CORPORATE GOVERNANCE IN CONTEXT: ASSESSING THE SUSTAINABILITY OF MANAGERIAL SYSTEMS IN THE GLOBAL ECONOMY WITH EVIDENCE FROM GERMANY’S INSIDER MODEL

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ABSTRACT

This thesis will assess the sustainability of managerial corporate governance systems in the context of the current economic globalisation wave. In order to do so corporate governance is studied as the function of decision-making undertaken by managers as corporate controllers, which is embedded in the national and supranational institutional context. The latter determine not only how much discretion managers have but also how they use it. Two main workable institutional equilibria are identified, reflecting two respective visions of the corporation that emerge from an overview of the most influential theories developed to study the nature of the firm. The first emphasises market transactions by promoting the externalisation of corporate functions and tends to align managerial decision-making to the interests of current shareholders, i.e. the maximisation of the firm's market value. The second contains a tendency towards the internalisation of corporate functions by the corporate organisation with enhanced managerial discretion being a crucial element for the sustainability of this sort of coordination. The crucial difference between these two institutional equilibria, i.e. the shareholder-oriented and the managerial, is that the former is less growth-oriented/dependent and emphasises the lack of commitment between stakeholders and "exit" from corporate relationships, whereas the latter is more growth-oriented/dependent and relies on stakeholder commitment and "voice". It is due to this difference that the managerial system is more susceptible to price competition which involves drastic cost-cuttings that affect stakeholder relationships and therefore more reliant on stable but relatively high macroeconomic growth rates and effective demand. A central hypothesis of this project is that this fundamental difference between the two systems is the decisive factor behind their ability to survive within the current context of economic globalisation. It is argued that globalisation, as a process where national institutional structures are gradually replaced by others determined by world market forces, not only promotes market based macro- and microeconomic coordination but has also (as a result) led to a global economic slowdown due to the inherent imperfections of the market mechanism. Simultaneously, the gradual removal of economic barriers has brought national corporate governance systems in competition with each other with increasing emphasis being placed on cost-reductions and short-term investments due to slower demand-growth. This has a negative impact on the workability of managerial systems and through a process of global isomorphism leads to the emergence of the shareholder-oriented system as the most likely winner not because it is better in terms of economic efficiency, but because it is more flexible. While these pressures are real, global corporate governance convergence is not guaranteed in the short and medium term due to different institutional dynamics that exist in each national system and which determine the scale and scope of adaptation. Empirical evidence from Germany confirms this since, although many basic institutions supporting German managerialism are being eroded, some path dependent ones remain stable and thus prevent the complete institutionalisation of shareholder supremacy. However, this creates systemic workability problems that can in the long term undermine even those institutional structures that are highly path dependent. The progress of further adaptation in the future depends on whether the costs of unworkability exceed adaptation costs.
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CHAPTER 1
THEORIES AND INSTITUTIONS OF CORPORATE GOVERNANCE: MANAGERIALISM VERSUS SHAREHOLDER SUPREMACY

1.1. INTRODUCTION: CONCEPTUAL ASPECTS OF CORPORATE GOVERNANCE

In recent years, corporate governance has been attracting the attention not only of academics from a whole range of disciplines but also of legal and economic practitioners all over the world. Nonetheless, as a concept it remains rather ambiguous, not least because of the diversity of approaches to it.

A reason for this divergence of opinion about corporate governance is that there is no general consensus about the nature of the corporation and its role in society. Thus the principal aim of this chapter is to review some of the most influential theories formulated to deal with this issue and to synthesise them in order to identify the main theoretical visualizations of the corporation. For doing so two elements are of crucial importance, namely ownership and control. Theoretically, it is difficult to imagine these two elements as distinct, because they are closely tied together. This is illustrated in Holmes' attempt to define the idea of legal ownership:

But what are the rights of ownership? They are substantially the same as those incident to possession. Within the limits prescribed by policy, the owner is allowed to exercise his natural powers over the subject-matter uninterfered with, and is more or less protected in excluding other people from such interference. The owner is allowed to exclude all, and is accountable to no one. (Holmes 1963: 193)
It is evident that, following this definition, the right of corporate ownership also constitutes a right to unfettered control and *vice versa*. Thus, at least in theory, once it is possible to identify who owns the corporation, the issue of control is also resolved, just as the issue of ownership is also resolved if it can be identified who controls the corporation.

