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Corporate Governance in Germany

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Corporate governance is concerned with the institutions that influence how business corporations allocate resources and returns. A system of corporate governance shapes who makes investment decisions in corporations, what types of investments they make, and how returns from investments are distributed. Retained earnings—undistributed profits and capital consumption allowances—have always provided the financial resources for investments in physical and human capital that make economic development possible. How major corporations allocate their vast revenues is a matter of strategic choice, and the strategic choices of corporate decision makers have profound effects on employment opportunities, income levels, and international competitiveness.

Corporate governance has become a highly charged political issue in Germany. Since 1993, when Germany entered its worst recession in postwar history, the perennial debate about *Industriestandort Deutschland*, or "Germany as an industrial location," has escalated. Employers claim that high wages, short working hours, tight labor market regulations, and high taxes have undermined Germany's international competitive position. According to one estimate, 1.3 million jobs, or 15 percent of Germany's manufacturing employment, were lost from 1991 to 1996, and the trend has continued unabated into 1998. Prominent corporate managers have been calling for a reform of corporate structure with an increased focus on "shareholder value."

In emphasizing the need to create value for shareholders, these managers are expounding a view that has dominated Anglo-American debates on corporate governance for more than a decade. According to this view, when corporations are run to maximize shareholder value, the performance of corporations and the economic system as a whole is enhanced. Shareholders may have to rely on managers to perform certain functions to run the corporation, but as long as there is a free flow of financial resources in pursuit of maximum returns and as long as corporate managers are induced to act in accordance with the dictates of financial markets, the optimal allocation of corporate resources and returns will be ensured.

It is surprising that a view that stresses financial mobility is gaining ground when only a short time ago the availability of "patient capital" (or, long-term commitment of financial resources) was regarded as the critical strength of the German postwar system of governance in comparison with its U.S. and British counterparts. The strength of the patient capital view is that it recognizes the critical importance of innovation—the development and utilization of resources to generate higher-quality and lower-cost products than were available before. It recognizes that innovation takes time and requires a long-term commitment of financial resources. The shareholder view ignores innovation as a central phenomenon in creating new opportunities for generating returns and in determining the performance of corporate enterprises and the economy in which they operate. The patient capital view, however, cannot explain why, when patient capital is available, investments sometimes fail to generate innovation. This weakness stems from not looking beyond financial issues to take account of the organizational requirements of innovation. Underlying innovation is an organizational learning process: higher-quality and lower-cost products result from changing old ways and learning how to do things differently. Financial commitment is a necessary but not sufficient condition for innovation.

The Postwar System of German Corporate Governance

A system of corporate governance, if it is to support innovation, must generate the financial commitment and organizational integration that permit collective and cumulative learning to take place. Financial commitment involves the organization's continuing access to the financial resources required for sustaining the development and utilization of productive resources. Organizational integration is the integration of an organization's human and physical resources into a process to develop and utilize technology. Financial commitment and organizational integration together support "organizational control" of the critical inputs in the innovation process: knowledge and money.

In the late nineteenth and early twentieth centuries the competitive success of major German enterprises was built on a system of managerial control. Managers were integrated into the organizational learning process and managerial "insiders" had control over the allocation of resources and returns. Immediately after World War II, the Allies sought to break up the concentration of economic power in German industry and banking and to replace it with market control, but the prime aspects of managerial control, namely, intercompany shareholding networks and close bank-industry relations, remained and played an important role in insulating enterprises from market control. Another important source of insulation from market control was enterprises' access to internally generated funds, which rendered most of them relatively independent of external sources of finance (Esser 1990).

The industries in which Germany has always been strong are likely to be able to produce and export successfully, but it is unlikely that they will be capable of making up for the loss of wealth-generating capacity in the industries in which deficiencies in cross-functional integration have proven to be debilitating.

The adoption of some degree of codetermination after the war gave workers more influence in corporate decision making than they had had before the war, although that influence was limited. The system of apprenticeship, which continued from before the war, provided institutional support for the inclusion of workers, along with managers, in the processes of organizational learning (in contrast to the United States where, to a large extent, workers have been excluded from organizational learning in the postwar decades).

