

The Convergence of the German Corporate Governance System with the  
Anglo-American Model: Does focusing on Shareholder Value  
Philosophy put an end to the German Social Model?

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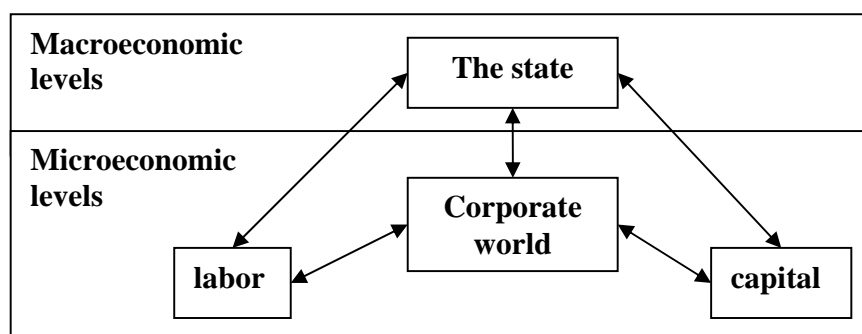
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## 1 Introduction

The German social model of an institutionalised high-wage economy combined social cohesion, competitiveness and a low level of social inequality. German markets are politically instituted and socially regulated so that a competitive market economy coexists with an extensive welfare state. Globalisation, however, seriously affects the national policy autonomy through two major factors: First, the rise of new technology and growing competition competitiveness exposes the German economy to increasing product market pressure (competition for demand). Second, the integration of financial markets increases capital market pressure (competition for supply). During the last decade, the European capital markets have seen a change, which was initialized by the internationalisation of world financial markets. Accelerated by political reforms, the previously underdeveloped capital markets became more important. In this essay I aim to link the microeconomic level of economic actors, whose actions are influenced by underlying corporate governance ideology, with the macroeconomic level of political institutions which companies are embedded in. I will address the question of what impact the emergence of markets for corporate control and increasing internationalisation of firms do have on the co-ordinated market economy. Do the factors that led to the deregulation of capital markets will eventually turn into the inescapable pressure to a deregulation of the labor market? Or is there a hybrid approach of liberal and non-liberal features that can be maintained?

This essay aims to highlight the interdependence of economic institutions, markets and the prevailing ideology. I want to describe how changes in the one sector affect another one. Thus I will argue that external forces in form of internationalization and competition pressure have led to ideological change: the focusing on Shareholder Value philosophy.

Figure 1: The interdependence of industrial relations in an organized market economy



Shareholder Value philosophy changes the behaviour of the firm and implies a shift of priority from employees to shareholders. Labor market regulation tries to prevent the shift. But as national governments can no longer protect companies from market pressure and even contributed to the creation of a market for corporate control companies become subject to market forces on product and capital markets. They respond with restructuring, shedding off employees, outsourcing and the call for the deregulation of the labor market. As long as the welfare state absorbs workers that were made redundant, companies can pursue those strategies that Shareholder Value ideology suggests and maintain cooperative relations with their workforce at the same time. The consequences for the welfare state, suffering from minimal growth and rising unemployment, are fatal. The crucial question for politics is therefore if they should liberalize the labor market, thus give up socialist features and allow for the move towards a liberal market economy. This would be more efficient but might result in increasing differences between people's economic well-being. The second way would be to maintain a regulated labor market and accept less economic efficiency.

To solve the question, I will first present the Anglo-American Corporate Governance philosophy in section 2 and contrast it with the German Social Model in interdependence to which the stakeholder philosophy of the German firm evolved in section 3. I will highlight how the system was able to reconcile economic competitiveness with social cohesion and draw upon the German company "Porsche" to illustrate this. The fourth section analyzes the challenges and pressures for "Shareholder Value" philosophy, which companies adapted in response to the challenges. The fifth section discusses the political and institutional implications for the German Social Model and –based on this analysis- finally try to see if liberalization is a necessary reaction to existing problems and if this would put an to the German Social Model.

## **2 The Corporate Governance debate**

Why does Corporate Governance matter? Corporate Governance is a response to general institutional conditions and at the same it shapes these conditions. The way corporations are managed and the philosophical rationale that underlies their operation has a considerable impact on society. Large corporations create the greatest part of an economy's wealth and its employment. They shape the face of our society and social institutions that determine the relationship between society and economy. Economic success and social well-being depend to a great extent on the cooperation of the company with political institutions.

With the opening of capital markets, which was fulfilled during the 1990s, the corporate governance question has become a central topic for nearly all OECD economies and raises new issues for economic regulation and legal reforms.<sup>1</sup> Special attention has been paid to the issue in Europe, since in course of the European integration the need to solve the Corporate Governance debate on a cross national level becomes prevalent.

The prevailing Corporate Governance paradigm is virtually an Anglo-American concept, that arose with the publication of the classic work on “The modern corporation and Private Property” by Berle and Means in 1932. Aiming to overcome the “alienation of owners from their capital”, the concept is mainly centred on the relationship between the management and the shareholders of a firm.<sup>2</sup> In accordance to the liberal tradition in America and Britain, where individual liberty and competition provides the ideological rationale for a market economy, the company –as a private affair- is seen as a contractual arrangement that is to satisfy the individual interests of the contracting parties. The problem arises with the separation of ownership and control in large-scale, public companies where the plurality of owners mandates a board that is charged with the management of the firm.<sup>3</sup> Therefore, corporate governance is also defined as the process that “*deals with the ways in which suppliers of finance to corporations assure themselves of getting a return of their investment*”<sup>4</sup>. Extensive literature (Berle and Means, 1932, Modigliani and Miller 1958, Jensen and Meckling 1976, Harris and Raviv 1991, Shleifer and Vishny, Hart 2001) is concerned with the allocation of decision-making rights between management. The principal-agent-conflict requires the "principals" or owners of the firm to establish institutional arrangements within corporations by which they may best control their managerial "agents". “The” corporation as personal entity is a fiction. The firm is rather a net of individual relationships that are strengthened by contracts. The role of the state is thus reduced to a liberal regulator that enables contracting between self-interested individuals.

In 1986, Alfred Rappaport links the principal-agent theory to economic performance with his work: “Creating Shareholder value”. He draws upon modern finance theory and its integration to strategic management, especially Porter’s competition analysis.<sup>5</sup> With the growing importance of capital markets, Rappaport realizes that a company’s supply with capital is a crucial factor for

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<sup>1</sup> Jackson 2002, 3

<sup>2</sup> Shleifer/Vishny 1996

<sup>3</sup> Berle/Means 1999

<sup>4</sup> Shleifer/Vishny 1997, 737

<sup>5</sup> Porter 1980/1985

long-term economic success and thus justifies the satisfaction of shareholders' interests as the main goal for company in their own interest in going concern. The shareholder's primary interest lies in maximizing the wealth of the corporation to assure them future cash flows in form of dividends and a positive stock price development. When corporations are managed to maximize shareholder value, so do the advocates of shareholder value philosophy argue, the performance of the company as a whole is enhanced and thus provides benefits for all parties involved, not only shareholders. A healthy corporation can meet the fixed claims of stakeholders that have been negotiated in their contracts. Shareholders, who burden the general business risk as they are the legal owners of the firm, are entitled to a higher chance in form of all residuals. Also from a macroeconomic viewpoint, shareholder value maximization coincides with optimal economic outcomes: the free flow of financial resources enables efficient allocation of resources to those economic actors, who will employ them most profitably.<sup>6</sup> Actual market regulations in the US reflect the shareholder-oriented philosophy and favor market transparency. Corporate accounting standards and stock market regulations therefore require public disclosure and reporting on the company's market performance according to the "*true and fair view principle*".<sup>7</sup>

### **3 The German Social Model**

In Germany, Corporate Governance is a controversially debated political issue because the market-driven shareholder value ideology is opposed to Germany's consensus-oriented Corporate Governance model, which I will present in this section.

