Negotiated shareholder value: the German version of an Anglo-American practice

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ABSTRACT

Negotiated Shareholder Value: The German Version of an Anglo-American Practice

by Sigurt Vitols

In comparative political economy it has become commonplace to distinguish between two types of corporate governance systems. In shareholder systems, influence over company management is concentrated with institutional investors holding small percentages of companies' shares. In stakeholder systems, influence is shared between large shareholders, employees, the community, and suppliers and customers. This paper contributes to the literature addressing recent changes in the German variant of the stakeholder system by proposing a few new concepts. On the level of institutions, it is argued that the stakeholder system is not being replaced by a shareholder system in Germany. Rather, an *augmented* stakeholder system is emerging through the inclusion of institutional investors in the old stakeholder coalition of interests. On the level of practice, it is argued that *negotiated* shareholder value is being adopted in Germany. This German variant of shareholder value is distinct from Anglo-American practice because major changes implementing shareholder value must be negotiated within the augmented stakeholder coalition. As a result, performance incentives for employees tend to be less strong than is the case in the US and UK.

Keywords: Corporate governance, Shareholder Value, Varieties of Capitalism

JEL Classification: G3, J5, P5

ZUSAMMENFASSUNG

Verhandelter Shareholder Value. Die deutsche Variante einer anglo-amerikanischen Praxis

In der vergleichenden politischen Ökonomie ist es Allgemeinplatz geworden, zwischen zwei Arten von Corporate-Governance-Systemen zu unterscheiden. In *Shareholder-Systemen* ist der Einfluss auf das Firmenmanagement bei institutionellen Investoren konzentriert, die kleine Anteile der Firmenaktien halten. In *Stakeholder-Systemen* ist dieser Einfluss geteilt zwischen Großaktionären, Beschäftigten, Gemeinde sowie Lieferanten und Kunden. Dieses Papier ist ein Beitrag zur Literatur über neue Veränderungen in der deutschen Variante des Stakeholder-Systems mit einigen neuen Konzeptvorschlägen. Auf der institutionellen Ebene wird behauptet, dass das Stakeholder-System in Deutschland nicht von einem Shareholder-System ersetzt werden wird. Eher wird eine *erweiterte* Stakeholder-Koalition durch die Einbeziehung der institutionellen Investoren in die bisherige Stakeholder-Koalition entstehen. Was die Praxis anbelangt, so wird behauptet, dass *verhandelter* Shareholder Value in Deutschland entsteht. Diese deutsche Variante des Shareholder Value unterscheidet sich von der anglo-amerikanischen Version dadurch, dass die Einführung von Shareholder Value-Maßnahmen innerhalb der erweiterten Stakeholder-Koalition verhandelt werden muss und die Leistungsanreize für Manager und Mitarbeiter weniger stark sind als in den USA und Großbritannien.

1. Introduction

In comparative political economy it has become commonplace to distinguish between two types of corporate governance systems (Hopt, Kanda, and Roe 1998; Jackson 2001a; Kelly, Kelly, and Gamble 1997; McCahery et al. 2002).[1] In shareholder systems, shareholders are the dominant interest group exercising influence on management, and the major goal pursued by companies is the maximization of shareholder value, that is, of the financial value of the firm. The US and UK are the best known examples of shareholder systems. In stakeholder systems, in contrast, power is shared between shareholders and other groups with an interest in the firm, particularly employees. Reflecting the diverse interests of these different groups, increasing the value of the firm may be only one of a number of key goals pursued by firms in these types of systems. Germany and Japan are exemplars of stakeholder systems.

A major point of controversy is the extent to which stakeholder systems like Germany are currently facing pressures to change. At issue is the extent of influence of institutional investors, such as pension funds and mutual funds, that hold small amounts of stock in each of a large number of companies. These types of investors, who are particularly strong advocates of shareholder value, have accounted for a steadily increasing proportion of share ownership in the recent past. Given the stark choices offered by the shareholder versus stakeholder dichotomy, one position in the debate is that these institutional investors are powerful enough to force stakeholder systems to convergence on the shareholder model (Eckert 2000; Itami 1999). A second position is that these investors do not exercise enough influence to change the fundamental features of stakeholder systems, i.e. that heterogeneity in corporate governance systems will continue to exist (Hall and Soskice 2001; Jürgens, Naumann, and Rupp 2000; Van Den Berghe et al. 2002).

Recently, however, a number of researchers have been arguing that the stakeholder-shareholder dichotomy is inadequate to describe the changes occurring in stakeholder systems. In Germany, for example, although the financial system and its role in corporate governance has evolved in an Anglo-American direction, labor has maintained its strong influence within the company through works councils and board representation (Cioffi 2000; Goyer 2002). Attempts to theorize this process include the concept of "hybrid" systems (Vitols 1999), multi-dimensional schemes for classifying corporate governance systems (Jackson and Aguilera 2003), and greater attention to the process of change (Höpner 2003).

This paper seeks to contribute to this new body of research by developing a few ideas for conceptualizing recent changes in Germany. On the whole these recent developments are characterized as *incremental* changes in the German variant of the stakeholder model. These changes have occurred both at the level of *institutions* and of *practice*. At the institutional level, the postwar coalition of stakeholders influencing the firm (large shareholders, employees, the community, and suppliers and customers) has not been replaced by or driven out by institutional investors. Instead, this postwar coalition has been *augmented* through the integration of institutional investors into the coalition. One can therefore speak of the emergence of an *augmented stakeholder coalition* in Germany. At the level of *practices*, the typical

[1] Many thanks to Lutz Engelhardt and Jana Meier for invaluable research assistance, to Pablo Beramendi for helpful comments, and to Martin Höpner and Gregory Jackson for useful clarifications.

goals that German companies have focused on after World War II (sales growth, employment stability and product quality) have also have been *enhanced* by rather than replaced by shareholder value. In contrast with the variant of shareholder value practiced in the US and UK, the German variant can be characterized as *negotiated shareholder value,* which has two key distinguishing features. First, the implementation of measures designed to achieve shareholder value in the interests of institutional investors must be *negotiated* with other members of the stakeholder coalition, particularly large shareholders and employee representatives. Second, reflecting the balance of power in this augmented stakeholder coalition, measures designed to achieve shareholder value are typically *modified* during the process of negotiation to take into account the interests of other stakeholder groups. Many shareholder value measures, such as remuneration incentives designed to align the interests of shareholders, managers and employees, thus take significantly different forms in Germany than in the US and UK, particularly where the interests of labor are concerned.