The postwar system of organizational control played a crucial role in the success of companies competing on the basis of quality in markets such as luxury automobiles, precision machine tools, and electrical machinery—industries that until recently could be characterized as having stable technology. Where the system has been least successful is in computers, semiconductors, and telecommunications—industries that came into existence or were transformed after the war and are based on rapid adaptation and development of new products.

The system of governance has an important influence not only on how wealth is generated but on how that wealth is distributed. The postwar German system ensured that employees participated in the fruits of industrial success and facilitated spreading the social costs of industrial rationalization by means of plans to protect workers if restructuring required mass layoffs in combination with federally funded programs such as unemployment insurance, early retirement schemes, and compensation for part-time work. The system has proven most effective in advancing the interests of skilled, male workers in industries in which their representation is strongest and the organizational integration of their skills is critical to industrial success.

Challenges to the German System of Corporate Governance

The acceptance of the postwar system of corporate government has been threatened by failure of industries to maintain competitive advantage and pressures for financial liquidity driven by those who have accumulated substantial holdings of financial assets and by those who are concerned about the pension system.

In the late 1960s and 1970s industrial competitors, especially from Japan, became a serious threat to German industry. Companies whose competitive advantage rested on their ability to produce high-quality products managed to avoid direct confrontation with the Japanese, but, by and large, companies in cost-competitive industries failed to develop distinctive bases of competitive advantage and these industries saw significant job losses. Furthermore, reunification and the process of European integration created some structural problems.

The source of the Japanese success in cost-competitive industries was their relative strength in innovative capabilities. In Germany the organizational structure of the enterprise derived from an industry-wide strategy to set high quality standards, whereas in Japan the structure derived from an individual enterprise strategy to engage in continuous problem-solving to cut costs. The key organizational advantage of Japanese companies was their capacity to achieve cross-functional integration on the shop floor and in management structures. German enterprises attained considerable hierarchical integration of technical skills in the postwar period, but specialized skills among production workers and functional divisions within management impeded cross-functional integration (Herrigel 1996). The industries in which Germany has always been strong are likely to be able to produce and export successfully, but it is unlikely that they will be capable of making up for the loss of wealth-generating capacity in the industries in which deficiencies in cross-functional integration have proven to be debilitating.

Growing pressures for financial liquidity are rooted in the rising level of savings generated by the country's postwar economic success and increasing intergenerational dependence. Between 1972 and 1988 the financial assets of German households rose 290 percent as their total income increased 150 percent. By the end of 1988 households' financial assets amounted to nearly twice their annual disposable income, and at the same time households began to move their savings from bank deposits into higher-yielding instruments such as insurance, fixed-income securities, and mutual funds. The share of private household financial assets in bank deposits dropped from 52.4 percent in 1970 to 40.7 percent in 1992 (*Deutsche Bank Research Bulletin,* January 9, 1995, 7).

Another important source of pressure for liquidity is concern about funding pensions arising from demographic factors (growing life expectancy and a decline in fertility) and declining labor force participation by the elderly. Inducements to retire early have been used as a means of downsizing. In 1994, 190,000 people (21 percent) of all those making pension claims applied for early pensions. In 1995 the number had increased to 290,000. The restructuring of industry in East Germany left many older workers jobless and, as a result, claims for pensions in the east rose substantially (*European Industrial Relations Review,* September 1996, 24?26). How Germany deals with the problem of supporting the growing proportion of elderly in old age will have critical implications for financial commitment in corporate governance.

Responses to the Productive and Financial Challenges

During most of the 1980s and the 1990s the responses of labor and employers to the productive challenges have been in conflict with one another. Rising unemployment in the early 1980s led to the worst strike in the history of Germany in 1984 when IG Metall (Germany's largest trade union) struck for nine weeks. An important consequence of the agreement that ended the strike was the decentralization of negotiations over the allocation of working time from the industry level to the plant level.

Decentralization gave plant-level works councils a larger role in the bargaining process, but it did not give them any significant influence over the introduction of new technology and work organization. Labor adopted a more critical stance toward such introductions, but, in practice, the works councils often found themselves negotiating plans that had already been put in place without their involvement. The fear of job loss made the works councils succumb to the employers' demands and plans.

