end of cross-subsidization between the various segments within the firm. Alongside implementation of this strategic principle, transparency for outside investors (information quality in corporate reporting, investor relations work) and a variable management remuneration linked to shareholder relations are key elements.

TABLE 3 shows a ranking of the shareholder-value orientation of the 40 largest listed German non-financial corporations in the late 1990s (1996-1999) (Höpner 2001). The ranking touches upon the three major dimensions of

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[16] In interpreting these changes, the causality might be recursive. A given shareholder value orientation should also raise the demand for financially oriented managers. What is emphasized here is a distinct, non-recursive influence of “management culture” variables on management behavior. The professionalization and the marketization of management create a climate that favors some management ideologies more than others.

shareholder-value management.[17] The communication dimension involves the issue of transparency toward investors. Here intensive investor relations work is important, as well as adopting international accounting principles and reporting business results by business segment. The operative dimension aims at the implementation of value-oriented performance targets and monitoring systems. The last dimension is management compensation: increasing percentages of pay are contingent on the financial success of the corporation, particularly the performance of share prices. The degree of shareholder-value orientation varies substantially among German companies– which imply that the divergence in corporate governance inside the German economy is rising. This variation will be used in the following sections to examine the changes in other areas of human resource management.

3.2 Interactions with Employment Relation

This section examines how SV impacts the key aspects of employment relations, namely stable employment and the egalitarian wage structure. It is widely hypothesized that increasing SV orientation will lead to class conflict and a redistribution of wealth in favor of shareholders. As discussed above, Henk de Jong (1996) showed that the distribution of value-added between stakeholder groups varies strongly between corporate governance regimes. Germany is characterized by its high labor share and relatively small returns to shareholders, supporting its high-wage economy. Furthermore, high rates of internal reinvestment and focus on growth rather than profits help stabilize employment of core employees. The growing SV orientation and increasing threat of hostile takeovers suggests that these distributive relations may changing in an Anglo-American direction.

Shrinking Core Employment. Beyer und Hassel (2001) have analyzed the changes in the distribution of value added among large German corporations in the 1990s. Their findings confirm the above hypothesis: in SV oriented companies, the distributional position of shareholders has improved modestly at the cost of

[17] The indicator includes four items: the information quality of the corporate reports, the degree of investor relations efforts, the implementation of value-orientated performance targets and the incentive compatibility of managerial compensation.

employees. The improved position of shareholders is explained by high profits being distributed as higher corporate dividends. The redistribution effect is explained by the fact that SV orientation favors strategies of lower rates of growth and declining employment, while profits increase. Commitment to core employees remains strong, but the core of stable employment is shrinking through the increased used of negotiated employment adjustment and benevolent methods such as natural fluctuation, early retirement, part time work, etc. For example, the restructuring program at VEBA involved 29,000 layoffs managed through early retirement with 90 percent salary.

As shall be discussed below, shrinking core employment has not marginalized works councils. Works councils remain active in negotiating "site pacts" to keep high value-added production in Germany (Rehder 2001). First, in order to assure investment in core plants, works councils grant cost-cutting concessions: lower social standards, the elimination of premium wages above collective bargaining rates or cuts in bonuses for overtime and shift work (Nagel et al. 1996, p.99). Second, employment alliances involve concessions on wages or working hours in exchange for employment guarantees over a period of two to four years.[18] Work may be redistributed through reduced or flexible working time, or made cheaper by reducing company premiums above industry-wide rates .

Variable Compensation as a Consequence of Shareholder Value. The cause of the declining labor share described above is not a sinking wage costs per employee. The wage bill per employee is actually rising and may help explain why core employees have not mounted stronger resistance to restructuring. The major shift has been toward variable or contingent remuneration schemes. Compensation practices that link workers' pay more closely to individual and company performance[19] have diffused rapidly since the mid-1990s—although this development lagged behind countries such as the U.S., Great Britain or even France. Individualized wage components and remuneration schemes tying worker income to

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18 Pioneering examples can be found at Mercedes Benz, Bayer, Continental, and Adam Opel.

19 The term "performance-related pay" will be used for payments contingent on the performance of individual workers, whereas "profit-related pay" stands for payments that are related to the performance of the company.

the fortunes of the enterprise were successfully by unions and works councils. German labor supported a homogenous wage structure, secure and stable incomes, and protection from ratcheting performance standards.

However, variable pay schemes are now becoming widespread among large German firms, both at the managerial level as well as for non-executive employees covered by collective agreements (add footnote details of study). Many firms changed their compensation systems to permit greater differentiation among employees and increase the share of pay that is variable and related to both individual and company performance. They also make greater use of employee stock ownership plans. The details of variable pay programs differ considerably across companies, but all of them place an appreciable share of the pay of employees at risk (see **Table 4**).