In practice, however, this is too simplistic a view to hold because, as the next section will show, the unity between corporate ownership and corporate control cannot be taken as given. The emergence of professional managers as controllers of the corporation has broken the link between corporate ownership and control. It is precisely this *de facto* division between the two elements that now obscures the nature of the corporation and sustains the debate on corporate governance, which in essence is a debate about who owns or should own the corporation, if of course it is something that can be owned at all. It is for this reason that the focus of this thesis is on the managerial corporation.

An overview of the most influential theoretical approaches to the corporation in section 1.3 will show that two main models emerge. The first regards shareholder as the residual claimants of all corporate assets and thus grants them the right to own the corporation. In this way, the debate on corporate governance is transformed into one that focuses on how to ensure that those who are vested with the control function, i.e. the management, are held accountable to the shareholders as owners. The second model gives the corporation a real personality, which then precludes it from being owned by anybody. The implication of this is that managers should be accountable not to the shareholders but to the corporation itself.

Obviously these two visions of the corporation have important implications with regard to the ideal choice of managerial objectives. However, they have little to
say on how managerial choices in corporate decision-making are actually shaped. In order to explore this issue, section 1.4 adopts a simple but novel approach. Firstly, it gives corporate governance its literal meaning, i.e. the function of exercising a power to make decisions about the corporation’s affairs. Then, since the focus is on the managerial corporation, it examines the institutional factors that constrain and therefore shape the governance choices of managers. It thus argued that it is the network of such institutional constraints on managerial choices that determines the direction of corporate governance and through that the nature of the corporation itself.

1.2. DE FACTO SEPARATION OF OWNERSHIP\(^1\) AND CONTROL - EMERGENCE OF THE MANAGERIAL FIRM\(^2\)

In section 1.3.2 below it will be shown that the analysis of corporate ownership and control in traditional economic theory is inadequate to say the least. In fact, both elements are treated as a tautology in the sense that ownership also implies control and vice versa just as Holmes’ definition above implies. Furthermore, this tautology is seen in a static way so that even though the firm may change, for example by growing or shrinking, ownership and control as well as the relationship between them remain unaltered. Perhaps this is related to the tendency of (neo)classical economics to treat the company as one of a large number of small, specialised and single-product firms whose ownership and control are vested in the

\(^1\) The word “ownership” here is defined narrowly to describe the role of shareholders as owners. On the divergence between this common perception and the role of shareholders at law see section 1.4.1 below.

\(^2\) Instead of the word corporation economists prefer to use the more generic term “firm” which includes all types of production organisations irrespective of their legal nature. Nevertheless, economic theories of the firm tend to concentrate on the public listed corporation which is also the focus of this thesis. Thus, the terms “corporation” and “firm” will be used interchangeably here.
same person, the entrepreneur, and who are regulated by the “invisible hand”\(^3\) of a perfectly competitive market. Historically, however, the relationship between ownership and control has not been static.

The traditional model perhaps reflected better the economic conditions of the late 18\(^{th}\) and most of the 19\(^{th}\) century. Despite the existence of few large joint stock companies created to promote foreign trade and colonisation or to manage some utilities, all major economies were dominated by unincorporated business forms owned and controlled by individuals. The volume of firms' operations was limited and owners were able to manage their businesses on their own or merely with the help of a few family members (Chandler 1977: 14). As Bratton reports:

> Very little tension arose between economic practice and individualist economic and legal theory in the early nineteenth century. The economy closely resembled the atomistic type described in Adam Smith's classical theory. (Bratton 1989: 1483)

Therefore, the managers of the firm could easily be regarded as its owners and *vice versa*.

