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Abstract

This article examines institutional linkages between corporate governance and labour management in Germany. German corporate governance was characterised by the importance of banks, ownership concentration, long-term investment, and stable corporate networks. This system displayed important complementarities with stable long-term employment, investment in worker training, flexible quality production, low variability and dispersion in pay, and cooperative industrial relations during the post-war period. Since the mid-1990s, corporate governance has changed dramatically – a decline in the role of banks, the unwinding of corporate networks, the rise of foreign and institutional investors, en emerging market for corporate control, and changing careers and compensation of top managers. The paper investigates the resulting introduction of shareholder-value management practices and their impact on employees in large German companies. The findings show that these changes are related to the shrinking of stable core employment and the growth of variable pay. However, such tensions with shareholder value management have not undermined employee codetermination and collective bargaining institutions. Both play an important mediating role between capital market pressures and employment outcomes. The implications for the German "model" of corporate governance are discussed.

Key words: Corporate Governance; Labour Management; Germany; Stakeholder Theory

JEL classification: G30, J51, J53, L21, M12, P16

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Introduction

In comparative debates, Germany is often viewed as a 'stakeholder' model of corporate governance. First, the ownership of German companies is highly concentrated. Banks provide substantial 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. Taken together, these two features contrast with the market- or shareholder-oriented logic of Anglo-American corporate governance.

Existing literature presents two distinct views of the interactions between investors and employees within the German model. The 'varieties of capitalism' approach argues that patient capital and employee voice are mutually reinforcing, complementary institutions contributing to German industrial success (Hall and 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).

By contrast, the 'law and economics' literature has focused 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 may 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). Roe (1999, 194) thus 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, labour institutions can be viewed as an independent variable that impacts investors. Understanding how capital and labour interact 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 and Jackson 2003). Corporate governance involves various coalitions between capital, labour, and management (Cyert and March 1963; Aoki 1986). But these coalitions are shaped by their embeddedness within institutional settings which 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 behaviour.

Section 1 examines the basic features of post-war German corporate governance and HRM, 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 labour management, although the literature often overestimates the extent to which such linkages are tight and coherent. We interpret these results in terms of shifting patterns of coalitions among stakeholders.

1. German corporate governance in comparative context

The German 'model' defies easy categorization as an insider, employee-oriented, or stakeholder-oriented corporate governance.[1] Germany may be seen as a type of nonliberal corporate governance due to the limited the role of markets as mediating mechanisms for both capital and labour (Jackson 2001). Both factors of production are institutionalized based on organizational commitment and voice within corporate governance. Here Germany shares similarities with countries such as Japan, and is distinct from liberal market-oriented economies such as the U.S. or Britain. Yet Germany has its unique features. 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 labour 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 which 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.

Next, we examine more specifically the role of investors, employees, and management in turn focusing on the post-war era up through the 1980s. Our emphasis is on the relationship between institutional features and organizational commitment (limited role of markets) within German firms.

1.1 Corporate ownership, finance, and monitoring

Corporate ownership and finance in Germany has three well-known features: high ownership 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 and 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 has not changed 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 (*Konzern*) and dense bank-industry networks are both important (Beyer 1998). Sociologically, these ownership stakes involve high levels of commitment to particular enterprises, unlike the more diversified and liquid trading of U.S. institutional investors (Jackson 2000). Whereas Anglo-American institutional investors are oriented to financial gains from share-price appreciation and dividends, corporations and banks tend to pursue strategic organizational interests in promoting cooperation between firms and generating relationship-specific rents. Dense inter-corporate networks suppress markets for corporate control and create incentives for voice rather than exit.

Third, German universal banks 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 and Fischer 1994). Bank monitoring is an element of relational financing where debt and equity are commingled.[2] 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 and Jenkinson 1996; Borio 1990). Given the different preferences of shareholders and creditors, strong banks may weaken the position of minority shareholders.

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 deviated from the one share-one vote principle through multiple voting rights and voting caps. Banks also represent small shareholders by

voting the shares held in their custodial 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 US General Accepted Accounting Standards (GAAP).

1.2 Employment relations, industrial relations, and work organization

Employee voice is institutionalized through the legal institution of codetermination at the level of the supervisory board and works councils.[3] 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 decisions. In certain companies, the appointment of a labour 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 labour. Employment tenures are long and exhibit a low downward elasticity over the business cycle (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 comparatively low.[4] While employees tend to be highly skilled, training takes place within a multi-employer and quasi-public system of occupational training.[5] 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.

Stable employment relates to several other institutions. 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.[6] 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 resort first to 'benevolent' methods of retrenchment 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 is 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 labour market. The German training system organizes occupations into categories of overlapping skills that create a wide 'substitution corridor' between occupations (Sengenberger 1987).[7] Polyvalancy 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 by 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, industry-wide bargaining considerably reduces the scope for firm-level variation of wages and working conditions. Though large and successful companies often pay a wage premium above the level of collective agreements, their scope remains limited (Bellman 1995). 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—thus, the link between pay grades and qualification is not direct (e.g. everyone with this qualification must earn a standard salary) but is steered through the system of jobs. 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 (Jackson 2003).

Industrial relations are characterized by strong employee voice through codetermination within the firm, as well as multi-employer collective bargaining which regulates wages and 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 function 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 actively to 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.

Work organization in industry is characterized by high functional flexibility and incremental patterns of innovation (Boyer 2003; Hall and Soskice 2001). 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 labour. As Streeck (1992a: 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 pressures are somewhat attenuated by a highly consensus-oriented management culture. Interests must be negotiated in shifting coalitions which involve patterns of horse-trading, issue linking, and package deals between different groups of management. Several institutional features making up the social world of German management support this consensus orientation.