Some firms initially introduced company-wide bonuses because profits were high. But these "on-top payments" are rare. Rather, fixed but company-specific wage components that were paid above industry-wide wage agreements are being gradually replaced by variable components. Performance-related pay such as piecework - with rates negotiated by unions - is being replaced by budgeted performance appraisal systems. Such systems have been introduced to counter the egalitarian effects of collectively negotiated wages and greater reward for individual performance. Firms have also begun setting targets for individual performance ("goal setting") that are linked to financial rewards. Another new phenomenon is linked forms of performance- and profit–related pay: a profit-related budget is distributed according to individual performance. Linking pay to company performance is supposed to fulfill a variety of purposes.

One purpose is using financial rewards to strengthen work effort and to align individual incentives with those of the firm. Here variable pay is a major issue of internal performance monitoring. Performance related pay is supposed to help focus employee effort on key job objectives and to clarify the links between job objectives and overarching business goals. Furthermore, variable pay is aimed at giving greater recognition to outstanding employees and to thereby increase motivation. Employees are encouraged to identify with and feel committed to the company. They start to think about generating revenue, reducing costs and maximizing profit which stimulates entrepreneurial decision-making.

A special form of participating in the company's success – and a way of bringing shareholders' and stakeholders' interests closer together - is the introduction of employee stock ownership plans or stock options. With share ownership, the link between individual performance and financial reward is less direct than with other performance-related pay, profit sharing or other annual bonuses. The employee has hardly any influence on the share price and the motivational qualities are therefore limited. The advantages are the long-term character that binds employees to their company and enforces commitment.

Another purpose of variable pay is to increase the flexibility of business cost structures over time. When profits are high, compensation will be higher than without variable pay and lower when business is weak. Employees have to accept risk to share in the rewards of improved performance. Furthermore, managers expect a positive cost effect because of increased productivity or at least a better form of cost control. Given these different reasons for introducing variable pay, flexible remuneration schemes obviously fulfil purposes not only of performance but also of financial management.

The rise of variable pay in Germany can partially be explained by increasing competition on product markets and cost-cutting pressure. Nevertheless, a strong connection exists between the use of variable pay and the adoption of shareholder value strategies (see **Figure 3**). Variable performance-related pay for managers is one of the key characteristics of SV, and the correlation should not be surprising with regard to executives' compensation schemes. What is remarkable, however, is that the rapid diffusion of performance-related pay for managers to other parts of the company. This phenomenon has several explanations:

- First, SV strategy often includes performance-related pay for all employees, not only for management. The company's performance is supposed to be the one and only target aimed at by every single employee. Both the shareholder and the stakeholder benefit from the congruence of employee goals and financial rewards. Works council members sometimes argue that performance-related pay should be documented in the annual report in order to attract shareholders.

- Second, as bonuses for managers and dividends for shareholders rise, employees demand their piece of the cake as well. Bonuses for employees can reduce the conflict between shareholders and employees by giving a certain budget to the employees, instead of serving the shareholders first and letting employees divide the rest. Managers can also justify their own high income more easily as long as high bonuses are paid to the whole workforce.

- Third, existing SV strategies simplify the introduction of profit-related pay because the relevant business indicators are already calculated and announced. When target rates of return are set, reasonable rewards for meeting targets sound plausible.

- Finally, companies introduce SV strategies as a protection against hostile takeover. Increasing employee ownership can also function as a takeover protection and might therefore gain prominence in the future should hostile takeovers become more common.

The empirical evidence shows that variable pay is predominantly used by companies that compete in global markets and have adopted a SV orientation. The rise of variable pay in Germany can thus partially be attributed to changes in the financial regime.

Once in place, how do variable pay schemes impact corporate governance? Profit-related pay may indeed reduce class conflict over the distribution of rewards between shareholders and employees. In Germany, it can be shown that in most companies where dividends increased, strongly profit-related pay was also implemented for lower level employees. The most direct way to align shareholders' and employees' interests is, of course, the introduction of employee stock ownership plans. However, the introduction of employee ownership is yet to have a large impact on corporate governance. In some companies, employee shareholders now begin to organize to exercise their voting rights as employee owners collectively—for example, to prevent hostile takeover bids. Nevertheless, the percentage of capital is owned by employees rarely even reaches the 2% mark. Compared to employee ownership rates in the U.S., for example, this is a negligible proportion. The amount of shares held by single employees is also rather small, and far too small to place the interests of an employee shareholder as a shareholder above the interests of him as an employee.