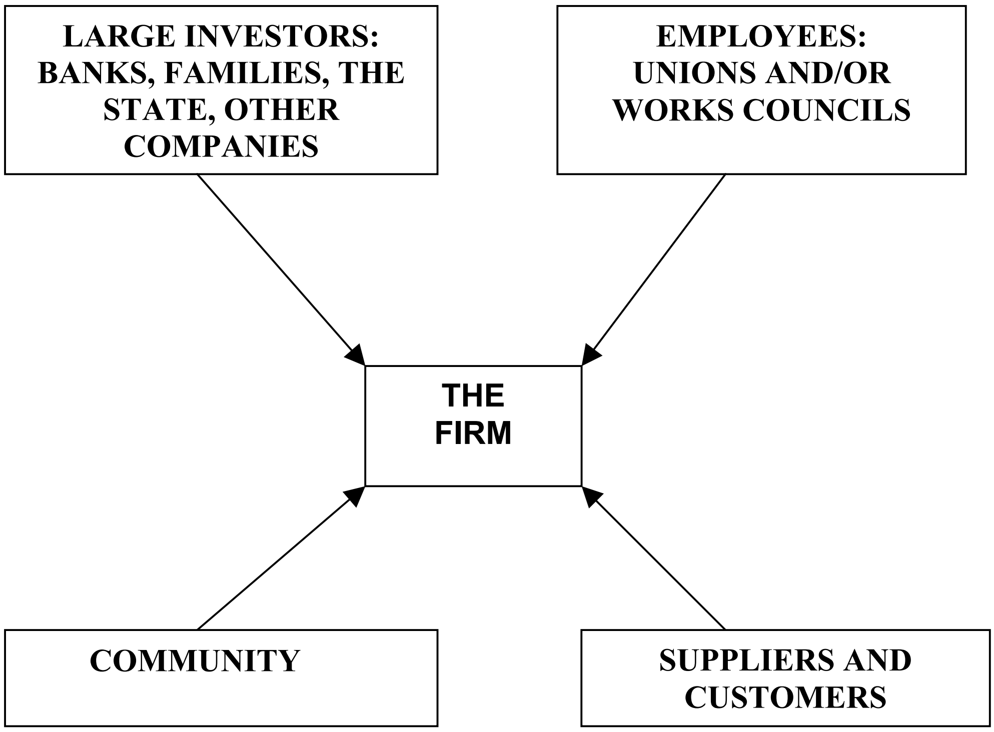
The second section of this paper summarizes the debate on the extent to which the German stakeholder model is changing. The third and fourth sections provide evidence supporting the "incremental change" interpretation of current developments. On the level of institutions, the third section analyzes changes leading to the emergence of the augmented stakeholder coalition. On the level of practices, the fourth section focuses on specific examples of negotiated shareholder value, as well as on general indicators indicating differences relative to the Anglo-American variant of shareholder value. The final section summarizes and concludes.

2. The Debate on the Nature of Change in the German Stakeholder Model

In analyzing systems of corporate governance it is useful to distinguish between two levels. At the *institutional* level, national institutions influence the relative power of different groups with an interest in the firm. This includes both institutions structuring the internal organization and cohesion of interest groups, such as laws regarding trade union organization, and institutions regulating the interaction of these interest groups, such as company law. At the level of *practice*, companies embedded in different national institutional settings are distinguished by different mixes of strategic goals pursued, differing distributions of value added, and different organizational and operational characteristics. Drawing on Hirschman's (1970) concept of "Exit, Voice, Loyalty", interest groups thus differ in the extent to which they can exercise "voice" within the firm's strategic decision-making processes and in the possibilities they have to "exit" their relationship with the firm.

In stakeholder systems, power is dispersed across a number of groups with an interest in the firm (Hutton 1995; Kelly, Kelly, and Gamble 1997; Vitols et al. 1997). These stakeholders typically include not only owners but also lenders, employees, customers and suppliers, and the community in which the firm is located (see figure 1). Stakeholder systems are "insider" systems, in which interested groups are closely tied to the firm and exercise influence through institutional mechanisms for expressing (in Hirschman's terms) "voice" within the firm.

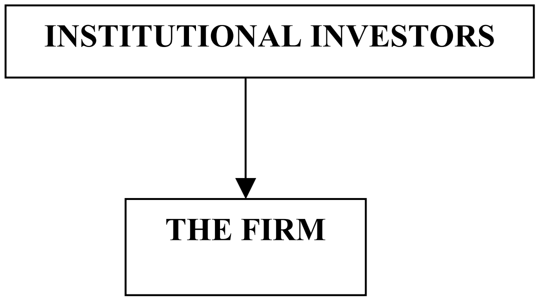
Figure 1: THE STAKEHOLDER MODEL



In shareholder systems, power is concentrated in the hands of shareholders, and other groups have little or no influence (see figure 2). Shareholder systems are "outsider" systems, in which market mechanisms play a much stronger role in governance, and owners exert influence on management through the threat of "exit" (selling shares). Owners in insider systems frequently hold large blocks of shares, often majority or controlling interests.[2] Owners in outsider systems in contrast tend to hold much smaller percentages of shares, leading to a highly dispersed system of ownership.

[2] The typical definition of a large shareholding, or blockholding, is that at least 5 percent of the total outstanding shares of the company are held by the same owner.

Figure 2: THE SHAREHOLDER MODEL



This heterogeneity in the distribution of influence is reflected in differences in company practices between corporate governance systems. The dominant goal of companies in shareholder systems is understood to be the maximization of the financial value of the firm (shareholder value), since this is the primary interest of shareholders. Correspondingly, firms in stakeholder systems are understood to be concerned with a broader mix of strategic goals, such as sales growth and employment security, than shareholder firms. Although profitability is a consideration in stakeholder systems, it will not be maximized if it conflicts with the interests of key stakeholders. Employees, for example, may have a greater interest in sales growth than in profitability, since sales growth implies an expanding firm and thus greater employment stability.

Table 1: Median Size of Largest Shareholding Block, mid-1990s

Country	*Largest voting block: Median (%)*
Germany	57.0
Belgium	56.0
Italy	54.5
Austria	52.0
Netherlands	43.5
Sweden	34.9
Spain	34.5
France (CAC 40)	20.0
UK	9.9
US – NYSE	5.4
-- NASDAQ	8.6

Source: Adapted from Barca and Becht (2001: 19, table 1.1).