#### ***3.1 The bank-based system lacks the market for corporate control***

In Germany, but also other regulated market economies such as Japan and France, where banks are the main provider of capital, dispersed ownership and markets for corporate control are historically lacking.<sup>8</sup> Companies tend to finance themselves from long-term bank credits and retained earnings rather than the equity market. Only a small proportion of German firms is traded at the stock exchange.<sup>9</sup> At the end of 1995 the market capitalization rate is only 23 % of GDP<sup>10</sup>. Ownership is rather concentrated among long-term shareholders, primarily families and banks, who often hold an equity share in deposit. They are less interested in the profits of their

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<sup>6</sup> O'Sullivan 2002, 257

<sup>7</sup> Lütz 2002, 7

<sup>8</sup> Baums 1994, 16

<sup>9</sup> Beyer/Hassel 2002, 313

<sup>10</sup> Dore 2000, 172

equity investment than in the business relation with the company. They thus often take part in the operation of the company and gain access to inside information. The German model of corporate integration is therefore also referred to as the “insider system of corporate control”.<sup>11</sup> Banks have the incentive not to speculate with stock, but rather use their proxy-votes on behalf of their shares they hold in deposit to control management performance. In addition to this, bank representatives frequently have a seat in the supervisory board. The close relationship between banks and firms has been seen as a key factor for economic success, as the reliance on low-interest capital (patient capital) provides a comparative advantage to German firms.<sup>12</sup> It encourages them to pursue long-term strategies of internal diversification and diversified quality production. This system has been mutually reinforcing, since due to the absence of developed equity markets, firms have to rely on bank loans as a source of external finance. Cross-shareholding among companies leads to the highly entangled inter-corporate network of the so called “*Deutschland-AG*”.

### **3.2 Industrial citizenship shapes the character of the corporation**

The concept of worker’s co-determination (Mitbestimmung) dates back to the late nineteenth-century, where social movements –fearing the growing power of capitalist large corporations–shaped the face of European industrial relations. “Active participation of employees in the decision-making process was seen as a way to overcome the contradiction between the classical liberal ideals of self-determination and the rights of the individual, on the one hand, and the reality of industrialisation, on the other, which was, as Marx termed it, the alienation of workers from the fruits of their labor” describes Pistor (2003, 164) the socialist roots of co-determination. Co-determination still has a strong influence on management-labor relations. Employees today enjoy strong participation rights that are formalized in law and allow for a significant decision-making impact of workers on business strategy. Worker’s co-determination is institutionalized in the current organisational structure of German corporations on two levels, which is also referred to as the dual board system:<sup>13</sup> Co-determination on the work council (Betriebsrat) represents the plant level and union representation on supervisory boards (Aufsichtsrat) represents the corporate level. The work council has a legal say in the operation of the firm and involves legal rights to information, consultation, co-decision making.<sup>14</sup> In large companies, more precisely in

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<sup>11</sup> Deeg 2001, 17

<sup>12</sup> Porter 1992

<sup>13</sup> Baum 1994, 17

<sup>14</sup> Jackson 2002, 94

companies with over 2,000 employees, 50% of the German supervisory board (Aufsichtsrat) is elected by employees, blue and white collars as well as lower-ranking management and labor unions. Employee representatives are involved in giving business advice, ratifying important strategic decisions along with shareholders and, of course, lobbying for their own interests. Thus, the members of German boards are considered to be agents of the stakeholders of the firm, rather than only agents of shareholders. Especially the benefits from cooperation have gained appraisal: “Co-determination between management and employees is a worthy principle which, in its 1960s heyday (during Germany’s economic miracle or *Wirtschaftswunder*, remark of the author), helped to build strong German companies, maintaining harmony between workers and employees”.<sup>15</sup> Like co-determination, the “*Tarifautonomie*” of wage-bargaining, that is the right of the bargaining parties to set their wages free from state interference, is enshrined in law. If profit increases, labor unions exert their bargaining power to ensure that their wages also increase proportionally.

The table below provides an overview of the main differences between the Anglo-American Corporate Governance system and Germany.

Table 1: Comparison of Corporate Government Patterns, following Jackson (2003) and Vitol (2003)

| <b>Regime Characteristics</b>           | <b>Liberal Market Economy (Anglo-American)</b>             | <b>Organised market economy (Germany)</b>  |
|---|--|--|
| <i>Financial system</i>                 | Capital markets  | banks  |
| <i>Corporate control</i>                | Market-based   | Insider-based  |
| <i>Capital interests</i>                | Financial, liquidity                                       | Strategic/organizational   |
| <i>Mechanism of corporate control</i>   | External takeovers, exit option                            | Internal coalitions  |
| <i>Advantages for smaller investors</i> | transparency   | stability  |
| <i>Constraints on large investors</i>   | Rule-based   | Incentives for responsible behaviour   |
| <i>Labour</i>                           | Voluntarism, collective bargaining, low legal intervention | Industrial Citizenship, legal or bargained rights to information, consultation and codetermination |

### 3.3 Stakeholder Philosophy

Regarding the diverse interest representation that is constitutionalized through politics, the crucial factor for economic success is the efficient reconciliation of all stakeholders’ interest, and not only those of shareholders. Stakeholders are all parties involved in the business process, such as employees, management, lenders of credit and equity capital, suppliers, clients but as well the environment and society. This fact is reflected in the stakeholder philosophy of the firm. The

<sup>15</sup> Economist II

main goal of the firm is to promote the interest of its various stakeholders rather than maximising its profits for the benefit of the shareholder: “The common good of the company is the fulfilment of the company: namely, to create the conditions that will enable its members (that is to say, all those that have a part in the company) to achieve their personal goals“<sup>16</sup> The corporation is seen as an economic and social entity and has rights and responsibilities like a natural person. Good corporate governance, therefore, means to strike a balance between the interests of the various stakeholders, protecting social peace and a harmonic relationship to the corporation’s social environment that goes beyond Anglo-American notions of voluntarily accepted "corporate responsibility".<sup>17</sup> Dore’s (2000, 182) anecdotic comparison illustrates the differences between shareholder value philosophy and stakeholder philosophy: In the Anglo-American capitalist firm capital hires labor through its manager-agents. In the cooperative stakeholder firm labor hires capital through its elected managers.<sup>18</sup>

There is a close interdependence of the welfare state and the corporate world. The socio-economic system stresses justice and co-operation and calls for social responsibility of companies. The German concept of “enterprise constitutionalism” (Unternehmensverfassung) ascribes to a firm features of a social institution and envisages that a firm’s organisation and its behaviour have to consider the interest of not only equity holders, but also employees and the social environment.<sup>19</sup>

The German system of mediating interests between workforce and management and the strong alliance of banks and companies has in the past been a symbiosis from which all parties involved benefit: social peace strengthened Germany as a business location, patient capital enabled firms to pursue the long-term strategy of diversified quality production, shareholders possessed monitoring power through direct involvement and corporate integration offered a strong protection against hostile takeovers.