During the 19\(^{th}\) century the enactment of general incorporation statutes dispensed with the need of special state corporate charters and made the creation of incorporated companies much easier. Gradually what Chandler (1977: chs.1 and 2) has called the “traditional enterprise” begun to be replaced as a business form by the incorporated company. Initially, incorporated companies were still “entrepreneurial” in their nature. Ownership and control were integrated since the owners of shares were also the managers of the company’s business without the need for extra managerial input. Segregated economies, small productions and slow movement of

\(^3\) The term belongs to Adam Smith who wrote that while “a businessman intends only his gain, he is led by an invisible hand to promote an end which is not his intention” (Smith 1976: 456).
goods generally meant that the operational workload was still manageable by the entrepreneurs themselves. So the use of salaried managers was minimal and even where it occurred those managers were acting under the guidance of the owner-entrepreneur.

The first big change came during the second industrial revolution around the 1900s with the emergence in the US and in Europe of large infrastructure and utility ventures like the railways, the telegraph, and mining. These ventures could only be undertaken by large corporations run not by owners-entrepreneurs but by extensive salaried managerial hierarchies who provided very little capital. The finance for such large capital intensive projects was only available by pooling the funds of thousands of investors and financiers. The owners of stock had neither the knowledge nor the power to administer those corporations, the pioneers of “big business”. As Chandler, states:

The building and operating of the rail and telegraph systems called for the creation of a new type of business enterprise. The massive investment required to construct those systems and the complexities of their operations brought the separation of ownership from management. The enlarged enterprises came to be operated by teams of salaried managers who had little or no equity in the firm. The owners, numerous and scattered, were investors with neither the experience, the information, nor the time to make the myriad decisions needed to maintain a constant flow of goods, passengers, and messages. Thousands of shareholders could not possibly operate a railroad or a telegraph system. (Chandler 1990: 1)

Thus, the first management controlled or “managerial”, as they are commonly called, companies emerged as one of the by-products of the second industrial revolution. The significance of this development is twofold. First, these managerial corporations provided a previously non-existent managerial and administrative know-

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4 In fact, Adam Smith (1976: 741) himself acknowledged that in the early joint stock companies of the 18th century the involvement of shareholders in management was an imaginary presumption rather than a reality. Nevertheless, the manager-controlled corporation then was merely an exception to the rule of integrated ownership and control.
how, such as accounting and statistical controls, which emerged as the basis for modern business. The second contribution was the creation of the transportation and communication infrastructure that created the opportunities for mass production in many other industries that transformed the nature of capitalism - from classical to "managerial" - and of markets - from rural, agrarian and commercial to industrial and urban. Fast and large volume transportation created large integrated markets which presented vast opportunities for industrial growth in scale and scope (Chandler, ibid.).

These growth opportunities that emerged from the enlarged markets and changing technologies during the late 19th and early 20th century demanded new organisational structures similar to those that had been developed by railway companies. In the 1890s and early 1900s intense merger activity in the United States and to a lesser extent in Germany resulted in the dilution of original entrepreneurs' stock ownership. Similar developments also occurred in Britain and Japan but at a slower pace which, nevertheless, accelerated after the World War II. Thus, the giant managerial corporation emerged, first in the United States and Germany and later in Britain and Japan, as the dominant economic player of the 20th century. This dominance over industrialised economies was so obvious to Chandler (1977) that he claimed that the "visible hand" of the managerial hierarchy had come to replace Adam Smith's "invisible hand" of the market. In 1941 James Burnham went even further to claim that the "managerial revolution" would give rise to a new "ruling class" of managers (Burnham 1941). Irrespective of whether such concerns eventually materialised, the truth was that managerial capitalism established a strong foothold in most major economies.

Differences of course did exist as each version of managerial capitalism reflected national institutional sets and historical events that also determined the time
when the separation of ownership from control took place. Such national differences, according to Chandler (1990: 12), give rise to a distinction between "competitive" and "cooperative" managerial capitalism. The US is an example of the former as the early prohibition of cartels, on the one hand, constrained close inter-firm cooperation and made merger combinations more attractive and, on the other, it enhanced competition between the large oligopolistic corporations that ensued. In contrast, as chapter 3 below will show, in Germany's cooperative capitalism cartelisation was not illegal—at least not before the end of World War II—and consequently intra-firm cooperation was common in the home market, although competition between German companies was intense in the international market (Wengenroth 1997). Nevertheless, in the somewhat peculiar case of Japan, manager controlled firms were allowed to cooperate closely by forming extensive group networks, but competition between those groups has been very aggressive both at home and abroad (Morikawa 1997).