Variable Pay and its Impact on Industrial Relations. Beyond its impact on employment relations, variable pay also has indirect effects with other linked institutions, particularly Germany's industry-wide collective bargaining. In principle, contingent compensation contradict certain aims of German collective bargaining, namely a homogeneous wage structure, secure and steady incomes and a protection against high and continuously increasing performance standards. Yet German variable pay programs have been implemented in conformity with collective agreements. Up until now, company-specific pay systems coexisted within companies alongside collective wage agreements. Companies were always able to pay performance-related rewards above the collectively agreed basic pay. The high occurrence of variable pay among banks and the chemical industry, where the wage drift is traditionally high, is evidence of this phenomenon.

Recently, new collective agreements incorporating new forms of profit-related pay have emerged, although exclusively at firm level. A new and highly recognized form of collective agreement was the one made at Debis (Daimler Chrysler Services AG) in 1999. It stipulates that up to 10% of annual income depends on the individual performance and a further 10% on the performance of the company. This collective agreement was made by the union of the metal industry (IG Metall) and Debis.[20] After Debis was purchased by Deutsche Telekom, a number of these innovations were copied in other parts of the company. Other collective agreements link part of the negotiated wage increases to the economic performance of the firm. Here both parties agree in advance that if a certain performance is reached, additional wage increases will be awarded (for example, Schott AG).

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[20] It is open for other companies in the IT sector to use, but no other firm applies it as yet, although other companies such as Infineon are trying to implement similar agreements.

As to individual performance-related pay, an important trend is to replace formerly fixed payments or potential wage increases by a budget used for performance-related bonuses. During the recent round of collective wage bargaining, the Deutsche Telekom AG agreed upon a model that increases wages by 1% and uses a further 2.15% for variable components. For the forthcoming year, an increase of 2.3% was agreed upon. However, there will be no linear increase. The volume of 2.3% of all wages will be distributed according to individual performance.

The regulation of variable pay via collective agreements is now discussed broadly at the industry-level. The main point of discussion is whether formerly fixed payments will be changed into a budget for flexible performance-related payments. But there are also discussions about the regulation of profit-related pay. The consensus seems to be that in the long-run there will be an adjustment of collective regulations to remuneration practices at the company-level, probably restricted to framework regulations while the formation of the remuneration scheme is left to be dealt with at company level in consultation with works councils. Thus, contingent pay does not only emerge "in spite of" collective agreements but in some cases is also supported by the system of collective bargaining.

Incorporating variable components into collective agreements threatens the notion of industry-wide collectively agreed wages or at least lowers the portion of income regulated by collective bargaining. Thus one of the main functions of collective bargaining – to attain a homogeneous wage structure – would no longer be fulfilled. As collective agreements frame conditions for variable pay, they support the differentiation of wages over time as well as between firms and individual employees. In some companies, collective wage bargaining no longer provides steady and linear wage increases but leads to an increase in the volume of wages, depending on the performance of the company, which is distributed unevenly among individuals.

In sum, the emergence of company-specific remuneration systems – either in form of a works agreement between works councils and management or in form of a collective agreement at company level between the union and management – brings about two major changes in the process of determining individual wages.

Firstly, it reinforces the decentralization of wage bargaining. Unions partially hand over their influence on the development of earnings to works councils. As yet, variable wage components do not substitute for base pay. However, while traditional variable pay systems such as piece rates were subject to collective bargaining, the new forms of variable pay are rather “an individualist management tool and may be used to either replace collective bargaining or reduce its significance in pay determination” (Gunnigle et al. 1997: 126). The large rewards associated with variable pay may also be intended to weaken union penetration in new sectors such as IT. This might make it more difficult for unions to organize low level employees collectively, especially where works councils acknowledge principles of competition and risk-taking as ways to raise the profitability of the company.

Second, incomes are becoming more marketized. The determination of wages is to a greater extent based on individual performance and on market mechanisms in the form of business indicators, e.g. cash flow or return on investment. A smaller portion of the individual wage is set by collective wage bargaining and a larger portion underlies entrepreneurial principles like risk-taking and competition.

3.3 Interactions with Industrial Relations

This section examines two questions. First, how do workers councils and unions impact the implementation of shareholder-value management? Do they support, oppose or remain indifferent and / or ineffective in this process? Second, how does the shareholder-value paradigm impact the existing institutions and practices within German industrial relations?

The Impact of Industrial Relations on Shareholder Value. Organized labor has not blocked corporate restructuring but played a subtle role shaping the implementation of corporate strategies aimed at improving share price performance (Höpner / Jackson 2001; Höpner 2001). This “co-management” role has preserved a basic continuity in industrial relations institutions, but shifted its functions over time.