### ***3.4 Industrial citizenship as a competitive advantage in the production process***

The discussion of corporate governance moves beyond purely financial issues and immerses in the production process. To understand the roots and impacts of corporate governance we must analyze the interplay between the latter and the process through which productive resources, such

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<sup>16</sup> Argandona 1998, 1097

<sup>17</sup> Streeck 2001, 1.1

<sup>18</sup> Dore 2000, 188

<sup>19</sup> Jackson 2002, 88

as capital and labor, are employed in the corporate economy. Corporate governance “must support financial commitment – the commitment of resources to irreversible investments with uncertain returns – and organizational integration- the integration of human and physical resources into an organizational process to develop and utilize technology.”<sup>20</sup> Organizational integration thereby means that existing social relations are such that they offer incentives to human capital to integrate their knowledge and capabilities within the organization so that they contribute to the innovation process and thus improve the performance of the corporation. Economic success depends on both committed physical capital and committed human capital, or, to make a long story short, money and knowledge. German companies have developed a specific production system that emphasizes the importance of labor-management cooperation and long-term employment, which is also referred to as “diversified quality production”.<sup>21</sup> This production system enjoyed a competitive advantage by concentrating on quality-competitive strategies rather than price-economic strategies. In well known cases of the automobile and machine tool industry, but also in textiles, precision engineering and food processing, German companies tended to produce high-quality products to a premium price.<sup>22</sup> The premium price enabled the payment of high wages and other non-wage benefits. In this area paternalistic job protection went well with the exigency of the market: To be competitive firms needed workers who were willing to make personal investments in general-, industry- and, most importantly, firm-specific skills.<sup>23</sup> Firm-specific skills, however, are worthless outside a specific firm, so that companies had to offer employment protection. Through secure long-term employment, workers had the necessary incentive to invest in firm-specific skills and firms had the incentive to provide their human resources with these skills. Skill formation and learning on the shop floor are still integrated into the organization of the company, typically through dual vocational training system, also known as the apprenticeship system, in which employees are dually trained in school and in the firm. Training on firm-specific skills in turn promoted specialization in high-quality products for market niches in which price competition was moderate but quality was really important. Furthermore, it created a high commitment among workers. Being interested in the long-term perspective of the firm and being involved in the operation of the firm, employees were both

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<sup>20</sup> O’Sullivan 2002, 258

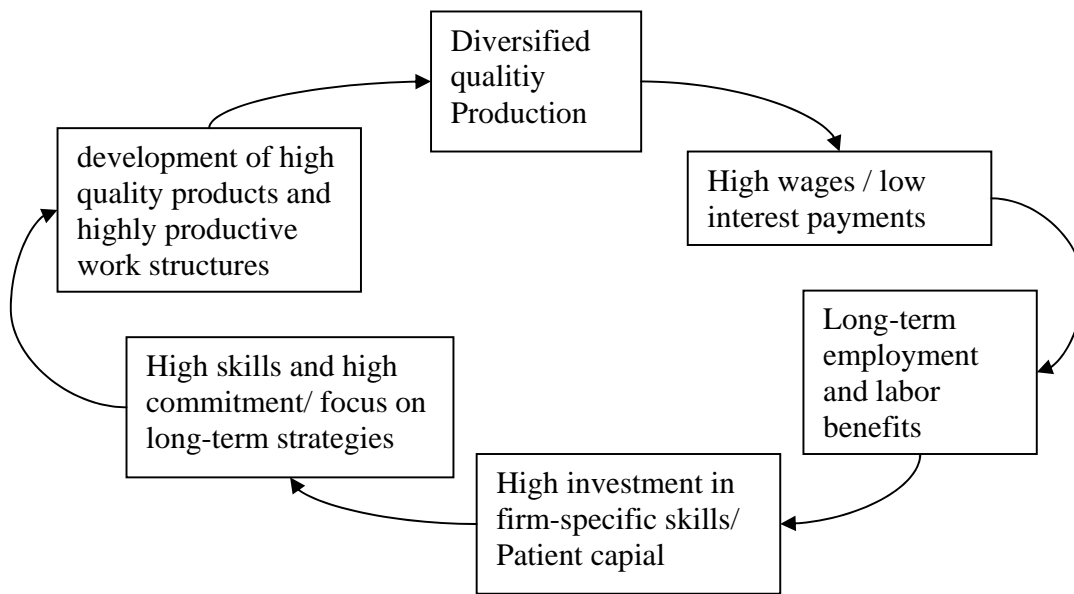
<sup>21</sup> Streeck 2002; Ulrich 2003, 220

<sup>22</sup> Ulrich 2003, 221

<sup>23</sup> Estevez-Abe/Iversen/Soskice 2001, 181

motivated and enabled to forward valuable information to the management, which does not operate “at the front” of the production, marketing or retail process.

Figure 2: The virtuous cycle in the German production model; in reference to Jürgens, 2003, 220



The availability of patient capital resulting from close bank-industry relations is considered as a comparative advantage in the sense that the development of high quality products and highly productive structures requires a long-term commitment of financial resources.<sup>24</sup> Since this is given, the management could pursue long-term strategies and improve business performance over a long time horizon.

### 3.4.1 Porsche: a successful example of the German production model

In this section I want to present a model company that –despite of the Shareholder Value pressure- still successfully achieves the reconciliation of industrial citizenship and stakeholder philosophy with competitiveness and high economic performance: the “Dr. Ing. h.c. F. Porsche AG”. The producer of thoroughbred luxury sport cars stands for “Made in Germany” and also for the success of the German Social Model. The corporation also ranks among the most profitable car manufacturers in the world. Porsche exclusively produces in Germany and –unlike most of other German companies- has constantly increased its workforce, 9.7 % alone in the last three

<sup>24</sup> O’Sullivan 2002, 257

years. What are Porsche's main ingredients for its outstanding success? Most importantly, the company follows the premium strategy and demands a considerable market premium for its high-quality products. Its exclusivity and superb image makes Porsche unrivalled in its market niche and highly successful on export markets. Porsche incorporates the perfect paradigm of a network-based stakeholder company: Mainly family-owned, Porsche is anxious to maintain good relations to all its stakeholders and an "intelligent" network management. Porsche knows that its business success depends on the motivation of their employees, the flexibility of their suppliers to deliver in order to satisfy unexpectedly high demand without delays and the satisfaction of their costumers with the product.

The company proudly advertises their above-average training quota within Germany's motor industry on their website: "Porsche is training the specialists of tomorrow right now. That not only contributes to long-term quality assurance, it also corresponds to our company strategy of responsibility"<sup>25</sup> The company achieves to motivate its employees through its status appeal as an employer, its various skill development programs training programs but also through its specific mode of production.

The owning family safeguards the common stock and allows outsiders to only hold preferred stock, thus depriving them from their voting rights and taking influence on the strategy planning. Porsche openly praises the insider-system of control: "being able to call on the expertise of individual family shareholders on specific subjects at any time represents an exceptional advantage for Porsche AG" The company even risks to put off their stockholders and rejects to disclose its quarterly business figures as the company does not want to attract investors with a focus on short-term achievements. They rather expect them to trust in fair treatment by management and long-term strategic business goals rather than short-term balance-sheet and investor-friendly transparency. Although Porsche opposes to all features that appraised within the rational of shareholder value ideology, Porsche has doubtlessly outperformed the market: Considering Porsche's last 10 business years, from July 31<sup>st</sup> 1993 until July 31<sup>st</sup> 2003, the stock price increased from EUR 29.50 to EUR 363. This appreciation of 1,131% is pitted against an appreciation of the DAX<sup>26</sup> of only 93%.