First, management careers tend to follow functional specializations, even within the management board. Educational backgrounds in science and engineering dominate the highest positions. Managers remain 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 considerations (Lane 1993).

Second, 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.

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

Fourth, 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 labour market also favours the orientation toward long-term profits instead of short-term success. Moreover, 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 labour management, on the other? Institutions in different domains may be viewed as complementary when one institution becomes more viable in combination with specific other institutions (Aoki 2001). Complementarities do not imply economic efficiency in an absolute sense, 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. Conversely, interdependence may create tensions because institutions imply conflicting principles of rationality (Lepsius 1990). For example, codetermination may be seen as diluting ownership rights and thus hindering particular patterns of organization.

Important methodological issues arise in studying institutional linkages. First, complementarity does correspond to the self-similarity of organizational principles across domains. Contradictory organizing principles may provide beneficial countervailing checks and balances (e.g. state and market, unions and managerial control) or be a source of requisite

variety for organizations in supporting flexible and beneficial recombination of practices (Stark 2001). Second, specifying complementary relationships requires theoretical models linking economic functions across institutional domains. However, corporate governance influences multiple dimensions of economic activity, such as agency costs, transaction costs, and so on. We often cannot tell *a priori* which function will be most important for overall performance or social stability given changing external environments and strategic choices. The inherently selective focus of theoretical models may account for a tendency to overestimate the degree to which institutions are very tightly coupled and exert strong causal influence as complementary elements of a system.

Rather than presenting an economic model, we analyse these relationships as governance coalitions from a sociological standpoint. Here organizational goals may be the outcome of governance processes, rather than organizational goals determining the choice of governance institutions as in most economic models. 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 coalition patterns can be observed. Each of these coalitions embodies a particular axis of conflict: class conflicts, insider-outsider conflicts, and accountability conflicts.

- *Class conflict* is manifested when shareholders and management have similar interests vis-à-vis employees, particularly regarding distributional issues such as wages or selected personnel and social issues.
- *Insider-outsider conflict* may arise when employees and management have similar interests vis-à-vis shareholders. This is often assumed in agency theory, such as when insiders favour

internal diversification ('empire building') or may block efforts at restructuring. Likewise, corporate insiders may favour takeover defences at the expense of outside shareholders.

- *Accountability conflicts* arise when shareholders and employees align their interests vis-à-vis management. Thus, both groups may favour measures to improve corporate transparency and disclosure. Good information on company performance may be used by both groups to control management, even when they oppose each other on how any surplus should distributed. Similar constellations may also appear around issues of risk management, in preventing perverse incentives in managerial compensation, and in some investment and restructuring decisions.

Whether or not these various potential coalitions and conflicts become manifest depends very much on the institutionalized relationships between each group of actors. Large shareholders may be more 'insiders' than smaller 'outside' shareholders, just as employees may be insiders or outside the core group. Thus, the discussion must be contextualized through a consideration of what interests dominant owners pursue and how these interests impinge upon the distributional outcomes for labour (and *vice-versa*).

2.1 Class conflict

In Germany, several features of ownership were institutionally important reducing class conflicts and facilitating mutually agreeable distributive outcomes. 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. Lower stock market capitalization stabilized a competitive rate of return to capital, while placing fewer constraints on the share of value-added going to labour. In addition, protections from hostile takeovers guard against 'breach of trust' (Shleifer and Summers 1988) 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 favourable in comparative terms and gave investors little incentive to exit.[8] Comparisons of German and British corporations have shown that shareholder returns are quite similar at the margin when measured in price-earnings ratios or dividend yields (Höpner and Jackson 2001). Yet top British corporations have higher market values. German shareholders could receive competitive rates of return as long as market capitalization remained low, e.g. ownership remains concentrated among existing stable shareholders. As a consequence of higher market valuations, British corporations must produce higher operative rates of return to sustain similar returns to capital. Meanwhile, top German corporations may maintain greater commitment to employment and place greater priority on high sales growth, rather than profits.

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; they can spend more on capital investments and / or R&D; they can absorb higher raw materials costs; they can concentrate on market segments offering lower returns but having large market size and relatively low risk; they can absorb higher labour 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) 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

Conflicts between insiders and outsiders were not predominant in Germany under conditions of rapid post-war economic growth. Resources generated by insiders were generally sufficient to be redistributed to outsiders without reallocation of control. For example, conflicts between inside and outside employees were limited by the ability to balance wage equality pursued by German unions and employment security pursued by works councils. Unions achieved a high wage floor that made German labour markets less 'dualistic' than in the U.S. or Japan. Labour peace was maintained within the firm by externalizing the costs of employment adjustment onto the German welfare state. But this balance changed as the core group of insiders has grown progressively smaller due to the decline of traditional industrial sectors. This tension presses unions and works councils to make strategic choices between their class-wide vs. firm specific interests. Union agendas of maintaining uniform wages face increased centrifugal pressures from firm-specific interests of works councils.

Likewise, insider-outsider conflicts among large blockholders investors and small shareholders were also relatively latent. As discussed above, small shareholders could benefit from relatively stable returns and low risk associated with the stable network of bank-industry relationships. However, slower growth and the rise of new individual and institutional investors sharpened conflicts with large investors who favour strategic interests or long-term

relationships. Outside institutional investors often favour shifting resources from corporate insiders to be reinvested through arms length market relationships. Moreover, the demands of institutional investors may create new patterns of cross-class coalitions with different employee groups. Outside investors and employee insiders may often share an interest in increased transparency, performance-oriented pay, and productivity-orientation. But these coalitions may increase tensions with Germany's industrial unions who bundle interests outside specific firms.