The role of the trade unions and works councils is most clear with respect to the communicative dimension of SV. Here German trade unions have decided to side with shareholders. Unions recognize that international accounting standards, whether IAS or US-GAAP, seem to be, at first sight, investor oriented. Yet unions also see them as increasing transparency and accountability for employees as well. Company transparency is an old demand of trade unions, because the aim of codetermination is to control economic power and authentic information is a condition for control. Unions have supported the legislation on company finance (*Kapitalaufnahmeerleichterungsgesetz)* that facilitated adoption of international accounting methods and have even called for an EU directive that requires German companies to use IAS. Works councils have strongly supported this demand due to their great interest in being able to compare the performance of subsidiaries in different countries, which becomes difficult in the case of different accounting standards. In sum, German unionists argue that transparency is a tool for codetermination [Bolt, 2000 #4689; Köstler, 2000 #4691; Köstler, 2000 #4787; Küller, 1997 #2580; Küller, 1997 #4786; Putzhammer, 2000 #4788; Scheibe-Lange, 1997 #2722].

Contrary to the rules of the traditional German accounting rules (as laid down in the *Handelsgesetzbuch* (HGB)), international standards place constraints on accumulating hidden reserves in times of good performance. One could, however, argue that it might be in the interest of employees to hide finances in good times and have reserves in bad times. Trade union experts do not agree with this view. Hidden reserves, they believe, have a leveling effect on the balance sheets of companies. With regard to the distribution of dividends and earnings, the effect of German accounting rules is not anticyclical but procyclical. In bad times, companies using German accounting rules publish earnings that come from hidden reserves, while in fact there is no operating profit at all. Published earnings lead to distribution demands that may eat up substance of the firm, which is dangerous especially for employees. In contrast, in the context of high earnings, published profits are minimized despite the fact that the company would be able to distribute to employees and shareholders.

This argument is not just theoretical but became important in the biggest German company crisis of the 1990s. In the case of *Metallgesellschaft*, management published earnings and paid dividends although the operative situation in the years 1990-1992 turned out to be disastrous [Knipp, 1998 #4714: 83;]. In the case of *Holzmann*, even in 1999 just before the government intervened to save the company from going bankrupt, dividends were paid to shareholders. The veiling of operative losses is also dangerous because it may delay necessary action against the causes of bad performance. The unions' position of rejecting traditional German accounting standards as being superior to international accounting standards is shaped by the works councils.

Another dimension of SV orientation where the preferences of employee representatives and shareholder activists are similar is top management compensation [Engberding, 2000 #4789]. Unions share the view of capital market participants that top managers' salaries should be variable according to the level of company success. Just like shareholder activists, unions criticize the trend towards escalating salaries.

The operative dimension of shareholder orientation turns out to be more complex. Works councils oppose profitability goals. In the late 1990s, an enormous wave of restructuring activity can be observed and does not appear to have been stopped by codetermination (Zugehör 2001). One reason is that in some cases, employees demand restructuring themselves. Here employees again share a broad interest with shareholders in promoting managerial accountability and reaction to poor performance. Another reason is that the negative impact of restructuring often has different impacts for core and peripheral employees within the corporation. Core employees may prefer a stronger core business, rather than continued support for ailing business that are less central economically.

Case studies show that even the operative side of shareholder value sometimes appears as a conflict over managerial control. For example, during the conflict over the separation of subunits at *Mannesmann* (before the hostile takeover), both employee representatives and shareholders pressed the management into restructuring. In 1999, *Mannesmann* was an extremely heterogeneous company, active in the telecommunications sector, in machine tools and automotive accessories, tubes and luxury watches. Telecommunications had become the focal segment within *Mannesmann* and attracted a growing proportion of funds for investment. An interviewed trade unionist at *Mannesmann* described the situation as follows: " The development of telecommunications slowly became dangerous for the other divisions. At the same time, as billions were being spent on the acquisition of *Orange*, in the classic businesses we had to fight tooth and nail for every hammer." Organized labor supported the separation of these firms in order to allow these businesses to continue on an "undisturbed" development. At the same time, trade unionists working in telecommunications preferred separation to get rid of the conglomerate discount that made acquisitions expensive and, of course, increased the danger of a hostile takeover.[21]

A similar constellation appeared at *Thyssen Krupp*, which was planning a (since revised) new company structure based on industrial services. The classic steel subunit was no longer a core business, but a peripheral marginal activity. *Thyssen Krupp* planned to spin off *Thyssen Krupp Steel* and planned to initially list 30 per cent of *Thyssen Krupp Steel* on the stock market. The works council chairman Dieter Kroll [, 2000 #4790: 27] supported the planned stock listing demanded by shareholders: “For two years now, we have observed that steel is no longer seen as a core competency. We don’t attract high investments. ... The scenario is: either be sold or become stunted. Under these conditions, the stock listing might be a prospect. ... Without stock listing, we would have no chance of becoming a core business.”