The example of Porsche shows that German corporate governance lives on and is successful. However, Porsche manufactures luxury goods and justifies its market premium by its brand

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<sup>25</sup> See <http://content3.us.porsche.com/prod/company/philosophy.nsf/usaenglish/howwearepeople>

<sup>26</sup> The DAX (Deutscher Aktien Index) is biggest german stock index

image, which enables them to pay high wages and still constantly increase profit margins. For other branches the challenges and pressures for “Shareholder Value” have a greater impact on their economic performance.

#### **4 Challenges and Pressures for “Shareholder Value”**

Until the 1980s, the bank-based system was upheld as a model of industrial relations and economists praised the availability of “patient capital” as a critical strength of the German post-war economy in comparison with its US and British counterparts<sup>27</sup>. In the early 1990s internationalisation expanded product, labor and capital markets beyond national boundaries.<sup>28</sup> The German economy heavily struggled with the costs of the reunification in 1989, the rising value of the German currency threatened price competitiveness in the important exports market, unemployment rose whereas growth rates slowed down. Managers and politicians began to take a glance overseas what was happening in the American corporate world. It was then, that the Corporate Governance debate was literally imported to Germany, as the use of the English term “Corporate Governance” or “Shareholder Value”<sup>29</sup> still reveals.

By analysing the institutional change we will acknowledge that the governance of German corporations is approaching a more market-driven and less network-based system. In this section, I will discuss the factors and institutional adjustments accounting for the transition to a more market oriented system of corporate governance.

##### **4.1 Reform of corporate structures and financial markets**

Supported by the prospering German stock market at the end 1990s, Germany’s socialist party (SPD), which came into power in 1998, established reforms that strongly supported and accelerated the creation of a market for corporate control. This happened opposed to the assumption that leftist parties should promote market-restricting institutions as they favor organized market economies with centralized wage-bargaining, codetermination and trade union participation under a welfare regime.<sup>30</sup> Politicians pushed the liberalization of the financial market. By changing capital market regulations and company laws they aimed to strengthen the competitiveness of the financial national sector in the emerging global market for financial

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<sup>27</sup> Porter 1992; O’Sullivan 2002, 257

<sup>28</sup> Beyer/Hassel 2002, 312

<sup>29</sup> Pistor 1999, 164

<sup>30</sup> Höpner 2003

services and to improve the access of national firms to foreign capital.<sup>31</sup> Despite of the loss in influence to supervise the exchanges, in 1993 the German stock-exchange became a publicly traded company (“*Deutsche Börse AG*”). From 1990 to 1998 three Financial Promotion laws were enacted, whose effort in market liberalization was to stimulate supply and demand. They pushed for greater openness and transparency, enforced a legal ban on insider trading and enacted strict requirements for issuers of securities to report information.

In 1998 IAS or US-GAAP was introduced as a new possibility to report the annual statement of accounts instead of the *German Commercial Code (HGB)*. The purpose was to increase transparency of accounting and give, on the one hand, better access to foreign capital and on the other enable private individual shareholders to judge the performance of the firm by giving them the same protection and information as was previously only available to institutional investors<sup>32</sup>. When big companies such as *Daimler-Chrysler* got listed on the New York Stock Exchange, the hence resultant internalisation of investors weakened the control of large domestic insider block holders and emphasised the importance of shareholder value management. Since 1998, banks also could no longer vote on behalf the proxy shares if they held more than 5% on the firm’s equity<sup>33</sup>. The loss of proxy votes weakened bank influence significantly. The 1998 law also enabled companies to buy back 10% of own shares, a technique used in the US to boost the share price, and permitted firms to pay managers with share options.

In 2000 the government radically broke from the old path by enacting a controversial tax law change in their attempt to trigger the modernization of the German economic structure: the *Corporate Income Tax Law 2000 (Körperschaftsteuergesetz)* totally abolished the tax on profits from the sale of long-term equity stakes held by banks and large firms.<sup>34</sup> The motivation was to dismantle the interlocking capital of large firms and thereby create an active market for shareholder orientation. During the large restructuring and entanglement of cross-shareholding that took place in response to the 2002 tax law, banks reduced their long-term equity holdings significantly. *Allianz*, a leading German insurance company, for example, sold its \$13.6 billion equity stake in *Hypovereinsbank*, a leading German commercial bank, and earned two billion dollar without paying tax. For German cities the loss of tax profit turned out to be disastrous. This law awoke major public criticism against the accelerated liberalization of the capital market. The

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<sup>31</sup> Streeck 2001

<sup>32</sup> Beyer/Hassel 2002, 317

<sup>33</sup> Deeg 2001, 29

<sup>34</sup> Deeg 2001, 29

public opinion about the recent reforms has at the latest since then been clouded by distrust despite the enthusiasm about the stock-markets boom in 2000.

These structural and behavioural changes -most notably the decreased role of banks, the change in corporate taxation law that disengages cross-shareholding and interlocking dictatorship and the greater transparency for shareholders- indicate significant institutional change.<sup>35</sup>

#### **4.2 From international competition pressure to Mergers & Acquisitions**

The first challenge to the German production system was posed by international competition on the product markets. Especially competition from Japan was threatening since Japanese products suddenly competed in high-quality niches in which German companies have previously been unrivalled. But since Japan's strategic strength was the solving of costs cuts and Germany's strategic strength was high-quality product standards, German firms managed to move to a pricier market segment and realize higher value-added strategies.<sup>36</sup> This illustrates that internalisation as a degree of foreign employees and sales as well as competitive pressure has long since existed without changing the behaviour towards shareholders. But as the sustained appreciation of the German currency made German products even less price competitive and revealed the German weakness to generate high-quality products at lower costs, market pressure became more drastic. Furthermore, Japanese firms began to move up-market, so that the high-quality market in which Germany specialized became subject to price competition. The decline of coal and steel industries and the burden of the German reunification additionally posed structural problems. In the 1990s companies increasingly tried to meet the challenge of growing pressure from international competition by restructuring their companies. Under reference to Shareholder Value theory companies justified their sometimes radical measures. Unprofitable divisions, which might have been subsidized by profitable ones, were consequently shed. New and promising technologies were immediately taken in through mergers and acquisitions. The 1990s reflected this new business ideology by a growing number of these mergers and acquisition transactions, which increased from \$200 billion in 1994 to 1.5 trillion in 1999, with "almost as many cross-border deals as domestic deals".<sup>37</sup> In 2000, the global trend of Mergers&Acquisitions reached its peak of a total transaction volume of 3500 billion US \$<sup>38</sup>. In order to grow as fast as possible and

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<sup>35</sup> Beyer/Hassel 2002, 318

<sup>36</sup> O'Sullivan 2002, 267

<sup>37</sup> Economist 29 April 2000, p. 10; quoted after Streeck, 2001

<sup>38</sup> Coenenberg/Salfeld 2003, 190

establish their market position and market share necessary to remain competitive on the expanded international markets, companies aimed to accelerate their internal growth through foreign acquisition. Especially for fast growing industries such as telecommunications and pharmaceuticals, cross-border merger enabled access to foreign markets, which proved crucial in times of markets becoming more and more competitive.<sup>39</sup> Anxious to catch up with the technology, companies bought themselves into new technologies to expand their product portfolio, foster innovation and shorten product cycles. The advantage of a high share price became obvious. A high market capitalisation value offered a reliable protection against hostile takeovers and moreover, enabled firms to engage in mergers and acquisitions transactions to their gusto since a high share price made acquisitions affordable and companies could just pay their with own shares.<sup>40</sup> The market for corporate control was born.