In practice Germany has become one of the most prominent national examples of an insider or stakeholder system of corporate governance. A recent large cross-national study showed that Germany had the highest levels of shareholding concentration among the countries examined (see table 1). According to the study, the median size of the largest shareholder for German companies listed on the stock exchange was 57 percent. In the US, in contrast, the median size of the largest shareholder for companies listed on the New York Stock Exchange (the largest stock exchange in the US) was 5.4 percent.

The role of large private banks has received special attention in the system of ownership in Germany. In contrast with banks in other countries such as the US, German banks are allowed to hold large blocks of shares in industrial companies on their own account. Furthermore, to a much greater extent than in the US or UK, individuals purchase their shares through banks and leave these shares on deposit with the banks. Banks have been able to exercise votes on the shares of these small, largely passive individual investors through a system of proxy voting. Banks have thus been able to control upwards of 90% of the votes exercised at many shareholder meetings (Pfeiffer 1986; 1993).

A powerful institutional mechanism supporting the influence of the banks is the dual board system, which is mandatory for joint stock companies in Germany. The supervisory board is responsible for making key financial and strategic decisions and for appointing top management in the firm. Day-to-day managers may only be members of the executive board. Banks insisted on this governance form in the reform of German company law in the wake of a wave of bankruptcies in the late 1800s (Jackson 2001b). Banks nominate representatives to the supervisory boards of most large companies, including the chairs of these supervisory boards where their voting power is particularly large.

Although receiving less attention than banks, other types of large shareholders have also played a key role in corporate governance, including founders and families (e.g. BMW, Krupp, Thyssen, Siemens, SAP), the state (e.g. VW, Preussag, RWE, VEBA) and other companies (e.g. Degussa, Fresenius Medical Care). These large owners are also represented on company supervisory boards, typically as chairpersons where they are the largest owners.

Employees are a second key stakeholder group in the German model. Employees enjoy particularly strong rights of representation within the firm through the institution of the works council. Employees have the right to elect delegates to works councils at the plant level. This works council enjoys a wide variety of information, consultation and codetermination rights vis-à-vis management. In multi-plant companies, plant works councils appoint delegates to a company works council. Furthermore, in large companies up to half of supervisory board members are employee representatives. These include both representatives elected by the workforce (typically top works councilors) and appointed by external trade unions.

The community in which the firm is located and suppliers and customers have also frequently been mentioned as two other important stakeholder groups in Germany (Hutton 1995). However, formal community influence is limited to companies where local or regional governments have ownership stakes and board representation (Bamberg et al. 1987). This is the case mainly in companies involved in transportation, utilities, or other local service provision. Community is therefore an important stakeholder group mainly through the ownership mechanism in a minority of companies. The importance of customers and suppliers as stakeholders in

Germany has also probably been overstated. Customers and suppliers probably played their most prominent role in governance during the 1920s through a corporatist system of cartel regulation. Although one frequently finds prominent customers or suppliers represented on company boards, this appears to be due more to the usefulness of having powerful and well connected industrialists on supervisory boards than to any intent to formally represent the interests of customers and suppliers (Vitols et al. 1997).

The shareholder (or outsider) model, which is predominant in the US and UK, is institutionally a much simpler construct. Ownership is dominated by institutional investors, such as mutual funds, pension funds and insurance companies, who are generally reluctant to hold ownership stakes of more than one or two percent, and who in principle do not wish to be represented on company boards. Other stakeholders such as employees generally do not enjoy voice in the company through formal representation. These countries have a single board system, and this board has in the past often been dominated by a single strong manager who assumed the role of both chairperson and CEO.[3]

In the mid-1990s, a number of developments triggered a debate on the extent to which the German stakeholder system is changing. The first development was the increasing activism of foreign funds in Germany, such as Calpers (the California public employee pension fund), who stated that they would try to use their influence to make German companies pay more attention to small shareholders. A second development was the announcement by the two largest banks, Deutsche Bank and Dresdner Bank, and by the largest insurance company, Allianz, that they wished to reduce their presence on company boards and manage their share portfolios more according to “shareholder value” principles. Changes in tax law in 2000 in fact were designed to make it less costly for the banks to reduce their shareholdings (Höpner 2000). A third development was Vodafone's takeover of Mannesmann, the first major hostile takeover in Germany (Höpner and Jackson 2003). A fourth development was that a number of large companies announced that they were adopting “shareholder value” as a key strategic goal; some of these companies made an explicit link between this step and the previous developments, such as the chemical/pharmaceutical company Hoechst (Eckert 2000).

The dichotomous nature of shareholder-stakeholder typology initially forced people to decide between the alternatives of "convergence" and "divergence" (convergence to the shareholder model versus continuing distinctiveness) in this debate. Convergence advocates argue that the changes currently taking place in Germany – as well as in other stakeholder countries -- represent the transformation of a stakeholder into a shareholder system. Large “inside” investors are gradually being replaced by internationally-active investors, who increasingly have the capacity to cut off funding to companies that do not fulfill their demands for shareholder value (Dore 2000; Inagami 2001). Wojcik (2001) finds some statistical evidence consistent with the convergence thesis. In particular, the median size of the largest shareholder has decreased by roughly five percentage points (from 65 percent to 60 percent) between 1997 and 2001. In a provocative article entitled "Deutschland AG – a.D" Beyer (2003) finds that the number of bank representatives on company boards has declined

[3] Recent reforms in both the UK and US have attempted to reduce the power of any single individual within the company board system, for example by seeing that the roles of CEO and chairperson are carried out by different persons.

substantially since the mid 1990s. Höpner (2003) finds a positive correlation between the degree of internationalization of share ownership and the adoption of shareholder value strategies by company management.