These cases show that spin-offs and return to corporate specialization can be undertaken with the consensus of organized labor. Here capital market orientation and “co-management-” style codetermination are hardly irreconcilable opposites. The mixture of core and marginal business is problematic for employees, too. Employee representatives in the core businesses see the advantages of strategies to focus on core competencies, because these strategies strengthen the core companies and decrease stock price discounts. In the view of employees engaged in marginal activities, a change in the main shareholder may increase the chance to become a core business. In most cases, management and employees oppose shareholders’ demands for radical restructuring. A good example of such an insider / outsider conflict is the demand of some major shareholders to break up the *Bayer* conglomerate into legally separate corporations.[22]

The Impact of Shareholder Value on Industrial Relations. There is little evidence that companies adopting SV attempt to put an end to codetermination. SV

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[21] For a detailed case study of *Mannesmann*, see (Höpner 2001).

[22] Handelsblatt, 21./22.07.2000, 24. Similar examples are *Veba, Siemens, MAN, Degussa-Hüls, Deutsche Telekom*. Most cases are a mixture: management tends to focus on core competencies, more (*Veba*) or less (*Siemens*) supported by works councils (Zugehör 2001), but shareholders’ demands turn out to be more radical and are opposed by insiders.

seems to strengthen trends that were already observable in the 1980s. Five trends in codetermination[23] can be distinguished (Mitbestimmung 1998; Kotthoff 1998; Streeck 2001; 1996; Thelen 1991)[Gerum, 1997 #1141; Deppe, 1998 #2367; Gerum, 1998 #2441; Müller-Jentsch, 1998 #4796: 367]:

1. System conformity. Codetermination is no longer seen as an instrument for transforming the economic system into a mixture of capitalist and socialist elements (*Wirtschaftsdemokratie*). It is fully accepted that codetermination operates in firms whose natural goal is to generate cash flows and earnings.

2. Efficiency orientation. Democratic participation at the workplace is still one legitimizing force behind codetermination. However, increasingly codetermination has also to prove that it is not only the more democratic or social, but also the more efficient model for organizing the micro-relationship obtaining between employers and employees.

3. Co-management and professionalism. In practice, codetermination goes far beyond its legal foundations, interfering in and legitimizing company policy not only in social and personal issues, but in economic issues also. The boundary between management functions and codetermination becomes increasingly harder to discern.

4. Consensus orientation. While confrontation between works councils and employers is becoming rare, codetermination seems to have committed itself as a co-operative process. Both sides see themselves as partners, not as opponents in class confrontation.

5. Negotiation of rules. Similar to the guideline on European Works Councils (EWC), evidence is growing that the role of legal foundations is decreasing, while the importance of negotiated codetermination rules is increasing. For example, several corporations have set up “working teams of works councils” (*Arbeitsgemeinschaften der Betriebsräte*) that rely on negotiated rules instead of *Konzernbetriebsräte* that are based on legislation.

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[23] Distinguished from wages policy.

Codetermination practices are thus becoming more micro-founded and micro-oriented. This complicates the relationship between works councils and unions who see themselves as the macro forces of the labor movement. Micro and macro goals of employees can contradict each other, so the micro / macro conflict of employees goals is a further conflict line that is influenced by the trends described. The unions' axiom that codetermination should go beyond micro goals becomes increasingly undermined by practice. One example of this is the discrepancy between micro and macro reactions to the hostile takeover attempt of *Krupp* in 1997. While *IG Metall* was fighting hostile takeovers as an illegitimate instrument of economic behaviour, *Krupp* employees were supporting the takeover attempt. When 30,000 members of *IG Metall* were demonstrating against hostile takeovers and the role of the *Deutsche Bank* in March 1997, not even the works council members of *Krupp* participated. The different micro interests of employees could not be dominated by common macro interests. Employees defined their interests as company member interests, not as class interests. Because the interests of employees as producers in a particular firm are more heterogeneous than class interests (Streeck 1992a), the heterogeneity of interests inside unions increases.