In particular, German commercial banks were confronted with competitiveness problems in the marketplace. They began to look out for new opportunities as they believed that their long-term equity investments could be more profitably employed in other ways. Indeed, American style investment banking and asset management far exceeded the profitability of traditional credit allocation. They found attractive potential in financial activities related to capital markets, as for example the underdeveloped securities market. All big players like Deutsche Bank, Dresdner Bank and WestLB purchased during the 1990s leading British investment banks to acquire their technology and human capital in order to accelerate their own organizational change.<sup>41</sup> They have been active in promoting an equity culture and convincing German savers, who stored 41.7 % of their savings in bank deposits<sup>42</sup> to move their financial assets into more market-based savings instruments.

Both developments, the emergence of M&A and the banks' shift of interest away from credit towards equity capital were crucial for the strengthening of capital markets

### **4.3 The New Technology and the stock market boom**

The corporate reorganization in the 1990s involved the privatization of what used to be large parts of countries' national infrastructures, such as the telecommunication industry. The state authorities lacked the skills and vigor to restructure these service giants according to new

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<sup>39</sup>Yamamura 2003, 127

<sup>40</sup>Bühner 1997; Rappaport/Sirower 2000

<sup>41</sup>Deeg 1999, 60

<sup>42</sup>Source: Deutsche Bundesbank Research bulletin, 9 January 1995, p.7 (Deutsche Bundesbank, Gesamtwirtschaftliche Finanzierungsrechnung, Kapitalstatistik.)

technological possibilities and consumer demands. Scarce treasuries blocked the access to capital appropriations necessary to catch up with the technological change. The wave of privatisation both coincided with and gave rise to a public interest in stock markets. In November 1996 the « Deutsche Telekom » went public. A huge advertisement campaign mobilized thousands of German savers who had never thought about buying shares before. The demand for the stocks was so high, that they were five times oversubscribed. Share Prices skyrocketed constantly until the first quarter of the new millennium to nearly a fivefold of its issuing price. The success of the “Deutsche Telekom” has motivated the broader population to invest in market-based instruments, where they can demand higher returns on financial assets grew. The trend is likely to continue since uncertainty about the future of the German pension system induces workers to make private arrangements for their post-working life. With the rise of “the new economy” in the 1990s a wave of company formations established “going public” as an instrument of external financing. Although high-tech SMEs account for only a small portion of the whole company sector, the success of those new internet and biotech start-up firms at the global stock exchanges boosted the belief in the miracle of the new technology. As stock mania reached its peak in the first half of 2000, dotcom companies gained share values greater than reputable companies before they had even made profits. These often new-found companies threatened established competitors by the force of their booming share price. The newly appraised goal of managers became to maximize shareholder value. In mid 2000 the dotcom bubble burst. By today, May 2004, Deutsche Telekom is down at below its issuing price again and the NASDAQ 100 index had fallen to less than half its peak value reached in the beginning of 2000. Nevertheless, the stock market boom has changed the attitude of managers towards their shareholder as they have experienced investors flexing their muscles and how it can affect the future of the company.

#### ***4.4 Companies respond to liberalized and strengthened capital markets by intensifying their focus on shareholder value***

The liberalisation of the financial market and decline of cross-shareholding extends attention to shareholders. Large institutional investors bought up the equity and, being rather prepared to restructure their portfolio and sell their shares, make themselves being heard through the market rather than through the traditional way of getting involved in management.<sup>43</sup> Replacing the insider-system of control by outsider control, the share price becomes the single most important

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<sup>43</sup> Streeck 2002

information for outsiders and gains tremendous importance. As we have seen, the most efficient way to redirect the focus on the stock price of a company is the threat of hostile takeovers. German management adapts features from the Anglo-American management culture. Companies voluntarily adopt American Accounting standards in an attempt to improve their transparency and intensifying investor relations. By using US-GAAP they also strive to get listed on the New York Stock Exchange. In an endeavour to satisfy shareholders' interests, investor relation departments popped up within months and firms began to undertake any effort to provide analysts and especially institutional investors with detailed information about the prospects of the company. The open approval for shareholder value maximization was expressed through the rhetoric of prominent chief executives of major German companies. Now, since recent stock market scandals have attached a negative connotation to the term, often associated with balance sheet manipulation and short-term orientation, the term has been replaced by its synonym "value-orientated company policy" or "wertorientierte Unternehmensführung".<sup>44</sup>

The Shareholder value strategy aggravates the vast problem of a rising unemployment rate, since it recommends pursuing business strategies that are favourable to shareholder value maximization. These often require employment reducing activities such as shedding off unprofitable provisions and cutting costs, which can be efficiently achieved by downsizing staff. The following part will analyze the consequences of liberalized capital markets and extended attention to shareholders in further detail.

## **5 Political and Institutional implications for the German Social Model**

Politics themselves actively facilitated a more liberalized market by enabling market forces to come into play, such through creating an independent stock exchange, enabling share buy-backs, stock options and market-oriented accounting and disclosure. Companies have quickly adjusted to the stronger pressure exercised by financial markets by adopting a shareholder value oriented business strategy. However, the German economic system is still far from being entirely market-driven.<sup>45</sup> National politics are pursuing a hybrid strategy between liberal and non-liberal features. Capital markets exhibit liberal features whereas employment relations are still highly regulated. Governments, in spite of having initiated reforms in favor of liberal capital markets, are reluctant

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<sup>44</sup> Dore 2000, 191

<sup>45</sup> Jackson 2001, 358

to liberalize the labor market since this implies significant cuts in employment protection and the welfare regime.

The economic system links a multitude of sub-systems, among which the capital market and the labor market are only one of the bigger subcategories. The notion of institutional complementary predicts that the change of one system has an impact on the functioning of another.<sup>46</sup> Capital markets converging towards a liberal market driven system might well affect management-labor relations. More market pressure is also likely to result in fading influence of the national government and eventually might bring the government to its knee in terms of complying with the needs of a capitalist market. “Internationalisation has, in fact, led to a declining capacity of the state to regulate economic activity within its boundaries” concludes Jackson (2002, 354) his study of institutional change in Germany and Japan. If this were true and liberalized capital markets turned out to be irreconcilable with regulated labor markets, the factors that led to the liberalisation of the capital market would eventually make the liberalization of the labor market an irrevocable second step. In this section I will first analyze how the shift towards more market pressure affects the factor labor and its relation to the management to see if an extended focus on Shareholder Value strategy is reconcilable with the cooperative management approach. After having analyzed the corporate level I will turn to the macro level and enlarge the focus of my essay. I will examine how the changes in the macro environment interact with the changes in company behaviour to see if the German Social Model as a whole is reconcilable with the institutional change as a whole. The result of this procedure will help to decide whether the hybrid approach is sustainable or whether a preferable outcome can be reached through deregulation of the labor market.

### **5.1 *Distributional consequences for the stakeholder « employee »***

The German corporate governance system had an important influence on the organization of industrial relations but also on how the wealth generated was distributed. Workers evenly participated in the fruits of the industrial success. This explains the relatively low level of income inequality as overall wealth increased.<sup>47</sup> Long-term investors, who were dominant in the German bank-based system, were more concerned with their business relationship than with the profits that might derive from their shares.<sup>48</sup> Therefore they did not push for dividends and a higher

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<sup>46</sup> Beyer/Hassel 2001, 311

<sup>47</sup> O’Sullivan 2002, 264

<sup>48</sup> Dore 2000, 174

stock price. The question that arises when considering the recent development therefore is: Do competitiveness pressure and shareholder value philosophy jeopardize the cooperative system of the German Social Model?