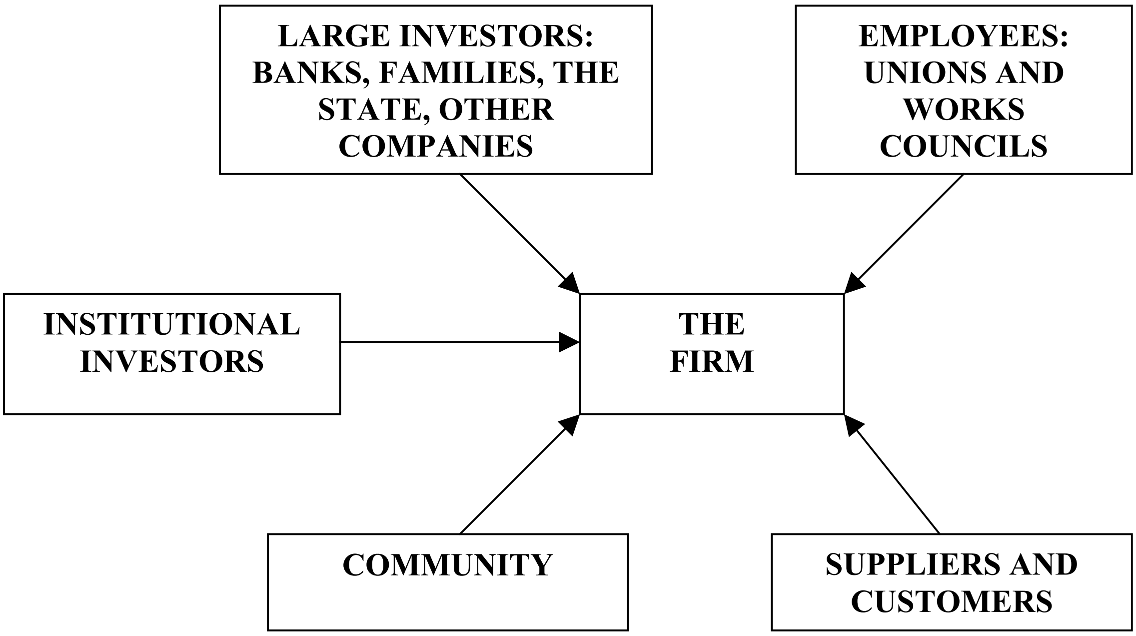
On the other side of the debate, others have emphasized continuity in the German system of corporate governance and argued that current changes are only minor (Jürgens, Naumann, and Rupp 2000; Vitols et al. 1997). Vitols (2002), Jürgens (2002) and Kädtler and Spering (2001) have argued that the degree of influence shareholders have over management in industries such as chemicals and autos has been overestimated by convergence advocates. The Varieties of Capitalism paradigm (Hall and Soskice 2001) provides a theoretical explanation of why shifts in ownership might result in only incremental changes in the overall coordinated market economy (CME) system. The existence of complementarities between different elements of a CME limits the overall impact that changes in one subsystem might have on the performance of a system as a whole. Hall and Soskice, however, leave open the possibility that changes in finance might eventually lead to a crossing of the "tipping point" and thus a hop to a new equilibrium (i.e. the introduction of a liberal market economy or LME system) in Germany.

Out of frustration with the strict corset of the "insider-outsider" dichotomy, a number of researchers have been trying to develop a more nuanced approach to classifying corporate governance systems and understanding processes of change within them. One key fact is that, although the partial "Americanization" of the German financial system and ownership is unmistakable, the labor relations system has remained quite stable and that works councils are still powerful (Cioffi 2000). Goyer (2002) for example has argued that labor in Germany exerts a veto right and thus has blocked the introduction of the most important parts of shareholder value in Germany. One approach has been to conceptualize change as a process of "hybridization", whereby elements of both the insider and outsider models are combined (Vitols 1999). Another approach has been to introduce multiple dimensions for classifying corporate governance systems; for example, Jackson and Aguilera (Jackson and Aguilera 2003) claim that there are three key dimensions of corporate governance – capital, labor, and management – and that each dimension can be conceptualized as a continuum. A further approach is to focus on change in Germany as a long-term process with multiple determinants and an uncertain ultimate outcome (Höpner 2003).

3. The Emergence of an Augmented Stakeholder Coalition in Germany

In an effort to contribute to this more nuanced approach, this paper proposes two new ideas for helping conceptualize the process of change in the German stakeholder system. Drawing on the distinction made earlier between the institutional level and the level of practices, the first idea is that institutional changes have encouraged the emergence of a mixed system of ownership in which both large shareholders and institutional investors play a significant role. The result has been an *augmented stakeholder coalition*, which involves the integration of pro-shareholder value institutional investors into the postwar coalition of stakeholders, of which the most important members were large shareholders and employees (see figure 3).

Figure 3: THE AUGMENTED STAKEHOLDER MODEL



Towards a "Mixed" System of Ownership by Large and Small Shareholders

A key argument of the convergence thesis is that, within the German system of ownership, large shareholders are being replaced by institutional investors who, as a rule, hold less than 5 percent of shares of individual companies. Statistically significant declines in the median size of the largest shareholder in the late 1990s is an important piece of evidence drawn upon by supporters of the convergence thesis. However, three critical points regarding the convergence thesis can be made here.

First, even with the decline in the late 1990s, large shareholdings in Germany are still many orders of magnitude apart from the US. The median size of the largest shareholding in German listed companies in 2000 was still around 60 percent, as opposed to around five percent for companies listed on the New York Stock Exchange. Even with a continued decline of five percentage points every half decade in Germany, it would take another 55 years to decline to the US level.

Table 2: Largest Shareholders in the 30 Dow Jones Companies (2001)

Company	Largest Shareholding		
	% of Shares	Shareholder	Type
3M Co.	5.8	Timothy P. Smucker	Founder/family
Alcoa Inc.	10.3	Fidelity Mutual Fund Group	Institutional Investor
American Express Co.	11.4	Berkshire Hathaway	Institutional Investor
AT&T Corp.	7.7	Putnam Investments	Institutional Investor
Boeing Co.	5.3	Fidelity Mutual Fund Group	Institutional Investor
Caterpillar Inc.	> 5		
Citigroup Inc.	> 5		
Coca-Cola Co.	> 5		
E.I. DuPont de Nemours & Co.	> 5		
Eastman Kodak Co.	11.6	Alliance Capital Management	Institutional Investor
Exxon Mobil Corp.	> 5		
General Electric Co.	> 5		
General Motors Corp.	5.6	Fiat S.p.A.	Company
Hewlett-Packard Co.	10.4	The Packard Foundation	Founder/family
Home Depot Inc.	6.1	Fidelity Mutual Fund Group	Institutional Investor
Honeywell International Inc.	5.2	Alliance Capital Management	Institutional Investor
Intel Corp.	5.3	Gordon E. Moore	Founder/family
International Business Machines	> 5		
International Paper Co.	6.9	Alliance Capital Management	Institutional Investor
J.P. Morgan Chase & Co.	> 5		
Johnson & Johnson	> 5		
McDonald's Corp.	9.5	Fidelity Mutual Fund Group	Institutional Investor
Merck & Co. Inc.	> 5		
Microsoft Corp.	12.3	William H. Gates	Founder/family
Philip Morris Cos. Inc.	7	Fidelity Mutual Fund Group	Institutional Investor
Procter & Gamble Co.	> 5		
SBC Communications Inc.	> 5		
United Technologies Corp.	> 5		
Wal-Mart Stores Inc.	38.4	John T. Walton	Founder/family
Walt Disney Co.	10.8	Steven T. Kirsch	Founder/family
Median	5.3		