2.3 Accountability conflicts

While post-war Germany had its share of corporate scandals and managerial excess, overall corporate accountability does not appear to have been deficient relative to other countries. The financial system remained quite stable, as have the fortunes of large industrial firms.

However, a first point of criticism is that accountability has relied largely on private information, rather than public transparency and information disclosure. For example, universal banks were thought to have extensive access to private information through their multiplex relationships as creditor, owner, and board member. Banks achieved economies of scope through comparable information from competitors and other firms throughout the sector. Likewise, 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, accumulation of private information may improve corporate accountability in the absence of more public information disclosure.

Similar debates surround monitoring within the board. Supervisory boards are often criticized for being too large, poorly informed, and hence too inactive in monitoring. Others question whether codetermination leads to factionalism within the board that induces

ineffective monitoring. However, the virtues of the two-tier board system include the clear separation of management and monitoring functions now advocated worldwide. Boards also have a large number of outsiders who represent strategic stakeholders in the firm. Much debate remains as to whether more independence is required to prevent detrimental conflicts of interest or whether stakeholders also act to provide beneficial checks and balances. These debates cannot be discussed further here. However, no quantitative evidence exists to show that German firms are comparatively slow to remove poorly performing management (Kaplan 1994).

3. Changing institutional interactions since the 1990s

Germany proved to have a stable 'model' of corporate governance during much of the post-war period. Distributional compromises were able to reduce class conflict, while insider-outsider and accountability conflicts were held in check. But considerable pressures for change developed from the early 1990s onwards. Economic pressures of internationalization and political pressures for liberalization promoted a growing role of capital markets. New capital market actors, such as foreign and institutional investors, brought different investment strategies and an increased focus of financial returns. 'Shareholder value' became widely discussed 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 which reflected international standards for investor protection.

How will trends toward shareholder- or market-oriented corporate governance impact labour management and employee representation? As discussed above, the existing literature posits tight complementary relationships between capital market institutions and labour

institutions, but offers divergent hypotheses about change. On the one hand, strong institutional complementarities may gravitate against change and allow only gradual 'path-dependent' evolution. For example, codetermination may prevent the emergence of dispersed ownership and active capital markets. On the other hand, institutional complementarities also imply that successful change in one set of institutions will lead to changes in the other linked sets of institutions. Change would ripple through the system like a house of cards and lead the German model to collapse. Thus, market-oriented capital would bring forth a 'fitting' set of market-oriented labour institutions, characterized by stronger external labour markets, numerical flexibility, variable pay, and fewer vested participation rights.

This section empirically examines how changes in capital market pressures are impacting German labour management and industrial relations by reviewing some selected empirical findings from our own research on the changes in corporate ownership and monitoring during the 1990s (Höpner 2003 and 2001; Jackson 2003; Streeck and Höpner 2003; Höpner and Jackson 2001; Kurdelbusch 2002).

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. Several reforms of capital market regulations have liberalized markets and set up new regulatory agencies (Lütz 2002; Donnelly et al. 2001). New institutional and foreign investors have emerged as key capital market actors. The monitoring capacity of German banks has been substantially eroded by the change toward more market-oriented ownership patterns and new capital market regulation, leading many of the core private banks to move away from 'house bank' relationships and enter into the Anglo-American dominated field of investment banking. One result is a declining stability and density within the German

corporate network. Given this 'marketization' of ownership ties among large firms, a market for corporate control has begun to emerge on a small scale. These trends are most pronounced among large internationally oriented corporations. A number of related points must be made.

First, data on the aggregate ownership of listed shares in Germany in the 1990s (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 held 40 per cent of Mannesmann shares, 31 per cent of DaimlerChrysler, and 27.5 per cent of Deutsche Telekom.[9]

These new investors have led to new types of pressures. Institutional investors pursue financial interests through their investments, thus favouring 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 studies show that institutional investors only rarely attempt directly to influence management (Steiger 2000). Their monitoring capacity lies in professionalizing information gathering and exit-oriented strategy. Therefore, stock prices are becoming more responsive to management decisions and more volatile. Investor activism targets the promotion of general practices of good governance, but rarely translates into strategic interest in corporate control.

Table 2 shows that the growing proportion of institutional investors coincides with declining shares among individuals. But declines were also seen for the government and other non-financial corporations. While growing 'institutionalization' increases concentration, a parallel trend exists toward de-concentration of ownership and unwinding of corporate

networks. Privatization of government enterprises is one important factor. However, the density of corporate networks in Germany is declining substantially (Höpner and Krempel 2003; Beyer 2003; Windolf 2002). This trend will likely continue as large blocks are sold tax-free under new tax regulations introduced in 2000.

Second, the monitoring capacity of banks is substantially eroding. Bank credits to large corporations have declined, as these corporations have become largely self-financing (under conditions of slow economic growth) or have new alternative modes of finance (Jackson 2003). 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 (Deeg 2001; Beyer 2003), because a close relationship to industrial companies would weaken their reputation among international customers of financial services. Banks' investment portfolios have also become more market-oriented and less focused on stable relationships. Thus, banks are reducing the size of their large ownership stakes and diversifying their investments. The withdrawal of banks is also evident in the declining number of supervisory board chairs held by bankers among large corporations (Höpner 2001). The Deutsche Bank has led this trend by reducing its supervisory board chairs by nearly half. Increasingly, supervisory boards are being chaired by former management board members from inside.