Despite those differences, the common denominator in major capitalist economies has been the managerial corporation with de facto separation of corporate ownership from control. Obviously, this major socio-economic development did not go unnoticed. Keynes (1931: 314-315) himself observed this practical departure from economic classicism in 1926 when he wrote that shareholders had dissociated themselves from company management. In another early account of the developments in large corporations, Veblen (1924) claimed that there was a gradual transfer of corporate control from capitalistic owners to engineer-managers who had objectives that were different from those of owners. However, the milestone work on the separation of ownership and control came from Berle and Means, a lawyer and an economist respectively. In 1932 they published *The Modern Corporation and Private*
Property which was the first systematic study of corporate control in the United States (Berle and Means 1932).

Berle and Means assumed that corporate control derives from the ability to select and appoint directors since the board of directors is the main decision-making body of the corporation. Their study of ownership structure of American corporations showed that shareholdings were so dispersed as to preclude shareholders from having sufficient interest in exercising their control rights over management. According to their analysis, 65% of the largest two hundred American corporations were manager-controlled which in their view signified the de facto separation of ownership and control (Berle and Means 1932: 110).

What has to be noted here is that the Berle and Means thesis applies merely to corporations with diluted shareholdings. So it has an application to large British corporations which are characterised by an ownership structure similar to that of US companies. Nevertheless, in most other countries the pattern is rather different even for large firms. In both Germany and Japan, for instance, ownership is much more concentrated, as banks, families and, most importantly, corporations themselves are large shareholders. This could lead one to assume that due to these ownership patterns the separation of ownership and control thesis has prima facie no relevance. A closer look, however, reveals that, although there can be no direct application of the thesis, managerialism can exist even in these countries. As it will be shown below, the divorce between ownership and control does not only occur in the Berle and Means type of corporation. Despite its concentrated ownership a company can come within the managerial category due to the identity of its large shareholders, if the latter are not interested in controlling managers. For instance, chapter 3 below will demonstrate

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5 This has indeed been the mainstream view. See for example Pettet (2000: 55 and 59).
that extensive cross-shareholding networks have this very effect since they are used as a shield against control-oriented shareholders’ influence. But even where families are still present in large companies, their ability to direct company affairs can be substantially reduced by the scale of operations that demands the delegation of control to a large managerial hierarchy. Thus, concentrated shareholdings do not automatically imply the integration of corporate ownership and control.

The importance of Berle and Means’ study does not lie solely in the realisation that there was a control gap in the large modern corporation. Even though that in itself constituted a challenge to conventional legal and economic thinking, perhaps more challenging was the two authors’ concern that managers were becoming increasingly unaccountable in the absence of shareholder control, and that they could abuse their unchecked power to pursue their own interests to the detriment of corporations and shareholders (Pettet 2000: 112-116).

This assertion was not entirely original. Over a century earlier Adam Smith himself had made a similar observation about the joint stock companies of his time when he wrote:

The directors of such companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private coparty frequently watch over their own (Smith 1976: 741).

However, what made The Modern Corporation and Private Property a milestone was that, unlike in the 18th century, by 1932 the managerial corporation had emerged as a significant force in society, instead of being a mere exception to the rule. As Berle and Means explained:

A society in which production is governed by blind economic forces is being replaced by one in which production is carried on under the ultimate control
of a handful of individuals. The economic power in the hands of few persons who control giant corporations can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another (Berle and Means 1932: 46).

As a result, the Berle and Means thesis not only gave a new spin to an old legal theory debate on the nature of the corporation but also attracted the interest of economic theorists. Both lawyers and economists searched for a solution to the problems of corporate legitimacy that managerialism raised. The former examined the social legitimacy of managerial power over companies and the latter looked for the economic efficiency implications of the separation of ownership from control. The following section provides a closer look at the most influential of these theories.