Source: Company annual reports and filings with the Security Exchange Commission

In this respect a comparison of the Dow Jones Industrial Index and the DAX (the Deutsches Aktienindex), the thirty largest companies in both countries, is instructive. In the US the median largest shareholding in the Dow Jones 30 Industrial (the thirty largest companies in the US listed on the stock exchange) is 5.3 percent (see table 2). Thirteen of the thirty companies had no identifiable blockholder (i.e. no shareholder with a stake of at least 5 percent).

Table 3: Largest Shareholdings in the DAX 30 Companies, December 2002

Company	Largest Shareholding		
	% of Shares	Shareholder	Type
Adidas-Salomon AG	> 5		
Allianz AG	23	Münchener Rückversicherung	Insurance
Altana AG	50.1	Quandt Family	Founder/family
BASF AG	9.2	Allianz AG	Insurance
Bayer AG	5	Allianz AG	Insurance
Bayerische Hypo- und Vereinsbank AG	26.3	Münchener Rückversicherung	Insurance
Bayerische Motoren Werke AG	48	Quandt Family	Founder/family
Commerzbank AG	10	CoBra Beteiligungs GmbH	Financial services
DaimerChrysler AG	12.5	Deutsche Bank	Bank
Deutsche Bank AG	> 5		
Deutsche Lufthansa AG	10.1	Bundesrepublik Deutschland	State
Deutsche Post AG	71.3	Bundesrepublik Deutschland	State
Deutsche Telekom AG	43.1	Bundesrepublik Deutschland	State
E.ON AG	7.6	Allianz AG	Insurance
Epcos AG	12.5	Siemens AG	Company
Fresenius Medical Care AG	50.3	Fresenius AG	Company
Henkel KGaA	58.2	Henkel Family	Founder/family
Infineon Technologies AG	71.9	Siemens AG	Company
Linde AG	13.1	Allianz AG	Insurance
MAN AG	36.1	Regina-Verwaltungsgesellschaft mbH	Founder/family
Metro AG	56.5	Beshaim/Haniel Families	Founder/family
MLP AG	27.3	Manfred Lautenschläger	Founder/family
Müncher Rückversicherung AG	24.8	Allianz AG	Insurance
RWE AG	13.3	Allianz AG	Insurance
SAP AG	62.5	Klaus Tschira Stiftung GmbH	Founder/family
Schering AG	10.6	Allianz AG	Insurance
Siemens AG	6.9	Siemens Family	Founder/family
ThyssenKrupp AG	16.9	Alfried von Bohlen u. Halbach Krupp-Stiftung	Founder/family
TUI AG (formerly Preussag AG)	29.1	Westdeutsche Landesbank	State
Volkswagen AG	20	Land Niedersachsen	State
Median	21.5		

Source: Company annual reports and company websites.

When examining the individual companies in the DAX, the index of the 30 largest German listed companies, one sees the continuing influence of large shareholders. Only three of the DAX companies at the end of 2002 had no large shareholder: Addidas-Salomon, Deutsche Bank, and Siemens (see table 3). Of these companies with large shareholders, banks were the largest shareholders at only two of the firms, versus insurance companies at eight, founders and families at four, and other companies at three.

Second, it is not clear that the trend can continue at this pace, or even at all. The increasing importance of institutional investors is predicated on their ability to capture a greater share of the flow of funds by the ultimate investors, namely households. The second half of the 1990s was characterized precisely by this development. Households in the US and UK significantly increased their investments in pension funds and mutual funds. As companies in those countries became overvalued, these institutional investors increasingly sought investments abroad, including in Germany. The net foreign purchase of German equities increased rapidly in the second half of the 1990s, reaching a high of almost €130 billion in 1999 (see table 4).

Table 4: Net Foreign Inflow of Stock Purchases in Germany (in billion €)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
German Purchases of Foreign Stocks	0.6	-4.3	4.5	0.4	-1.7	6.0	10.8	51.7	45.2	-24.6	68.8	14.2
Foreign Purchases of German Stocks	12.6	8.4	10.9	14.3	13.1	23.1	51.9	105.6	126.8	119.1	51.0	46.3
Net Foreign Inflow	12.0	12.7	6.4	13.9	14.7	17.1	41.1	53.9	81.6	143.8	-17.8	32.1

Source: Deutsche Bundesbank, Flow of Funds Accounts.

At the same time households in Germany also increased the allocation of their savings into stocks and stock funds in the late 1990s, reaching a high of a combined total of about €80 billion in 2000 (see table 4).

Table 5: German Household Allocation of Savings (in billion €)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Cash and Bank Deposits	57.8	68.2	98.8	4.2	34.5	52.2	28.6	45.8	10.7	-31.1	27.3	78.9
Bonds	24.1	3.6	-15.1	36.8	25.7	6.5	6.6	-11.3	1.9	5.5	9.5	1.4
Stocks	0.3	-0.5	3.4	6.1	-1.7	5.4	4.1	4.1	13.8	18.4	-28.7	-61.0
Mutual Funds	13.8	27.6	18.5	42.4	10.7	10.9	20.3	32.1	44.0	54.4	51.2	36.5
Insurance	31.9	35.4	42.4	47.3	51.0	54.7	57.7	59.9	61.7	56.4	48.0	53.8

Source: Deutsche Bundesbank, Flow of Funds Accounts.

These trends, however, appear to have been reversed since 2000. Foreign purchases of German equities declined sharply in 2001; taking into account German purchases of foreign equities (presumably mostly by German institutional investors), there was actually a net foreign outflow of € 18 billion in that year (table 4). German households also pulled a total of €29 billion from the stock market in 2001 and another € 61 billion in 2002. German household investments in mutual funds are also down sharply from levels experienced at the peak of the bubble in 2000 (table 5).