Third, barriers to hostile takeovers have significantly eroded and led to the emergence of a market for corporate control on a limited scale. The takeover of Mannesmann by the British Vodafone in 2000 was a watershed case illustrating the extent of change. Contrasting Mannesmann with other takeover attempts targeting German companies in the 1990s shows the erosion of barriers against hostile takeovers (Höpner and Jackson 2001). As large banks change from the *Hausbank* to the investment bank paradigm, banks are giving up their role as

guardians against hostile takeovers. 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) forbids voting rights restrictions. In the past, these restrictions were one of the most important of Continental’s defensive actions against the takeover attempt of the Italian tire company Pirelli. Legal reform (*Kapitalaufnahmeerleichterungsgesetz* - KapAEG) in 1998 also made the economic worth of corporations more transparent. Moreover, codetermination seems no longer to act as a strong barrier to hostile takeovers. A comparison of the cases of Thyssen (1997) and Mannesmann (1999/2000) shows 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 behaviour in 2001.

Fourth, 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 labour 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 (Höpner 2003). A few findings on the development of the career and education of top managers in the 1990s can be summarized.

- There is a strong trend towards further 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).

- The role of the external labour market is also 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. As a result, the role of in-house careers is declining.
- The percentage of top executives who can be classified as financial experts with experience working in the financial division 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.[10] Comparing these data with information on the 1970s (Poensgen 1982) 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.

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 labour market for managers requires the application of measurable performance criteria. At the same 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 this, it can be argued that the increased importance of Financial Economics in education and career favours the willingness to utilize financial indicators.[11]

In sum, these changes can be expressed as a rise of a shareholder-value paradigm. In the early 1990s, the conglomerate VEBA was one of the first companies which sought to raise the

importance of financial interests of shareholders within corporate policy. Numerous other companies such as Siemens, Hoechst, BASF, and Bayer followed suit (Vitols 2002). Shareholder value strategies aim primarily at making the market cost of capital the hurdle for corporate investment. In order to meet the minimum return to capital within each division or subsidiary, Shareholder value aims to end cross-subsidization between the various segments within the firm. Alongside this strategy, key elements include transparency for outside investors and a variable management remuneration linked to shareholder returns.

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 shareholder-value management.[12] The communication dimension involves greater transparency toward investors, via investor relations work, the adoption of 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 management compensation:dimension involves increasing percentages of pay 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 labour management.

3.2 Interactions with employment relations

This section examines how shareholder value impacts key aspects of employment relations, namely stable employment and egalitarian wage dispersion. Increasing shareholder orientation

is widely hypothesized to promote class conflict (as defined above) and a redistribution of wealth in favour of shareholders. As already discussed, the distribution of value-added between stakeholder groups varies strongly between corporate governance regimes (de Jong 1996). Germany is characterized by its high labour share and relatively small share 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. In this section, we show that growing shareholder orientation is associated with shrinking employment and the introduction of variable pay.

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 that in shareholder oriented companies, the distributional position of shareholders improved modestly at the cost of employees. Shareholders benefited from high profits being distributed as higher corporate dividends. The redistribution effect is explained by the fact that shareholder orientation favours strategies of lower rates of growth and declining employment, while profits increase. Shareholder value thus introduces a form of redistribution that results not from declining wages, but from a declining portion of cash flow being reinvested at a lower rate of return. Collective bargaining can do little to stop with kind of redistribution, since bargainers normally cannot negotiate over the profitability targets set by management. Corporations remained committed to avoid involuntary lay-offs for core employees, but this 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, VEBA reduced its workforce by 29,000 persons through early retirement with 90 percent of previous salary.

As shall be discussed below, shrinking core employment has not marginalized works councils. Works councils remain active in negotiating 'site pacts' to maintain jobs and keep high value-added production in Germany (Rehder 2003a, 2003b). 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, and cuts in bonuses for overtime and shift work (see also Nagel et al. 1996). Second, employment alliances involve concessions on wages or working hours in exchange for employment guarantees over a period of two to four years.[13] Work may be redistributed through reduced or flexible working time, or made cheaper by reducing company premiums above industry-wide rates. Often these involve cross-class coalitions between local works councils and management, either against the centralized management seeking to impose new financial controls or industrial unions seeking to impose uniform labour standards.

Variable compensation as a consequence of shareholder value. A sinking wage costs per employee is not the cause of the declining labour share described above. Although the overall share of net value added which employees receive as wages is in decline, wages of the remaining core employees rise. This is possible because while less profitable business units are being closed or sold, core employees increasingly receive profit-oriented pay under new variable remuneration schemes.

Such compensation practices that link workers' pay more closely to individual and company performance have diffused rapidly among large German firms since the mid-1990s. These schemes exist both at the managerial and for non-executive employees covered by collective agreements. A survey of the 100 largest German firms show that 70 per cent of firms had schemes with wage components based on individual performance evaluations or goal-setting targets (Kurdelbusch 2002). 51 per cent of firms paid remuneration based on the

profitability or performance of the enterprise as a whole and 57 per cent of firms had some form of employee stock ownership plans. This trend represents a departure from the historical stance of German unions in supporting a homogenous wage structure, secure and stable incomes, and protection from ratcheting performance standards. From the point of view of 'traditionalists' inside unions, variable pay therefore introduces perverse effects which are likely to destroy solidarity and make works councils tolerate too much corporate restructurings.

While some firms introduced company-wide bonuses when profits were high, these 'on-top payments' are rare. Rather, variable pay is replacing fixed but company-specific wage components which in the past were paid above industry-wide wage agreements. Older forms of performance-related pay such as union negotiated piecework rates are being replaced by appraisal systems to monitor and reward individual performance. Such performance-related pay systems have been introduced to counter the egalitarian effects of collectively negotiated wages and introduce greater individual incentives. In addition, profit–related pay is being introduced that links the size of the performance-related budget to profits of the company or business unit.