Collective bargaining is also seeing a move toward controlled decentralization as discussed above in conjunction with variable pay. None of the companies observed have opted out of central collective agreements (*Flächentarifverträge*). Shareholder-oriented companies even seem to avoid any sort of confrontation over pay policy. There are three reasons why big, international companies profit more from centralized collective agreements than small companies [Hassel, 2000 #4791; Manow, 2000 #4762; Thelen, 2000 #4031]: First, they enjoy greater productivity and would be confronted with higher wage demands if they opted out of central collective agreements. If unions base their wage claims on overall productivity development, highly productive corporations tend to have decreasing unit labor costs, while less productive companies are faced with increasing unit labor costs. Second, union organization tends to be greater in large companies than in smaller ones, which increases the likelihood of strikes. Third, shareholder-oriented companies belong to the exposed sector and are therefore more vulnerable than average in labor disputes. Shareholder-oriented companies are not indifferent to pay policy but have clear preferences: large corporations are particularly afraid of class conflict and are willing to place a premium on labor peace. Another reason why big firms do not opt out of central collective agreements is the existence of plant-level pacts, where managers and employees exchange job security against salaries above the centrally agreed scale (Rehder 2001). There is no statistical correlation between shareholder value orientation and the existence of plant-level pacts.

4 Conclusion

The past "model" of German corporate governance was characterized a high degree of complementary between corporate ownership and employee involvement. This complementarity was rooted in a specific class compromise where capital could receive favorable rates of return while allowing a distribution of value-added that favored labor and internal reinvestment in the firm. "Patient" capital thereby stabilized German employment relations and cooperative industrial relations. Corporate accountability was achieved by external contingent monitoring by banks, supplemented by internal accountability through consultation with works councils. This paper has shown, however, that these institutional interactions between capital and labor have changed substantially due to the changing composition of corporate ownership and monitoring. These changes permit several tentative conclusions.

First, a more marketized role of capital has led to changes toward more marketized role for labor. In employment relations, the stability of employment is available to a shrinking number of employees. While preserving labor peace within the firm, this trend suggests growing insider-outsider conflicts between core and peripheral employees, as well as between large firms and the larger society who supports these adjustment strategies though public welfare. Wage setting is becoming more decentralized and contingent by the market position of the firm or business sub-unit.

In industrial relations, codetermination and collective bargaining have remained stable on the surface. But a closer look shows that they are also undergoing functional changes in adapting to new pressures and managerial strategies. Collective bargaining is struggling to maintain its role in setting egalitarian and solidaristic wages. But unions are less available to exert a productivity whip on firms through high and uniform wages, which created “beneficial constraints” in the past. The new function of collective agreements has become more defensive in steering the process of decentralization. Likewise, codetermination has an increasingly micro-focus on the interests of core employees, thereby undergoing a institutional shift from a politically guaranteed right to a more contractual arrangement. While codetermination was the result of a historical effort to take labor and working conditions out of market competition in the interests of class solidarity, its function has changed ever more into the co-management of organizational change to make labor a competitive factor endowment.

However, market pressures continue to be mediated by the existing configuration of labor institutions. No rapid convergence on the U.S. model can be expected. Particularly where labor is strong and anchored by law, industrial relations institutions are relatively sticky even in the face of new pressures from capital markets. The German case shows a resilient process of inventing adaptive solutions to new economic problems.

Second, it remains an open question to what extent labor also impacts new SV practices. Will Germany adopt SV in ways that differ from countries where institutionalized employee representation is weaker? This paper documents several examples of the pro-active role of labor in shaping SV strategies, suggesting the possibility of an emerging hybrid form of “enlightened” shareholder value. The contours of such a model is one that seeks to maximize the accountability aspects in corporate governance (for example, in issues of transparency and management pay) while avoiding some negative sum aspects of class conflicts within the U.S. or British system.

In returning to the two views of Germany discussed in the introduction, this paper suggests that past literature has overestimated the degree to which capital and labor are tightly linked in a causal sense. Strong labor has not prevented a move toward SV in Germany, nor has SV undermined the distinctive institutional features of German industrial relations. The linkages between institutions are often indirect and mediated by corporate business strategies. Such strategies are not decided once and for all, but are in constant flux and renegotiation policy by policy and company by company. The “coherence” or “systemness” of national corporate governance models may be our retrospective explanation of what was painfully learned through decentralized experiments over a relatively long time period.

Hence, it remains to be seen whether an enlightened version of shareholder value in Germany can survive as a durable outcome capable of generating a distinct profile of competitive advantage. Alternatively, we may be observing a slow transition process of what is, in fact, a convergence in human resource management. While we think the prospects for a German “hybrid” are strong, the scope for national diversity of employment relations is declining as financial systems are becoming more alike. The study of these linkages to finance and capital ownership is becoming ever more important for students of labor.