Shareholder Value orientation forces companies to devote a larger part of their value added to boost the stock price and pay dividends, which happens to the cost of workers' shares and retained earnings. Beyer and Hassel found out in their 2002 study on 59 large German companies that the convergence of corporate governance with a capital market oriented system, affects the distribution of the net value added. In systems with weak markets for corporate control more resources are distributed to other stakeholders or they are reinvested, since the management cannot be forced to provide a high rate of return for shareholders through hostile takeovers.<sup>49</sup>

The figures in the table below suggests, that a stronger market for corporate control with an extended focus on shareholders as it exists in Anglo-American countries is correlated to a higher distribution of net value added to shareholders and a lesser share distributed to employees. In Germanic countries 86.1 % of total net added value goes to employees and only 3.0% are paid out in dividends. In Anglo-American countries 62.2 % goes to employees whereas shareholders receive 15% in dividends.

Table 2: The distribution of net value added, source: De Jong (1997:7)

|                  | <i>Labour</i> | <i>Creditors</i> | <i>Government</i> | <i>Retained earnings</i> | <i>Dividends</i> |
|------------------|---------------|------------------|-------------------|--------------------------|------------------|
| Anglo-American   | 62.2          | 23.5             | 14.3              | 3.2                      | 15               |
| Germanic         | 86.1          | 8.8              | 5.1               | 5.2                      | 3.0              |
| Latinic          | 80.3          | 14.4             | 5.3               | 3                        | 4.7              |
| European average | 79.0          | 13.7             | 7.3               | 3.6                      | 6.1              |

*Source:* De Jong (1997: 17)

*Note*

The eighty-two largest corporations in Europe, averages for 1991–4, net surplus value as a percentage of the total net added value. The Anglo-American world includes here Ireland and the UK, Germanic companies are from Germany, Switzerland, the Netherlands and Scandinavia, and Latinic companies are from France, Italy and Benelux.

These findings supporting, a 1997 Goldman Sachs study of manufacturing value-added in the United States, Germany and Europe found out that the share of gross value added going to wages has declined in the US since the early 1980s. Goldman Sachs' analysts make the pressures for

<sup>49</sup> Beyer/Hassel 2002, 310

competition for the returns on capital responsible for this trend which forced the US industry to produce higher returns on equity capital and distribute a higher share of the output to the owners of capital<sup>50</sup>.

The shareholder value philosophy ascribes ideologically less importance to the interest of stakeholders. Shareholder value philosophy and its derived business recommendations were particularly spread by the new generation of managers and management consultants who were trained at American business schools.<sup>51</sup> In this context a 2002 Aspen Institute study reveals interesting findings: their survey among 2000 MBA students observed that the course altered students' values. After course completion, they were less concerned with social goals, customer needs and product quality but attached more value to economic performance as expressed in shareholder value.<sup>52</sup> Not only external market forces might initiate a redistribution of economic resources to shareholders, but also the belief in its moral justification is likely to change the distributional outcome.

## ***5.2 Is focusing on Shareholder Value compatible with industrial citizenship?***

Astonishingly, work councils tolerate the Shareholder Value orientation, although it implies redistribution from workers to shareholders. Why is there no wave of opposition as long as workers enjoy strong rights of co-determination? It seems that the current adjustment to external pressures for higher economic efficiency and competitiveness, exercised by globalising product markets and stronger markets for corporate control, are compatible with the cooperative system of industrial citizenship.

As a recent article in "The Economist" points out that, since German companies are run by consensus, top managers have a better chance to survive and even improve their own position in a company if they play the "consensus game".<sup>53</sup> In contrast to their US counterparts, who are ousted in case of poor economic performance, German top managers have incentives not to upset trade unions and worker representatives, but to please them despite economic disadvantages. Obviously companies do not consider co-determination as economically burdensome as cooperative benefits compensate for economic disadvantages. Companies perceive peace at the workplace as an important competitive asset. Evidence is for example given by the Daimler-

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<sup>50</sup> Goldman Sachs International, 1997, quoted after Dore 2000, 9

<sup>51</sup> See Dore 2000, 171

<sup>52</sup> Economist May 22<sup>nd</sup>-28<sup>th</sup> 2004: Special report Business schools, 62

<sup>53</sup> Economist II

Chrysler merger. Instead of moving its headquarters to the U.S. –thus escaping the strict regulations with regard to workers’ co-determination- the new corporation voluntarily decided to keep its seat in Germany.<sup>54</sup> Also labor unions accept economic constraints and cooperate with the management in the restructuring process and make the process socially acceptable for the workforce. Although decision-making is significantly delayed when employees are negatively affected, as downsizing or closing of a business location, workers’ early involvement in the process helps implementing these measures and reduces later conflict.<sup>55</sup> Even relocation of production abroad is accepted provided that it proves necessary to maintain competitiveness and to protect domestic employment. There are numerous other successful examples of workers co-determination. Often relocation or outsourcing could even be prevented by cooperation of workers and management. They jointly searched for ways to improve organisational structures and production processes. This way they achieved to make in-house production more profitable. Such agreements occurred in 40 of the 100 largest companies during the 1990s<sup>56</sup>. Streeck points out that workforce representatives competing for corporate investment into their local production side sometimes act as "business agents".<sup>57</sup> Just as in competition with external stakeholders, they present competitive packages to the central management that then decides on the allocation of production or new investment.

New forms of payment, such as stock option plans –enabled by the 1998 “Law on Control and Transparency in Enterprises”- and variability of top-management pay were introduced to align the interests of management and investors. According to a study in 2001, already 70% of the 100 largest corporations made use of these options and 57 introduced Employee stock ownership programs (ESOPs).<sup>58</sup> Labour unions, however, regard ESOPs from a bifocal perspective. On the one hand, stock options impose income risk and undermine class consciousness. Management income also came closer to American levels.<sup>59</sup> The growing income difference causes dissatisfaction, since management pay is traditionally closer to workers’ pay. On the other hand, ESOPs are a potential mean to get a second voice and make employees heard not only as

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<sup>54</sup> Streeck 2002

<sup>55</sup> Pistor 1999, 188

<sup>56</sup> Streeck 2003

<sup>57</sup> Streeck 2003

<sup>58</sup> Kurdelbusch 2001, in Jackson 2003, 290

<sup>59</sup> Streeck 2002

employee representatives but also as a powerful party on the shareholder assembly. Hence, unions at Vodafone Mannesmann and Siemens try to organize the voting rights into blocks.<sup>60</sup>

### **5.3 State interference with the labor market, unions, and unemployment**

The compatibility of Shareholder Value orientation and cooperative management seems to come with negative externalities. Employers call upon the welfare state to ease the burden of corporate restructuring with which they respond to pressures for Shareholder Value. Where restructuring requires cuts in employment, management and labor unions jointly exploit the welfare state. Layoffs, for example, are even made attractive by options of early retirement. Early retirement plans grant retirees a munificent retirement income that has to be fully financed by the generous public pay-as-you-go pension system under which all private and public sector workers in Germany are insured. VEBA (merged with VIAG and became E.O.N. in 1999) for example shed 29,000 employees through early retirement and eased the dismissal by granting them full 90% of pre-retirement earnings.<sup>61</sup> By shifting the costs of the restructuring towards welfare institutions, the costs are successfully being externalised to society which bears the burden. To better assess the impact of early retirements, it is worth mentioning that this highly subsidized system already makes up the single-largest item in the German social budget<sup>62</sup> and amounts to almost 12 % of GDP. The pension insurance contribution rate today is 19,5 % of gross wages. Early retirement is, besides population ageing, threatening the stability of the pension system and thus the core of the social welfare system. Other labor-cost cutting activities involved heavily state subsidies, for example part-time work arrangements.