These new variable pay systems are intended to enhance employee motivation and commitment in several ways. By giving employees a greater stake in overall corporate performance, variable pay is supposed to help focus employee effort on key job objectives and to clarify the links between such objectives and overarching business goals. Furthermore, variable pay is aimed at giving greater recognition to outstanding employees and thereby to increase motivation.[14] Thus, employees are encouraged to identify with the company. Entrepreneurial thinking is stimulated about how to generate revenue, reduce costs, and maximize profits. A special form of participating in the company's success – and a way of bringing shareholders' and stakeholders' interests closer together - is employee stock

ownership plans or stock options. Here the link between individual performance and financial reward is less direct than with other performance-related pay, profit sharing, or other annual bonuses, because the employee has hardly any influence on the share price. But, for management, one advantage is their long-term character which binds employees to their company and enforces commitment.

Variable pay is also intended to increase the flexibility of business costs 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. Thus, flexible remuneration schemes are related not only to performance but also to financial management.

The details of variable pay programmes differ considerably across companies, but all of them place an appreciable share of the pay of employees at risk. To study its diffusion, an index was created looking at performance-oriented, profit-oriented, and share-oriented components (see Table 4). 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 2). The rise of variable pay in Germany can thus partially be attributed to changes in the financial regime.

The spread of variable performance-related pay for managers - a key characteristic of shareholder value - is not be surprising in the case of executives' compensation schemes. What is remarkable, however, is that the rapid diffusion of performance-related pay among non-managerial employees. This phenomenon has several explanations. First, introducing performance-related pay for all employees is often simply an element of shareholder value

strategy. Investors see these pay systems as a signal for the congruence of employee goals and financial rewards. Works council members even 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, companies with shareholder value strategies can more easily introduce profit-related pay because relevant business indicators already exist. When target rates of return are set, reasonable rewards for meeting targets sound plausible. Finally, a block of employee ownership can also function as a protection against hostile takeover as investor pressures increase.

Once in place, how do variable pay schemes affect 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 the introduction of employee stock ownership plans. However, the introduction of employee ownership is yet to have a impact on corporate governance. In some companies, employee shareholders have begun to exercise their voting rights as employee owners collectively e.g. to prevent hostile takeover bids. Nevertheless, the percentage of capital owned by employees rarely reaches the 2 per cent mark. Compared to employee ownership rates in the U.S., 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 as an employee.

Variable pay and its impact on industrial relations. Variable pay also has indirect effects on 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 protection against high and continuously increasing performance standards. Yet German variable pay programmes 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 in the banking and chemical industries, where 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 per cent of annual income depends on the individual performance and a further 10 per cent on the performance of the company. This collective agreement was made by metal industry union (IG Metall) and Debis. 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).

With 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 per cent and uses a further 2.15 per cent for variable components. For the forthcoming year, an increase of 2.3 per cent was agreed upon. However, there will be no linear increase. The 2.3 per cent of wages will be distributed according to individual performance.

The regulation of variable pay via collective agreements has been discussed 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 which leave the actual scheme 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 (e.g. works agreement pr company-level collective agreements) bring about two major changes in the process of determining individual wages. Firstly, variable pay reinforces the decentralization of wage bargaining. Unions partially hand over their influence over earnings to works councils. These variable wage components do not substitute for base pay, but often replace collectively bargained elements (e.g. piece rates) or reduce their significance. The large rewards sometimes associated with variable pay may also be intended to weaken union penetration in new sectors such as IT.[15] 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. Collective wage bargaining sets a smaller portion of the individual wage and a larger portion underlies entrepreneurial principles such as risk-taking and competition.

3.3 Interactions with industrial relations

This section examines two questions. First, how do works 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 labour has not blocked corporate restructuring but played a subtle role shaping the implementation of corporate strategies aimed at improving share price performance (Höpner and 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 what above was described as the communicative dimension of shareholder value. Here German trade unions have decided to side with shareholders. Unions recognize that international accounting standards, whether IAS or U.S. 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)* which facilitated the adoption of international accounting methods and have even called for an EU directive which 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 is difficult where there are different accounting standards. In sum, German trade unionists argue that transparency is a tool for codetermination (Bolt, 2000; Köstler, 2000; Küller, 1997; Putzhammer and Köstler, 2000; Scheibe-Lange and Prangenberg 1997).

Contrary to the rules of traditional German accounting (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 levelling 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 some of this to employees and shareholders.

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

The operative dimension of shareholder orientation is more complex. Works councils oppose profitability goals. In the late 1990s, an enormous wave of restructuring activity took place and was not stopped by codetermination (Zugehör 2003). One reason was that in some cases, employees demand restructuring. Here employees again share a broad interest with shareholders in promoting managerial accountability and in censuring 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 businesses which are less central economically. As we have seen, variable pay increases such incentives

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 management into restructuring. In 1999, Mannesmann was an extremely heterogeneous company, active in steel tubes, machine tools, automotive accessories, and the telecommunications sector. Telecommunications had become the focal segment within Mannesmann and attracted a growing proportion of funds for investment. One trade unionist at

Mannesmann described the situation as follows: ‘The development of telecommunications has slowly become 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 for every hammer.’ Organized labour 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 a break-up in order to remove the conglomerate discount which made acquisitions expensive and increased the danger of a hostile takeover.

Around the same time, a similar situation 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 activity. Therefore, Thyssen Krupp planned to spin-off. Thyssen Krupp Steel and to initially list 30 per cent of the latter on the stock market. The works council chairman 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 do not 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’(Kroll 2000).