Table 1 Stability of Employment

	Germany		**Japan**		**United Kingdom**		**United States**	
Current Tenure	**1990**	**1995**	**1990**	**1995**	**1991**	**1995**	**1991**	**1996**
Under 1 Year	12.8	16.1	9.8	7.6	18.6	19.6	28.8	26.0
1 to 5 Years	28.2	31.4	27.6	28.9	36.3	30.2	32.9	28.5
5 to under 20 years	42.3	35.6	43.3	42.2	35.4	40.8	29.5	36.6
20+ years	16.7	17.0	19.3	21.4	9.6	9.4	8.8	9.0
Average (Median) Tenure in years	10.4 (7.5)	9.7 (10.7)	10.9 (8.2)	11.3 (8.3)	7.9 (4.4)	7.8 (5.0)	6.7 (3.0)	7.4 (4.2)
	1980s	**1990s**	**1980s**	**1990s**	**1980s**	**1990s**	**1980s**	**1990s**
Layoffs and Quits as % of Total Employment[a]	1.6	4.3	1.9	2.4	4.4	4.4	5.1	4.0
Layoffs as % of Total Employment[a]	1.1	2.8	0.6	0.7	2.7	2.7	4.3	3.1
Separation Rate as % of New Hires [b]	25.0	27.2	na	na	40.5	42.9	60.5	65.9
Pace of Employment Amount Adjustments, 1974-1993	0.14		0.04		0.21		0.45	

Tenure Data: OECD. Employment Outlook, 1993 and 1997. [1] German data from the Socio-Economic Panel referring to German-born citizens employed at the time of the survey, excluding apprentices and others currently in training programs. Data relates to West Germany. [2] Japanese data relates to regular employees (persons hired for an indefinite period); temporary workers hired for more than one month; daily workers hired for over 17 days, in private establishments with over 9 employees.

Turnover Data: [a] Estimated separation rates for those currently unemployed or no in the labor force who left jobs within the past 6 months. *Source*: OECD Employment Outlook, p.148, 1997. The periods are as follows: Germany (1984, 1993-94), Japan (1987-88, 1996), UK (1983, 1993-94), and US (1982-82, 1991-92). [b] Estimated separation rates from 1 to 2 years (population with tenure of 1 to 2 years minus those with tenure under 1 year) as percentage of new hires (population with tenure under 3 months).

Employment Adjustments: Economic Planning Agency (1993). Economic Survey of Japan. Estimated speed of employment adjustment (labor input = number of hours * number of employees) in manufacturing relative to wages and output.

Table 2 Corporate Ownership in Germany, by Sector 1991 and 1999

	1991	**1999**	**Change in %, 1991-99**
Banks	12.7%	13.5%	+0.8%
Insurance Firms	5.5%	9.0%	+3.5%
Non-financial Corporations	39.4%	29.3%	-10.1%
Government	2.6%	1.0%	-1.6%
Pension Funds	--	--	--
Foreign	12.7%	16.0%	+3.3%
Investment Firms, & Other	4.8%	13.6%	+8.8%
Individuals	22.4%	17.5%	-4.9%

Sources: (Bundesbank 2000). German data is estimated from heterogeneous sources using both market and book values.

Table 3

Ranking of Shareholder Orientation in the late 1990s, 40 listed corporations	
Company	Score
Bayer AG	1,61
VEBA AG	1,48
SAP AG	1,33
Hoechst AG	1,20
BASF AG	1,14
Mannesmann AG	1,11
Henkel KgaA	1,09
Daimler-Benz AG	1,02
RWE AG	0,90
Siemens AG	0,86
Schering AG	0,74
Metallgesellschaft AG	0,72
Degussa AG	0,55
Viag AG	0,55
Preussag AG	0,45
MAN AG	0,36
Deutsche Lufthansa AG	0,28
Linde AG	0,22
Continental AG	0,21
Thyssen AG	0,17
Deutsche Telekom AG	0,16
Krupp AG	0,16
Buderus AG	0,04
Agiv AG	0,00
Beiersdorf AG	-0,17
Volkswagen AG	-0,26
Rheinmetall AG	-0,31
BMW AG	-0,43
VEW AG	-0,46
Metro AG	-0,70
AVA AG	-0,81
Deutsche Babcock AG	-1,08
Deutz AG	-1,18
Karstadt AG	-1,23
Bilfinger+Berger AG	-1,25
Spar AG	-1,28
Südzucker AG	-1,30
Axel Springer Verlag AG	-1,70
Holzmann AG	-1,90
Strabag AG	-2,29
z-transformed data. Source: Höpner (2001: 40)	

Table 4 Remuneration Index

Performance-related pay

▪ No performance-related pay	0
▪ Performance-related pay implemented in parts of the company	1
▪ Performance-related pay implemented throughout the whole company	2