The behaviour of work councils places emphasis on the issue of the insider-outsider conflict that has enjoyed theoretical acknowledgment especially by Olson (1992). The central argument of Olson's theory is that wrong incentives mislead the members of society, who effectuate collective misery against their own intention. Individual unions have strong incentives to maximize the benefit of their members which causes that they care less about the negative externalities their behaviour causes for the economy and outside job seekers. Thus, the interests of employees and management might be successfully reconciled on the microeconomic level, but pose difficulties for the macroeconomic environment. Unions make sure that at least those who are currently employed profit from restructuring and productivity improvement and push their wages above the

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<sup>60</sup> Jackson 2003, 291

<sup>61</sup> Jackson 2003, 289

<sup>62</sup> Börsch-Supan/Wilke 2003, 5

market-clearing level. When firms increase their average productivity through layoffs employees demand a higher average wage (as wages are at least partly bound to productivity) and enjoy personal benefit.

As we have seen, the reconciliation of interest of labor and capital is only made possible by intervention of the welfare state. Workers' co-decision-making strongly favours themselves as insiders. As long as the current workforce profits from otherwise unpleasant changes it is acceptable for them. If the welfare state no longer absorbed workers that are made redundant and subsidized short-term work and early retirement, work councils would be very unlikely to accept large scale layoffs and outsourcing. But those bargained solutions overall rather aggravate the situation for outside job-seekers and have negative effects on the macro-economic environment.

Considering the budget deficit of public finance, it is foreseeable that relying on the welfare state as the saving angel cannot be the long term solution to enable layoffs. It remains to be seen how work councils will react if this option is no longer available.

Apart from providing social security, the state interferes with the labor market in enforcing strong employment protection. Ironically, although labor market regulations are designed to protect jobs, negative incentives prevent the creation of new employment. Getting rid of people is especially costly in terms of negotiating time in work councils and on supervisory boards, who must agree to major changes in the company.<sup>63</sup> Companies are therefore extremely careful to hire new personnel although the order situation would require it. They know it will be tedious to scale down again when the business situation worsens. Above a certain number, employees gain significant decision making rights. If a company employs more than 5 people, for example, they have a right to set up a work council. Particularly in SMEs the constraints co-determination might impose on them hinders economic growth, flexibility and sets negative incentives not to enlarge workforce beyond crucial numbers. But the important German "Mittelstand", which comprises SMEs, employ 70% of all labor, account for 70% of new job creation and make 46% of investment.

#### ***5.4 From a competitive advantage to an economic constraint? The problem of rising social security contributions***

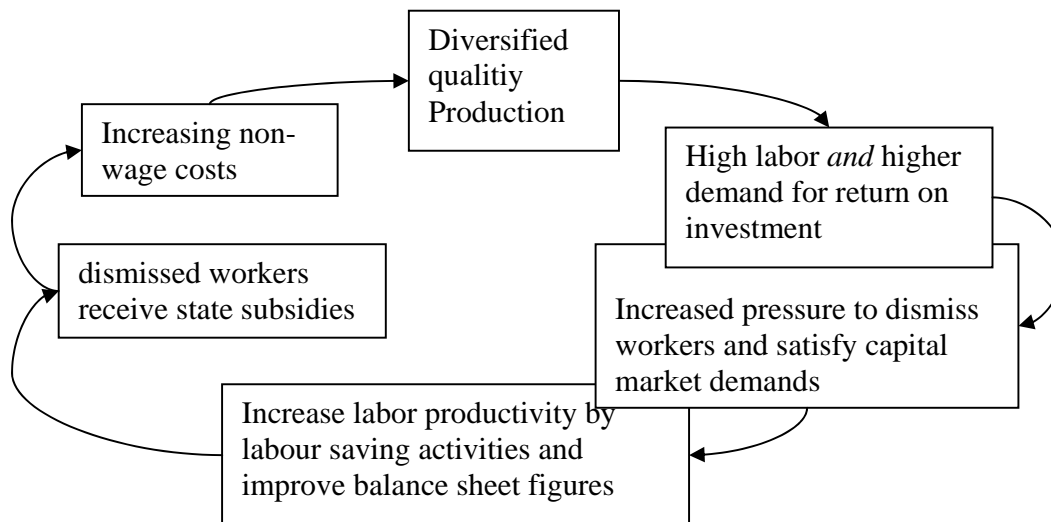
Particular organizational structures and social conditions that prove highly successful in generating innovations (through strategic investment and organizational learning processes) may

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<sup>63</sup> Dore 2000, 193

be constraining as a basis for competition under a different global context. Rising unemployment indicates that the virtuous cycle of the German high wage production regime, that combined economic success and social cohesion, has turned into a vicious cycle (Jürgens 2003; Hemerijck and Manow 2001). Under increased competitive pressure, firms in high wage production regimes can only be competitive if they increase labor productivity.<sup>64</sup> High quality vocational training contributes to a high productivity, but high productivity can be even more efficiently reached by making labour-saving investments and laying off less productive workers, this is usually older workers through early retirement plans. These measures are especially costly for the welfare state. An increase in welfare spending drives up taxes and social security contributions. Escalating social costs create a major non-wage labour problem for manufacturers.<sup>65</sup> Employees are most likely to respond with another round of dismissals. If more employees are being dismissed, the state must again increase its amount of welfare spending. This, in turn, again requires higher contributions of the working population and the non-wage problem becomes more and more critical. Hemerijck and Manow (2001) also refer to this as the “pathological spiral of welfare without work.”

Figure 3: The virtuous cycle has turned into the vicious cycle



High non-labor costs also hinder job growth in the labour-intensive service sector especially at the low-productivity end and turns relatively low skilled workers into permanent unemployed,

<sup>64</sup> Hemerijck/Manow 2001, 221

<sup>65</sup> Aperlidoorn/Rhodes 1997, 16

welfare dependent citizens. Productivity in service related jobs can less easily be increased by improving the production process than in manufacturing. Current unemployment has stubbornly remained on its all-time high of over 4 million unemployed job seekers. High unemployment and underfunded social welfare institutions underline that there is a major, structural economic adjustment problem. Boyer (2003, 175) identifies the aftermath of the unexpectedly large costs of the German unification in 1989 as a particular worsening condition for the German economy. The costs amount to €1.25 trillion, still consume 4% of GDP in 2004 and add 20 % unemployment to the already strained labor market situation.<sup>66</sup> Germany's GDP has hardly grown by 1.4% over the past decade, which is only half the EU average and far away from America's 3.3% growth.<sup>67</sup> Gross government debt is forecasted to rise again to 65.6% GDP in 2004. Slowing innovations and exacerbated competitiveness accentuate the urgent need for the government to promote a new dynamism in the growth regime.