1.3. THEORIES OF THE CORPORATION

The corporation and its governance has been the subject matter of academic debate even before the rise of the managerial firm as the dominant economic actor in major economies. Incorporation and corporate personality raised legal and economic efficiency questions that gained importance as the company became a more common business form. The practical usefulness of answering those questions lies in their regulatory significance. In order to determine the purpose and extent of corporate governance regulation one has first to understand the nature of the corporation. As the following discussion will show, this is by no means a straightforward task. Different theoretical approaches can lead either to regard the corporation as real as a human person or as a pure fiction that exists only by name in people’s minds and not in
reality. These two perceptions of the corporation are called corporate realism and nominalism respectively.

The choice between corporate realism and nominalism has important implications for corporate governance, because our views about the nature of the company reflect how we comprehend the concept of corporate ownership and its relation to control. If, for example, a company is a real person, the question of ownership becomes irrelevant since real persons are legal subjects that cannot be legally owned. They are owners and controllers themselves as legal subjects and have their own rights and duties. Thus, corporate governance is internalised and integrated into the corporate organisation and its purpose is to serve the needs of the corporate person subject to its duties as such. On the contrary, if the nominalist approach is followed, the corporation resembles a legal object. As such, it has no rights or duties and can be owned by real persons who are vested with the corporate control rights in order to serve their own needs.

1.3.1. Legal Theories of the Corporation

During the early formative years of corporate law the theoretical debate essentially concerned the origins of the new business form and only indirectly its nature. What theorists looked for was the source from which the right for corporations to exist derived.

The origins of the corporation can be traced in the Roman societas, an association of persons with a common purpose, and the medieval canon law which allowed religious foundations to incorporate as legal personae fictae in order to
receive and own property. These were the first forms of incorporated bodies with some legal capacity as persons though not natural ones. Contract was the basis of such legally recognised bodies⁶ as it was for forms that evolved later such as common law partnerships and the civil law société en commendite, the ancestors of the incorporated company. The existence of those bodies depended on the private initiative of individuals who were free to draft association agreements. This led to the belief that the very existence of corporations too derived from contracts between natural persons who could thus create fictitious persons with legal capacity.⁷ In other words, the basis of the corporation’s existence were contractual relationships between private individuals.

However, this contractual view was not left unchallenged. Until well into the 19th century full incorporation associations could not take place unless a special charter were granted by statute or decree. Such privileges conferred by the sovereign or the state were common since the 16th century when the corporate form was used for the expansion of foreign trade and colonisation or for the creation of national monopolies in utilities, transport, finance, etc. The state was heavily involved in the incorporation process and was therefore a party to the corporate contract. That is, for associations of individuals to become legal persons a concession from the state was necessary. Thus, according to this “concession” theory the origins of the corporation lay in the regulatory power of the state rather than in the private initiative of contracting individuals (Millon 1990: 206).

Concession theory was very influential so long as the state’s participation in each and every incorporation was necessary. That was to change considerably with the adoption of general incorporation statutes. These instruments turned the act of

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⁶ See Buckland and McNair (1965: 300-301).
incorporation into a private right rather than a privilege, since no special charter grants by the state were necessary any longer. Thus, with the enactment of general company statutes the state’s micro-level involvement was transformed into macro-level regulation. The most important illustration of this is that now the state has no power to designate what the objectives of a corporation will be when corporate charters are drafted by and according to the needs of private individuals. All the state can do to exert its influence is to formulate general macro-level rules that define the boundaries of corporators’ freedom to draft charters.

Despite this change neither concession theory has entirely lost its relevance nor has contract theory emerged as the dominant theory about the origins of the corporation. Although the latter theory has gained more relevance, the concession approach is still valid since incorporation is still based upon the enactment of company laws by the state (Foster 2000: 583). In other words, the right of incorporation is still granted by state law. Thus the presence of general company laws may not necessarily imply a decrease of state influence. Indeed some have argued that the state has had a dominant role even after the shift of incorporation regulation from the micro- to the macro-level.8

In sum, by looking at who the actual corporators are, both concession and contract theories attempt to explain the origins of the corporation. The former contends that the state has a prominent role, while the latter tends to project the associated individuals. But both theories have an inherent legitimation element; their direct purpose is to provide justifications for or against state influence on private individuals’ ability to form corporate bodies. However, although their primary focus

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8 Hazen (1991: 297-298). for instance claims that, even though corporate charters were not created by the state, tight regulatory constraints on corporate activity gave a public element in company law. Similarly, Millon (1990: 211) writes that “extensive regulation indicated a conception of corporate law as public law.”
is on the corporators, these legitimation attempts also entail indirect implications about the nature of the company. Concession theory's centrality of law in the formation of a company strips the latter of any real, natural existence. The corporation is thus a mere construct of the mind and exists *artificially* simply because the law says so.