Profit-related pay

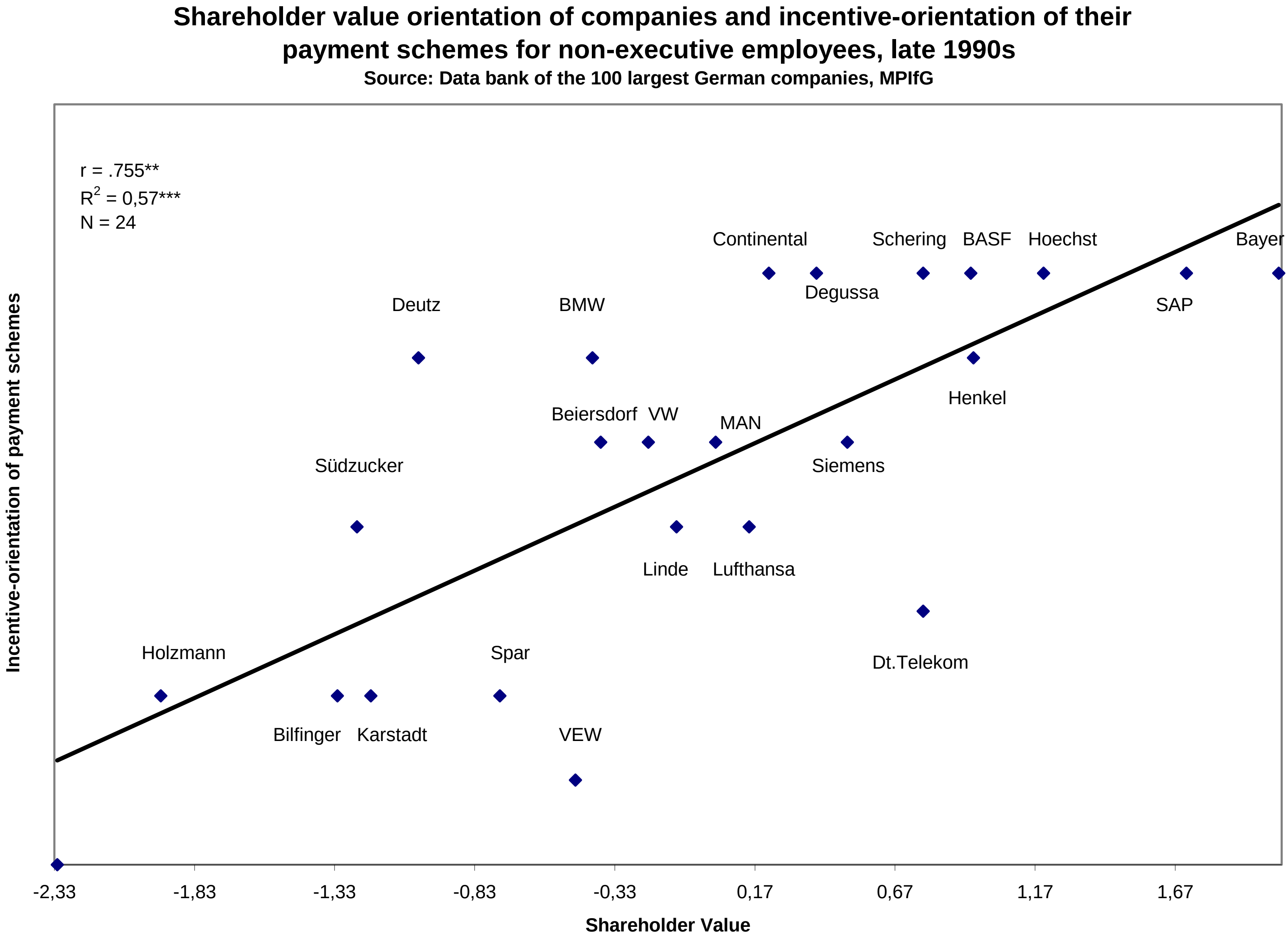
▪ No profit-related pay	0
▪ Bonus is set unilaterally by management	1
▪ Works council and management negotiate	2
▪ Bonus is set according to a fixed formula	3

Share-ownership

▪ Participation program does not exist	0
▪ Traditional share ownership program	1
▪ Extended share ownership program	2

Incentive-orientation of payment system: 0 – 7 pts

FIGURE 3


Shareholder value orientation of companies and incentive-orientation of their payment schemes for non-executive employees, late 1990s
Source: Data bank of the 100 largest German companies, MPIfG
r = .755**
R^2 = 0,57***
N = 24
Continental
Schering
BASF
Hoechst
Bayer
Degussa
SAP
Deutz
BMW
Henkel
Beiersdorf
VW
MAN
Siemens
Südzucker
Linde
Lufthansa
Dt.Telekom
Holzmann
Spar
Bilfinger
Karstadt
VEW
-2,33
-1,83
-1,33
-0,83
-0,33
0,17
0,67
1,17
1,67
Shareholder Value
Incentive-orientation of payment schemes

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