As manufacturers today face much tougher competition it is hard for them to maintain the pay standard and remain competitive at the same time. Furthermore, German workers have –apart from their co-determination rights- accumulated a high level of benefits: high wages, paid holidays, 100% sick-pay compensation and other fringe benefits that originate from the times, when German companies gained high market premiums and when they were relatively unrivalled, so that they could afford such luxurious agreements.<sup>68</sup> A lively debate about the future for the “Standort Deutschland – Germany as an industrial location” has been triggered by companies' response to high labor costs with relocation and outsourcing. With the European integration, European firms can suddenly choose where to have their firm headquarter not depending on how much business they do. Relocation as an “exit” option puts *market* pressure on national governments to initiate institutional changes that makes their jurisdiction the most attractive location. “Firms have increasingly used locational threats to renegotiate established industrial relations bargains, and in recent years they have been extensively used to weaken the power of (labour) unions and force concession bargaining by Daimler Benz, Bosch and BMW”.<sup>69</sup> The president of the German federation of commerce and industry (Deutsche Industrie- und Handelskammer) Ludwig Georg Brown, recently suggested that companies should relocate

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<sup>66</sup> Economist II

<sup>67</sup> Economist II

<sup>68</sup> Dore 2000, 196

<sup>69</sup> Aperldoorn/Rhodes 1997, 18

business abroad in the new member states of Eastern Europe.<sup>70</sup> Comparing average worker's wage in Germany, which amounts to 26\$ per hour with a wage of 4\$ per hour in neighbouring Eastern Europe "where the German unions' stiffest competition lies"<sup>71</sup> makes the advantage companies can gain from relocating their workforce obvious.

High non-wage costs are not only highly costly for the demand side of the labor market, but might also deter supply. It is often economically favourable for low-end earners to receive unemployed benefits and have the state pay all social insurance contributions, than accepting a low-end earning job where not much more than half the gross wage remains after subtraction of social security contributions and taxes.

### ***5.5 The alignment of the German economy: regulation or liberalization?***

The question that I will approach in this section is whether it is possible to accommodate the forces of global capitalism within the existing institutions of a regulated social market economy. In the moment, national governments are struggling between liberal and non-liberal modes of regulation: liberal features in the financial system are opposed to rigid regulations on the labor market, such as dismissal protection and obligatory social security contributions from both the employer and employee, the latter results in unsustainably high non-wage costs. The stability of the system depends on the ability to reconcile necessary reforms to strengthen economic competitiveness and maintain social cohesion.

In contrast to the capital market reform, there is considerable resistance from politicians and labor unions to undertake reforms that liberalize the labor market and cut welfare aid in order to lower non-wage costs. Politicians are afflicted with interest conflicts of various lobbyists, all of which accuse politicians of an "inability to reform". Politicians fear the prompt sanction of German voters, who are overall suspicious of market forces. In the socially-oriented business culture, people rather attach selfishness to a capitalist society than individual liberty and the freedom to choose. The population therefore does not only oppose to personal disadvantages, but oppose to the market ideology as such. For them, an egalitarian society that relieves economic pressure and defends the citizen from economic misfortune is more important than an open competitive society rewarding drive and ability.<sup>72</sup> Deregulation opponents also question that giving up equality in

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<sup>70</sup> Source: see above; comment: On May 1st Malta and Cyprus and eight countries from Central and Eastern Europe - the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia joined the European Union

<sup>71</sup> Economist II

<sup>72</sup> Dore 2000, 171

form of cutting welfare benefits and liberalizing the labor market does create more employment. Even if non-wage costs were brought down significantly, German wage costs of 26\$ would still hardly be able to compete with Eastern European wage costs of 4\$ in terms of price. Giving up dismissal protection and lowering dismissal costs might just result in unconstrained outsourcing. The recently introduced “mini-job” for example, designed for casual employment with a pay of 400€800€, has, according to the Economist failed to attract the long-term unemployed. Instead this “cannibalistic” invention has shown to “tempt the young and the old out of full-time employment”.<sup>73</sup>

During the reform process of capital markets, politics themselves have made a vast contribution to increasing market pressure and lowering their own influence for the sake of competitiveness. As a consequence, there seems to be an irreconcilable gap between *capital* and product markets, where unconstrained market forces rule and *labor markets*, which are highly protected. One could argue that the state must not allow competition in some markets but then make companies prone to strict regulations on others, so that companies are constrained in their response to competition. Many of those who call for reform therefore call for improving competitiveness. In the tradition of neoclassical economic models, according to which deregulation is equated with the creation of efficient markets,<sup>74</sup> they call for loosening labor market protections. Their major remedy is to reduce high wages connected to cutting social security contributions (and benefits), ease the rigidity of the wage-bargaining system and weaken “industrial democracy” structures to accelerate decision-making, all of which are seen as restraints for international competitiveness. Iversen summarizes the situation for European coordinated market economies: “One of the primary dilemmas facing social democracy in the 1990s is that governments have to increasingly choose between equality and employment”<sup>75</sup> Economists also point out that the impersonal forces of world markets have become more powerful than national states, to whom political authority over society and economy is supposed to belong.<sup>76</sup> On many crucial issues, markets have replaced politics concerning the government of the state. Increased market integration and mobile capital exert pressure on national economic policies by the ultimate threat to exit economic regimes that are not tailored to corporations’ preferences.<sup>77</sup> In the long run, the welfare system

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<sup>73</sup> Economist II

<sup>74</sup> Vitols 2003, 247

<sup>75</sup> Iversen 2000, 205

<sup>76</sup> Garrett 1998, 787

<sup>77</sup> Garrett 1998, 792

will not be able to ease the burden of layoffs in such a generous way they previously did. Corporate management is more likely to come into conflict with employee representatives and might perceive their co-decision rights as economically burdensome. As soon as the welfare state becomes unable to bear its own interventions financially, a clash of labor market policy and firms demand for freedom becomes inescapable. Companies may make their threats come true to relocate their headquarters to the foreign countries of Europe. German economic policy may as a consequence indeed lose its previous capacity to impose relatively uniform corporate governance and labor relations arrangements on national firms, but has to allow for greater freedom.

To conclude, the state is likely to be subject to the external forces of internationalization and increased market pressure, partly exerted by their own national firms. These forces and their own inability to sustain welfare institutions financially make reforms necessary. The German Social Model will be subject to change and the state's responsibility is to find a way that reconciles global market forces with social cohesion. Then it might be possible to accommodate the forces of global capitalism within the existing institutions of a regulated social market economy. Deregulation of the labor market, however seems to be inescapable. The state therefore has to find put more emphasis on helping employees to prepare them for a more market oriented economy. The policy effort therefore must put emphasis on education and other training and skill-upgrading measures to provide everybody with the ability to compete on a deregulated labor market.

## **6 Conclusions**

The Internationalization of financial markets has in recent years made national governments change company laws and capital market regulations, both to improve the access of national firms to outsider capital, especially foreign capital, and strengthen the competitive position of the national financial sector in the emerging global market for financial services. This resulted in a stronger market for corporate control. As the state can no longer protect national firms from international competition, firms come under intensified competitive pressure on product and capital markets. In response, they apply more stringent methods to assess the profitability of their operations, frequently in the form of Shareholder Value-oriented management. Corporations demand for greater freedom in corporate laws and on the labor market that would allow them to adapt to new and changing product, capital and labor market environments. Public policy is confronted with the difficult alternative of either promoting a convergent liberalization in the

style of Anglo-American market organization or defending distinct features of a social market economy, based on industrial citizenship and corporate social responsibility. It is unlikely that German coordinated market system will completely converge with the Anglo-American liberal market system, given the strong roots of industrial democracy that is enshrined in law and the citizens' demand for a socially acceptable economic system. Germany, however, has to solve its unemployment problem which seems to reflect the related socio-economic deficiencies. This might require incisive cuts in social security benefits, deregulation of rigid labor market structures and an adjustment of the German Social Model towards a more market-oriented system.

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