Labor, with the backing of the federal and state governments, called for more training for workers and an overhaul of the traditional apprenticeship programs in the belief that this would help maintain existing jobs and create new ones. The effectiveness of these programs was undermined by ongoing changes in production technologies, as evidenced by the shortage of workers with requisite computer skills. As a result, employers increasingly began to conduct training programs at their own discretion without the mediation of unions and works councils. Employers were resistant to any extension of codetermination that appeared to them to interfere unduly with managerial decision making.

In addition to making changes in technology and work organization, employers sought to maintain competitiveness by reducing costs, mainly labor costs. Employers rallied against collectively bargained wage increases and, as the economy went into recession in 1993, agreements at the plant and enterprise levels accepting reduced wages in exchange for employment security became widespread.

Industry-level studies suggest that the key productive challenge to German competitiveness lies in productivity rather than cost differences. It is only through organizational transformation that this challenge can be overcome and the foundations for the sustainable prosperity of enterprises and the economic system can be laid. Progress in dealing with organizational issues has been patchy and it remains to be seen if employers and labor take initiatives to confront this issue systematically.

With regard to financial challenges, the initiatives undertaken by the government to improve the funding of state pensions have focused on adjustments within the existing pay-as-you-go system. Efforts have been made to reduce costs—by raising the retirement age, making early retirement more difficult, tightening eligibility for disability benefits—but the contribution rate has had to be raised. If unemployment continues to rise and if shortfalls in funding worsen, the government may be forced to consider a fundamental overhaul of the system—a change to a funded scheme, replacement of existing pensions with a flat-rate minimum pension, and an increase in private pensions—whatever the merits of these strategies for equitable retirement provision.

If the trend toward financial liquidity continues, and particularly if it gains a major boost from reforms of the pension system, it is plausible that German financial enterprises may find willing allies in the country's corporate managers attracted by the possibilities to enrich themselves.

The implications of any move to market financing of pensions for the financial system and, in particular, for pressures for financial liquidity would be serious. If such a move were made, the German equity market would grow substantially. Studies show that a deepening of the equity market does not necessarily lead to an increased allocation of funds to productive investment. To the contrary, it is more likely to promote escalating demands for financial liquidity among those with accumulated financial assets and thus undermine the financial commitment necessary to support the development and utilization of productive resources (Lazonick and O'Sullivan 1997a, 1997b).

Recent changes in the regulatory framework of financial markets have increased competition among financial enterprises. Earlier, when competition among savings instruments and the securities market was restricted, the big banks provided German enterprise with financial commitment because being "patient capitalists" advanced their economic interests. As competition for growing household savings has intensified, the banks began to see their interests as better served by replacing financial commitment with financial liquidity.

The Future of German Corporate Governance

If the trend toward financial liquidity continues, and particularly if it gains a major boost from reforms of the pension system, it is plausible that German financial enterprises may find willing allies in the country's corporate managers attracted by the possibilities to enrich themselves. Many Germans are sanguine about the possibility that this type of behavior will take hold. Nevertheless, it is dangerous to dismiss such a possibility since the confluence of structural changes in the productive and financial spheres poses a formidable challenge to the existing system of corporate governance. One of the most important lessons that the history of American corporate governance teaches us is that, in the face of unprecedented productive and financial challenges to a system of corporate governance, "organization men" can be induced, with appropriate incentives for self-enrichment (such as stock options), to become ardent proponents of shareholder value (Lazonick and O'Sullivan 1997a, 1997b).

An important difference between Germany and the United States is that German managers who try to follow their American counterparts down the path to shareholder value will have to contend with a politically powerful labor movement. Already the German advocates of shareholder value have been attacked by workers and their representatives, at least for their more blatant attempts to introduce "casino capitalism." A strong labor movement does not, however, ensure that the foundations of sustainable prosperity will be regenerated in Germany. Perhaps the biggest risk that the German system of corporate governance now faces is that German labor and finance will insist on pursuing their own independent strategies to extract returns from industrial enterprises and the system will dissipate into a "stakeholder economy" in which different interest groups fight for their claims to corporate returns without any concern for whether these returns are sustainable.

In Germany, the foundations for organizational control were put in place long ago and they persist despite enormous pressures. These foundations provide the possibility for the coordination of financial, labor, and managerial interests to institute a new system of organizational control that allows a regeneration of the basis for sustainable prosperity in the German economy.

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