Although some of this volatility is driven by short-term influences, primarily the bubble and its bursting, there are reasons to believe that long-term trends will stabilize or even reverse the shift of funds to institutional investors. One reason is that the baby boomer generation, which invested a large proportion of its retirement assets in stocks, is now starting to retire, and withdrawals from this group will increase over time (Davis and Li 2002). A second is that trends in investment activity are very long-term, and an aversion to financial assets with higher levels of risk may last a very long time. In Germany the aversion to risky financial assets was always higher than in the US, and the serious losses that many of the German "latecomers" to the game suffered may be reflected in very long-term aversion to stocks. It appears that the Riester reform of 2001, which was designed to encourage more private savings, will not do much to encourage the flow of funds to the stock market. The requirements imposed on personal and company pension plans by the Riester reform encourages the flow of funds into more conservative financial assets such as bonds and bank savings deposits (Vitols 2003).

Third, although the large private banks and Allianz, the largest insurance company, have announced that they wish to change their practices, it is not clear that this means that they – or other large shareholders – wish to reduce their holdings and role in governance down to US levels. The subsidiary that Deutsche Bank set up to manage its equity holdings, DB Investor, has taken new large stakes in companies, for example in the battery manufacturer Varta.[4] Insurance companies, particularly Allianz, are accumulating more and more funds over time and thus will have to increase their overall stakes in companies. Many founders and families have maintained their commitments to companies and have not reduced their equity stakes. Finally, spinoffs by firms have generally taken the form of *partial* stakes being sold on the stock exchanges (e.g. Siemens has retained stakes of 72 percent and 12.5 percent of the semiconductor manufactuer Infineon and components producer Epcos, respectively). Companies also remain eager to acquire new equity stakes in other companies that fit into their strategic portfolios. For example, at the end of 2002 the electronics company Robert Bosch bought up an eight percent stake in the mid-cap company Buderus from the Deutsche Bank. The federal state has also generally pursued partial rather than full privitizations, retaining 71 percent of the Deutsche Post and 43 percent of Deutsche Telekom.

When calculating the median size of the largest shareholding in Germany for each individual year, it is therefore not surprising that this size appears to have stabilized (and in fact slightly increased, from 63 to about 64 percent) since 1999.[5] It thus appears that a mixed system of ownership involving large shareholders and institutional investors is a feature that will characterize Germany for the foreseeable future.

Stability in the Role of Labor

Many accounts of the declining role of labor in Germany have focused on the collective bargaining system, primarily on the decline in the level of trade union

[4] Varta was in the MDAX, the midcap index for German stocks, but its management wished to take it private (i.e. delist it from the stock exchange) since it felt that its stock was undervalued by small investors.
[5] This figure was calculated on the basis of data files supplied by BAFin, or the Federal Supervisory Office for Financial Services. Note that this estimate is slightly higher than that derived by Wojcik (2001).

membership and the flight of some employers from employers' associations. Within firms, in contrast, works councils have, if anything, become a more important force for representing the interests of labor, both vis-à-vis management at the plant level and via the supervisory board at the company level (Thelen and Kume 2003).

Recent legislative changes have affected both company law and the works constitution act. Resisting proposals from some parties to reduce the influence of labor, the conservative-liberal coalition government's reform of company law in 1997 confirmed the dual board system and left the parameters of employee representation on company boards essentially unchanged (Ziegler 2000). A reform of the Works Constitution Act in 2001 under the red-green coalition government even strengthened the legal rights of works councils. For example, the minimum number of employees in a plant needed before a works councilor is released from normal duties to work full-time on works council business was reduced from 300 to 200. The ability of works councils to represent employees in companies with many small branches, which is typical of the service sector, was also strengthened (Behrens 2003).

Accounts of industrial relations claim that there is no tendency of works councils to lose influence, and in many companies influence even seems to have increased through a closer "partnership" with management to solve problems (Höpner, Jackson, and Kurdelbush forthcoming; Jacobi, Keller, and Müller-Jentsch 1998).

Summing Up: Changes in the Role of the Stakeholders

As reviewed above, the importance of the community and of suppliers and customers as stakeholders has probably been overestimated in many stylized accounts of the German model, with the exception of companies in which local or regional governments have a significant ownership role. Although some regional and local governments have announced the intention to privatize some companies, progress in this respect has been slow, and the tendency of local and regional governments has been to partially rather than to fully privatize.

Thus the main change in the German stakeholder model has been the integration of institutional investors into the coalition. Although the role of some large shareholders, particularly the large private banks, may have been reduced, other large shareholders remain committed to a strong corporate governance role. The influence of employees as stakeholders has also remained stable, and in some respects even been strengthened by the reform of the works constitution act. Thus it is possible to speak of the emergence of an augmented stakeholder coalition in German corporate governance.

4. Consequences for Practice: Negotiated Shareholder Value

At the level of practice, a major consequence of the integration of institutional investors in the augmented stakeholder coalition is that their interest in shareholder value must be taken into account. However, due to the existence of this coalition, the practice of shareholder value in Germany differs in two important ways from the Anglo-American variant of shareholder value. First, the introduction of shareholder value concepts must be *negotiated* with other members of the coalition. Due to the reluctance of institutional investors to be linked too closely to firms, e.g. through representation on the supervisory board, this requires the establishment of new institutional mechanisms for mediating this relationship. Second, due to the different interests of the members of the stakeholder coalition, compromises need to be found which typically alter the nature of the demands made by institutional investors. This German variant can thus be characterized as *negotiated shareholder value*. This contrasts with Anglo-American shareholder value, which tends to be unilaterally imposed by management in the interests of shareholders.

What sort of evidence would support this thesis against the alternative theses of convergence or no essential change? First, one would expect evidence of a bargaining process, in which the original demands of a member of the coalition are confronted with objections or alternative proposals from other members of the coalition. Second, one would expect that where opposition is strongest, the original proposals for shareholder value would be modified or even blocked. As a result of the dynamics of this augmented stakeholder coalition, one would expect a modification of the practices in German companies which take into account some of the demands of institutional investors, without at the same time fully converging to the Anglo-American style of shareholder value.

An important change at large German companies has been the introduction of investor relations departments to institutionalize the dialogue with institutional investors. These departments are typically under the finance director, and are responsible for providing institutional investors with timely and detailed information about the financial status of the company and other key information. Studies indicate that the introduction of investor relations units has been virtually universal within large German companies (Welskopp 2002).