These cases show that spin-offs and return to corporate specialization can be undertaken with the consensus of organized labour. Here capital market orientation and codetermination are hardly irreconcilable opposites. The mixture of core and marginal business is problematic for employees. Their 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.[16]

The impact of shareholder value on industrial relations. There is little evidence that companies adopting shareholder value attempt to discontinue codetermination. Shareholder orientation seems to strengthen trends that were already observable in the 1980s. Five trends in codetermination can be distinguished (Mitbestimmung 1998; Kotthoff 1998; Streeck 2001, 1996; Thelen 1991):

- *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.
- *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.
- *Co-management and professionalism*. In practice, codetermination goes far beyond its legal foundations, interfering in and legitimizing company policy not only in social and personnel matters, but in economic issues also. The boundary between management functions and codetermination becomes increasingly harder to discern.
- *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.
- *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*) which rely on negotiated rules instead of *Konzernbetriebsräte* that are based on legislation.

Codetermination practices are thus becoming more micro-focussed and insider-oriented. This complicates the relationship between works councils and unions, since the latter see themselves as the macro outsider force in the labour movement. The interests of employees as insiders in a particular company may contradict the interests of other employees who are outsiders. The unions' axiom that codetermination should go beyond the goals of existing company insiders has increasingly undermined by practice. One example is the discrepancy of 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 1997, not even the works council members of Krupp participated. The heterogeneous and firm-specific employee interests were not overcome by common class-based interests. During a similar incident in summer of 2003, works councils of large automobile companies protested against the Eastern German strike to demand a 35-hour week. Trade unions find it increasingly difficult to impose discipline and solidarity upon strong works councils who are involved with company-based cross-class coalitions. 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 the section on variable pay. None of the large companies referred to here 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 large companies benefit more from centralized collective agreements than small companies (Hassel 2001; Manow 2000; Thelen 2000): 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 firms tend to have decreasing unit labour costs, while less productive companies are faced with increasing unit labour 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 labour 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 labour 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 2003). There is no statistical correlation between shareholder value orientation and the existence of plant-level pacts.

4. Conclusion

The post-war ‘model’ of German corporate governance was characterized a high degree of complementary between patient, bank-based capital and employee involvement. This complementarity was rooted in a specific class coalition where capital could receive favourable rates of return while allowing a distribution of value-added that favoured labour and internal reinvestment in the firm. ‘Patient’ capital thereby stabilized German employment relations and industrial relations. Meanwhile, corporate accountability was achieved by external contingent

monitoring by banks, supplemented by internal accountability through consultation with works councils. Potential conflicts between corporate insiders and outsiders were held in check by high economic growth and the redistributive politics of the welfare state.

This chapter has shown that these institutional interactions have changed substantially due to changes in corporate ownership and finance and related diffusion of shareholder-value strategies. These resulting changes in employment and industrial relations remain a matter of degree and should not be interpreted as a convergence on the liberal corporate governance models of the U.S. or Britain. Market pressures continue to be mediated by the existing configuration of labour institutions. Here we venture several conclusions.

First, a more marketized role of capital has led to changes toward more marketized employment relations in Germany. Stable employment is available to a shrinking number of employees, while the costs of 'benevolent' employment adjustment can no longer be effectively shouldered by the existing public welfare system. Variable pay is making wage setting more decentralized and contingent on the market position of the firm or business sub-unit. This trend suggests growing insider-outsider conflicts between core and peripheral employees, as well as between big firms and the larger society.

Second, the diffusion of shareholder-value has not undermined the core institutions of German industrial relations, namely codetermination and collective bargaining. Particularly where labour is strong and supported by law, industrial relations institutions are relatively sticky even in the face of capital market pressures. These institutions continue to preserve labour peace within the firm. However, the economic functions of these institutions are evolving incrementally in light of new pressures and managerial strategies. Collective bargaining is struggling to maintain its past role in setting egalitarian and solidaristic wages. Unions are thus less able to exert a productivity whip on firms through high and uniform wages

which were a ‘beneficial constraints’ on German work organization in the past. Now collective agreements are more defensive and steer the process of decentralization. Likewise, codetermination has an increasingly insider-focus on the interests of core employees. This shift is transforming codetermination from a politically guaranteed institution to a more private and contractual arrangement (Jackson 2003). While codetermination was the result of a historical effort to take labour and working conditions out of market competition in the interests of class solidarity, its function has changed more into the co-management of organizational change with the aim of making labour a competitive factor of production.

What can the German case tell us more generally about corporate governance and labour management? In returning to the two views of Germany discussed in the introduction, this chapter suggests that past literature has overestimated the degree to which capital and labour are tightly linked in a causal sense. Our chapter shows that since the mid-1990s, strong labour has not prevented the emergence of shareholder value in Germany, as implied by Roe (2000), nor has shareholder orientation undermined the distinctive institutions of German industrial relations. Roe stresses how employees may increase agency costs. However, we argue that this might be misleading because works councils may work in coalition to promote greater accountability and thereby actually decrease agency costs by monitoring managerial pay, fighting for transparency, opposing prestige investments, and also siding with shareholders in corporate restructuring. Likewise, committed bank finance does not appear necessary to support credible commitments by management toward labour. Capital market constraints are often more pliable, and labour can accommodate some new distributional constraints within the existing institutional framework of codetermination. However, we leave the long-term stability of these arrangements as an open question. In addition, while codetermination may coexist with capital market pressures, it also remains to be seen whether the distinctive German profile of

comparative institutional advantage based on their past complementarities (Hall and Soskice 2001) will be reproduced.