Interviews conducted by the author of this paper with works councilors and managers in a number of large German companies indicate that demands for shareholder value are typically transmitted by the finance director into the management board and into negotiations with other stakeholders. This is not surprising given that the finance director is the nearest of the managing directors to investors.

One fairly rapid and universal change in the practices of large German companies was the introduction of international accounting standards (US-GAAP or IAS) at large German companies. German companies have traditionally used HGB (Handelsgesetzbuch) standards, which make comparison between companies difficult due to the numerous options for the accounting department to recognize income, or to even hide some of this income from investors ("hidden reserves"). The introduction of international accounting standards is one of the key demands of institutional investors, since they feel that they cannot truly measure the value of the firm in the absence of such transparency. Other members of the stakeholder coalition, in contrast, are relatively indifferent regarding the type of accounting standards used.[6] Thus it is not surprising that adoption of these standards has been very rapid and practically universal.

[6] Höpner and Goyer emphasize the extent to which employees may have a positive interest in international accounting standards. Interviews with works councilors. However, the author's interviews indicate that relative indifference is probably a more accurate characterization of their actual attitudes towards these changes.

One also finds that many companies have explicitly adopted shareholder value as one of their main corporate goals. Interestingly enough, however, many German companies have taken pains to avoid using either the English term or its direct translation into German, for example, with the phrase *wertorientierte Unternehmensführung*.

More interesting are the cases where there are real concerns or differences of interest between large shareholders. There are numerous recent examples which show that that large shareholders remain intimately involved in decision making in the firm, including in decisions about the implementation of corporate restructuring to achieve shareholder value. One interesting example is the introduction of shareholder value at Hoechst, one of the "Big Three" diversified chemical-pharmaceutical companies in Germany (Vitols 2002). One of the key demands of institutional investors was that the company should "de-diversify" by selling off either its chemicals or pharmaceuticals divisions. In fact Jürgen Dormann, the CEO (and former finance director) of Hoechst, proposed that Hoechst should become a pure life sciences company by selling off its chemicals operations and building up critical mass in pharmaceuticals through merger. Dormann entered into merger negotiations with Rhone-Poulenc, a French company also involved in a variety of chemicals and pharmaceuticals operations. As part of the merger negotiations, however, Dormann had to fly to Kuwait to negotiate with the Kuwaiti government, which held a 25% stake in the company. Dormann could proceed with the merger of the two companies into a new company, Aventis, only after the Kuwaiti government was satisfied that its interests would not be harmed by the merger.

Another interesting example of the continued importance of large shareholders is the restructuring of the German financial services industry. German financial services firms, particularly banks, have come under increasing criticism from institutional investors, since their profitability is particularly low in comparison with Anglo-American banks. One of the demands of institutional investors is that German banks should merge in order to achieve economies of scale and reduce the degree of "overbanking" in Germany. As a key shareholder in the large German banks, Allianz plays a key role in the restructuring of the German financial services industry. Allianz's consent had to be obtained in negotiations between Bayerische Hypobank and the Bayerische Vereinsbank, which merged to form the third largest private bank, Bayerische Hypo- und Vereinsbank. Allianz's permission was also needed in the merger proposal between Deutsche Bank and Dresdner Bank. When this merger failed due to internal management differences, Allianz stepped in and bought up the rest of Dresdner bank itself.

There are even more numerous examples of the involvement of works councils in negotiations over the introduction of shareholder value. One key demand of institutional investors is that employee and management remuneration should be tied more closely to performance, in the ideal case directly to share price. In Anglo-American companies, changes in incentive pay to base a greater proportion of pay on performance and profitability are generally imposed by top management. Furthermore, performance bonuses and pay increases are typically based on evaluations by immediate supervisors. In Germany, in contrast, changes in remuneration systems must be negotiated with the works council, which generally requires elements of collective regulation and limits on the extent of performance pay.

One typical example of how negotiated shareholder value works here is the response of the works council at Schering AG to demands from the finance director for more incentive pay.[7] The works council agreed in principle to introducing performance pay, but imposed a number of conditions for agreement. One was that performance pay only represent a small proportion of total remuneration. A second condition was that certain floors and ceilings be imposed on the amount of incentive pay received by each employee, to help maintain solidarity among the workforce. A third condition was that evaluations be based on standardized forms agreed between management and the works council, in order to improve transparency and fairness in the evaluation procedure.

A second example of involvement of works councils are involved in negotiated shareholder value is the problem of under-performing business units. Anglo-American companies typically impose relatively short periods of time on business units which do not achieve important financial goals to improve their performance before they will be closed or sold off. In German companies, however, the involvement of works councils typically alters the way in which this problem is dealt with. First, the right of works councils to negotiate social plans for large scale layoffs makes closure more difficult and expensive. Second, once the decision to sell has been made, works councils are typically involved in negotiations with potential buyers, and can influence the decision in favor of buyers who will better take into account the interests of employees rather than top price. VEBA's sale of AstaMedica (Zugehör 2001) and Bayer's sale of its pigments division to the US company Kerr-McGee are examples of this kind of involvement.[8]

Many other types of examples of works council involvement in different kinds of restructuring can be found which alter the original demands to achieve shareholder value in the interests of shareholders. The works council at Mannesmann agreed with the takeover proposal of Vodafone when an arrangement was made to find a "good German buyer" for the non-telecommunications parts of the company (steel and auto parts) (Höpner and Jackson 2003). Siemens, the large diversified electronics company, has also been seen as one of the most dramatic examples of an attempt to introduce shareholder value in Germany. Siemens has long been criticized by institutional investors for the "cross-subsidization" of under-performing divisions by better-performing divisions. When the telecommunications equipment division made serious losses in 2001 and 2002, the division head demanded serious job cuts to try to attain profitability. The works council, however, opposed such drastic job cuts, and instead a more moderate package of job cuts in the telecommunications equipment division was agreed.

Overall indicators of company practice and performance are also consistent with the picture that German company practices have in fact been modified, but remain far away from convergence to the Anglo-American model. One example of this is the use of stock options to align the interests of top company managers with shareholders. A change in company law change in 1997 authorized German companies to introduce stock option plans, thus making it much easier for management remuneration to be

[7] Based on an interview with the chairman of the group works council, September 1999.
[8] The case of Bayer based on an interview in May 2001 with a works councilor at the subsidiary that was sold.

tied to share performance.[9] Since then most large German companies have in fact established stock option plans. However, German companies use stock options to a much lesser degree than Anglo-American companies.