Change in the 1990s is consistent with a historical pattern of co-evolution, where these institutions revealed a largely unintended fit and their 'coherence' or 'systemness' as a national corporate governance model was attributed only in retrospect (Jackson 2001). Their stability often depended upon the fortune of ever changing economic circumstances. Thus, institutional linkages are not established once and for all, but are in constant renegotiation—policy-by-policy and company-by-company. Institutions themselves are often ambiguous for actors, and the linkages between institutions indirect. Linkages are often made by the strategic choices on how to use institutions, as well as stakeholders entering into effective coalitions to promote and defend those strategies. A key example in this chapter was the finding that shareholder orientation is related to changes in the career characteristics of the German managerial elite. Shareholder value management has spread rapidly because it is an important way for a new managerial generation to promote their careers. Here strategic management plays an important intermediating role beyond a mechanistic relationship between inputs (functional pressures from product and capital markets) and outputs (shareholder oriented strategies).

Germany will remain an important test case as to whether labour can remain resilient in the process of adapting and inventing solutions to the new governance problems posed by market finance and shareholder-value management. The potential for a 'hybrid' model of corporate governance depends perhaps on the extent to which labour also impacts new shareholder value practices. Will Germany adopt shareholder value in ways that differ from countries where institutionalized employee representation is weaker? This chapter documents several examples of the pro-active role of labour in promoting an 'enlightened' form of

shareholder value. Such a model would utilize employee voice alongside shareholders to promote greater accountability in issues of transparency and management pay, while continuing to avoid class conflicts and negative sum solutions associated with the U.S. or U.K. model. However, doing so will require Germany to confront the growing rift between corporate insiders and outsiders by developing new forms of interest intermediation and use of public power.

It remains to be seen whether an enlightened version of shareholder value in Germany can survive as a durable outcome, and one that is 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 labour 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 labour.

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	

Sources: Tenure Data: OECD. *Employment Outlook*, 1993 and 1997. 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 programmes. Data relates to West Germany. 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 not in the labor force who left jobs within the past 6 months. 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 (labour 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, percentages

	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, 40 listed corporations in late 1990s

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

Source: Höpner (2001: 40)

Table 4 Components of the 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 programme does not exist	0

- Traditional share ownership programme 1
- Extended share ownership programme 2

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Incentive-orientation of payment system: 0 – 7 pts