Table 6: Stock Options Outstanding as a % of Total Shares Outstanding 30 Dow Jones Industrial Companies (end 2001)

Company	Options as a % of Share Capital
3M Co.	8.8
Alcoa Inc.	8.7
American Express Co.	11.0
AT&T Corp.	8.9
Boeing Co.	3.4
Caterpillar Inc.	9.4
Citigroup Inc.	7.2
Coca-Cola Co.	5.7
E.I. DuPont de Nemours & Co.	6.7
Eastman Kodak Co.	17.3
Exxon Mobil Corp.	3.9
General Electric Co.	3.6
General Motors Corp.	3.7
Hewlett-Packard Co.	11.2
Home Depot Inc.	3.0
Honeywell International Inc.	6.6
Intel Corp.	11.5
International Business Machines Corp.	9.3
International Paper Co.	6.0
J.P. Morgan Chase & Co.	9.8
Johnson & Johnson	5.4
McDonald's Corp.	11.6
Merck & Co. Inc.	6.6
Microsoft Corp.	16.6
Philip Morris Cos. Inc.	6.4
Procter & Gamble Co.	7.7
SBC Communications Inc.	4.0
United Technologies Corp.	7.2
Wal-Mart Stores Inc.	1.1
Walt Disney Co.	9.0
Average	7.7

Source: Company annual reports and filings with the Security Exchange Commission.

One simple but useful indicator for comparing the degree to which stock options are used in a company is to divide the number of stock options granted and outstanding to the total number of shares outstanding. Table 6 shows the stock

[9] Previous to this legal change it was much more difficult for companies to link management performance to share price. The main instrument for doing this was to give management loans to purchase convertible bonds, which however was a quite complex and indirect mechanism.

option/outstanding shares ratio at Dow Jones Industrial 30 companies. The average option/share ratio for these companies is 7.7 percent. The ratio ranges from a low of 1.1 percent (at Wal-Mart) to a high of 17.3 percent (at Eastman Kodak).

Table 7: Stock Options Outstanding as a % of Total Shares Outstanding DAX 30 Companies, December 2002

Company	Options as % of Share Capital
Adidas-Salomon AG	1.1
Allianz AG	0.3
Altana AG	1.7
BASF AG	0.5
Bayer AG	0.0
Bayerische Hypo- und Vereinsbank AG	0.0
Bayerische Motoren Werke AG	0.0
Commerzbank AG	0.0
DaimerChrysler AG	4.2
Deutsche Bank AG	2.7
Deutsche Lufthansa AG	0.4
Deutsche Post AG	0.5
Deutsche Telekom AG	0.2
E.ON AG	0.6
Epcos AG	0.9
Fresenius Medical Care AG	2.6
Henkel KGaA	0.2
Infineon Technologies AG	1.8
Linde AG	0.0
MAN AG	0.0
Metro AG	0.4
MLP AG	0.0
Müncher Rückversicherung AG	0.1
RWE AG	1.0
SAP AG	2.2
Schering AG	1.1
Siemens AG	1.4
ThyssenKrupp AG	1.5
TUI AG	0.0
Volkswagen AG	1.7
Average	0.9

Source: Company Annual Reports

Table 7 shows the same ratio for the DAX 30 companies. It is striking that the average ratio in the DAX 30 companies is only 0.9 percent compared to an average of 7.7% at the Dow Jones Industrial companies.[10] Only DaimlerChrysler has a level

[10] Given that stock option plans are typically long-term (three to seven years), convergence would not require that these ratios be the same, given the lag period needed for "catch-up". However, even allowing for a catch-up effect, the magnitude of the difference is still quite striking.

remotely approaching the US average (4.2 percent), which is not surprising given the attempt to increase German managerial compensation towards US levels within the merged firm.[11]

A second overall indicator is the distribution of value added between different constituencies of the firm. Earlier research noted that a much higher proportion of value added goes shareholders in US and British companies than in German companies; De Jong (1997) finds that in the first half of the 1990s, shareholders (in the form of dividends) in Anglo-American companies received 15 percent of net value added versus three percent with "Germanic" companies. Beyer and Hassel (2003) in a study of the distribution of value added in German firms find that the proportion of value added going to shareholders has increased somewhat (from 2 to 2.8 percent in the second half of the 1990s, but sill remains far behind the level of 15 percent that de Jong reported for British firms.

5. Conclusion

This paper has argued that current developments in Germany can be characterized as important, but essentially incremental modifications in the stakeholder system of corporate governance. In this respect it has disagreed with the theses of "no essential changes" and of wholesale convergence to the Anglo-American shareholder model. The key issue for German corporate governance in the recent past has been how to change to deal with the demands for the implementation of shareholder value by institutional investors. These changes have been analyzed on two levels.

On the institutional level, the major modification of the postwar stakeholder model has been the integration of institutional investors into an *augmented stakeholder coalition*. The greatest stability can be seen in the representation of labor, with the key role of the works council actually being strengthened through the reform of the Works Constitution Act in Germany in 2001. The power of the employees as a stakeholder group has therefore remained stable or even increased. The greatest changes have occurred in the sphere of ownership. In the postwar stakeholder coalition, large shareholders were the dominant owners. Small investors were generally passive and allowed their interests to be represented by banks. Rather than a wholesale shift toward dispersed ownership by institutional investors, which characterizes Anglo-American companies, however, the paper has argued that a "mixed" system of large shareholders and dispersed institutional investors is emerging. The postwar stakeholder coalition has thus been modified through the inclusion of institutional investors, rather than replaced by a shareholder system.

On the level of practice, a system of *negotiated shareholder value* is emerging. Negotiated shareholder value is a stable alternative that is distinct from Anglo-American shareholder value 1) in the processes by which decision-making takes place, and 2) in the outcomes that these negotiating processes lead to. Evidence can be found for bargaining processes between the members of the augmented stakeholder coalition, leading to a modification of the original demands for

[11] Höpner (2003: 214) reports that the salaries of top German managers at Daimler Chrysler have also increased by 467 percent between 1996 and 2000, versus less than 50% at most other large German companies.

shareholder value when other members of the stakeholder coalition object. Macro data, for example in the granting of stock options and the division of value-added between different stakeholders, also supports this interpretation of a German variant of the Anglo-American form of shareholder value.

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