Figure 1
The Legal Structure of Corporate Governance in Germany

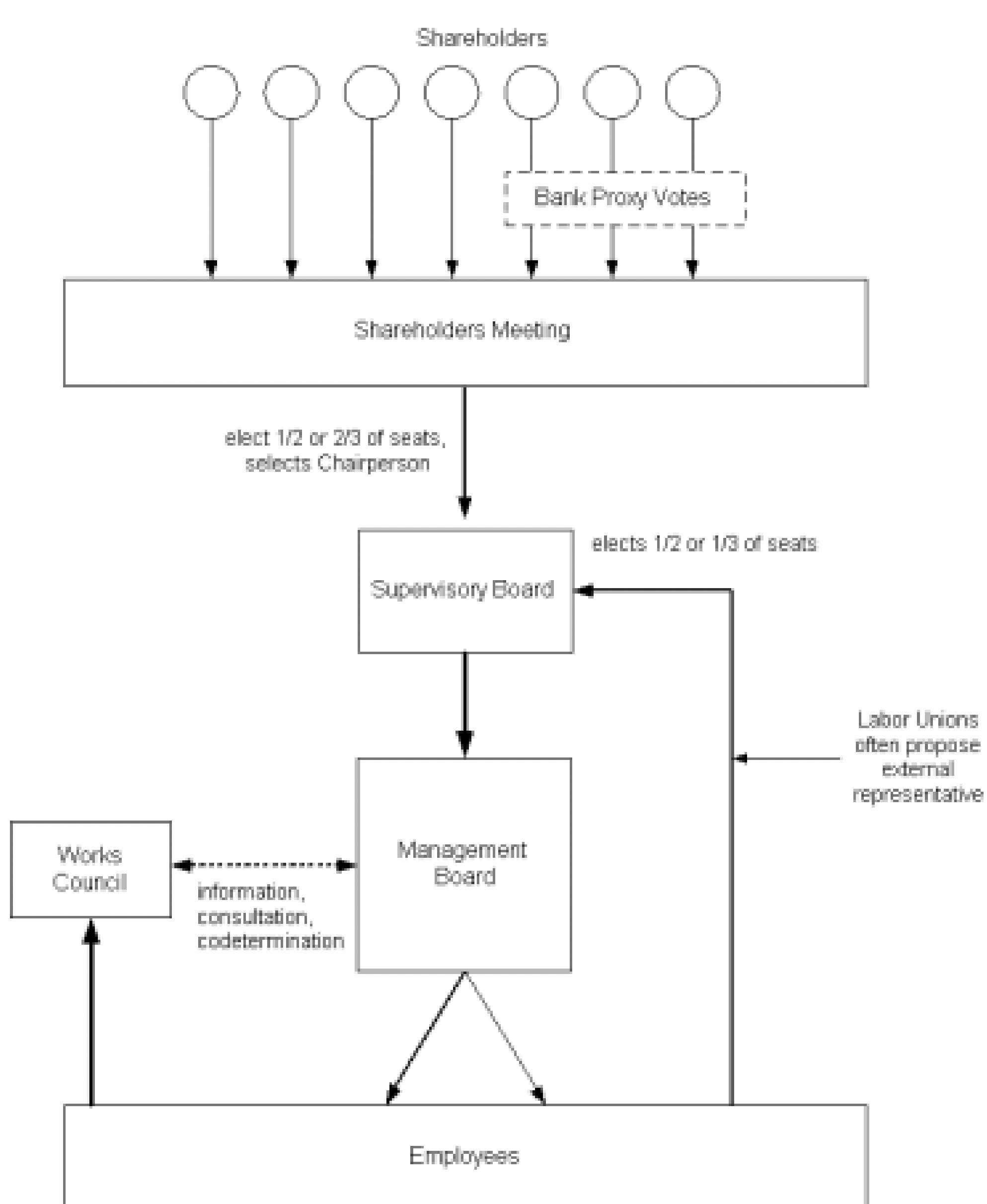
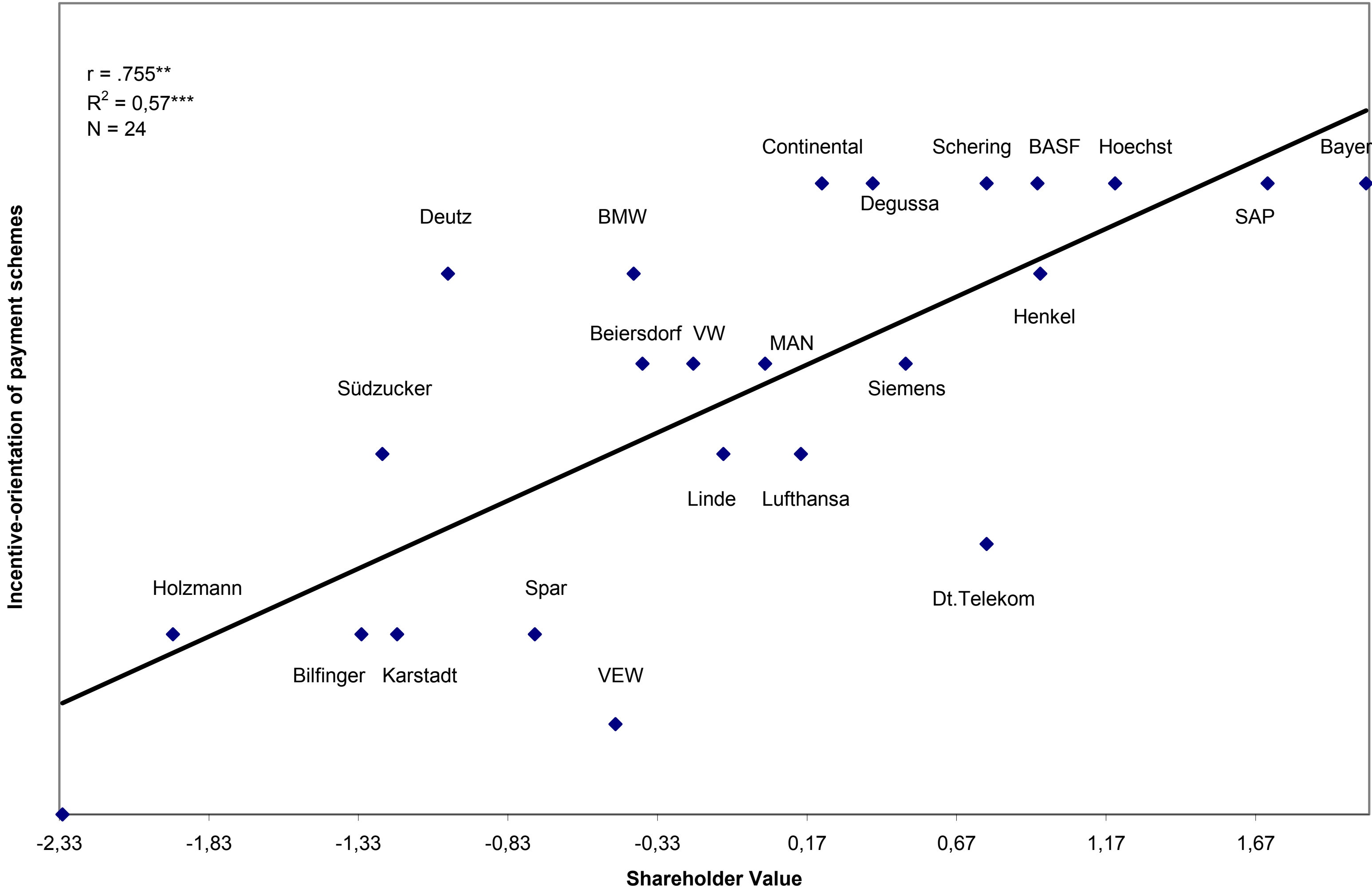


Figure 2

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



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Endnotes

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

[2] On relational financing, see Aoki and Dinc (1997: 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 and Albach 1995).

[3] Works councils represent all workers at the level of the establishment and enterprise. Meanwhile, codetermination also extends to the supervisory board, where employees are represented with between 1/3 and 1/2 of the seats.

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

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

[6] Inter-industry wage differentials are nearly twice as large in U.S. even when controlling for differences human capital variables (Bellmann and Möller 1995; 152; Schettkat 1992: 36-37).

[7] For example, apprenticeships in German metalworking occupations last 3.5 years. Six occupations share an identical basic training the first year . In the second year, these occupations split into three 'groups' that share an additional half year of training. The next half year is spent in training in six 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.

[8] The real rate of return on the national stock market index averaged 10.2 per cent in Germany and 7.8 per cent in the U.S. between 1950 and 1989 (Jackson 2001).

[9] *Handelsblatt*, 8.11.1999

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

[11] 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 behaviour. The professionalization and the marketization of management create a climate that favours some management ideologies more than others.

[12] 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.

[13] Pioneering examples are Mercedes Benz, Bayer, Continental, and Adam Opel.

[14] However, the danger is that competition among employees for these rewards may reduce motivation for cooperation, passing along skills, and the sharing information.

[15] Variable pay 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.

[16] *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 2003), but shareholders' demands turn out to be more radical and are opposed by insiders.