Due to these implications the concession approach has been associated with the "fiction" theory which attempts to describe the company's nature rather than its origins. The most prominent exponent of this theory was the German Romanist Friedrich Karl von Savigny. His initial contention was that a legal relation could only exist between persons as subjects (Savigny 1884: 1). But in order for such a relation to take place the persons involved should recognise each other as capable of assuming the role of a legal subject. Having established this as his starting point, Savigny then went on to determine who or what can be such a person. Firstly, he contended that humans should fall within the definition of a person because, due to their real corporeal existence, they can be recognised as the subjects in a legal relation *naturally*. He then distinguished such human persons from numerous others that are recognised in law as persons but which are not real as they do not exist naturally. Such entities, according to Savigny, can also be legal subjects, or legal persons, but only because the law makes them so. The law gives them those attributes that allow them to be recognised as subjects in legal relations. Thus, such legal persons exist merely as fictitious ones rather than naturally and only with the essential contemplation of law.

Following this line of thought, the corporate entity, lacking a natural existence, falls within this second type of person. Thus, according to Savigny, the corporation is an entity that has an existence of its own which is distinct from its
corporators but only as a fictitious legal person rather than as a natural being. It can effectively be a subject in legal relations and it is also recognised as such by other persons, but this is so only with the assistance of the law. As Iwai explains:

> the corporate personality is an inter-subjective concept which has been introduced into the legal system as a legal device to simplify the web of contractual relations between a group of individuals and a multiple of outside parties (Iwai 1999: 603).

Thus, the law appears to be a core element in the fiction theory as it is in concession theory. It is because of this observation that the two theories have been largely merged.⁹ Since, according to concession theory, the corporation is a mere legal creation, it must only be an artificial construct, a fiction.

Although fiction theory attempts to define the nature of the corporate entity, its explanatory power regarding the relationship between ownership and control is minimal. Although it recognises that a corporation can exist as an entity in law, it fails to determine the exact nature of this entity's relationship with the corporators. Thus, fiction theory's normative usefulness is more apparent in explaining the role of the state in corporate governance. Since the law is vital for the corporate entity's existence as a person, the state, being the main promoter of the law, can have an important interest and influence in corporate activity (Phillips 1994: 1082). However there may be an indirect implication from this. If the state does have an influence this is so to the detriment of the corporators as private individuals free to create associations without state interference. Thus, the corporate control role of corporators is weighted against the role of the state. In other words, there is a balance between statism and nominalism.

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⁹ In fact Savigny has been severely criticised for this. See Maitland's criticisms in Gierke (1900: xxi) and Phillips (1994: 1064).
Nevertheless, for the same reasons that the concession theory lost much of its significance with the decline of the state’s chartering authority, the fiction theory’s assertions about the nature of the company also lost ground to other less statist ones. These were the aggregate theory and corporate realism.\footnote{These theories are also known as group theory and real entity theory respectively. It should be noted here that corporate realism should be distinguished from the “realist” movement in general legal theory.}

The former is in fact based upon the contract theory presented above. It was originally developed by 19th century European theorists like von Jhering (1873-1875) and de Vareilles-Sommieres (1902) who shared a different view about the nature of the corporation which was one founded on the individual freedom to form contractual associations without any state interference. The basis of the aggregate theory is the premise that human beings, being the only “real” persons, have the ability to be legal subjects and have rights naturally without the prior operation of law. One such natural right is the freedom to establish contractual relations with each other in order to form business associations. Thus, corporations are seen as associations that are formed by aggregates of individuals and are comprised of the contractual relations between those individuals. The company being an aggregate of contracts becomes neither a real entity nor an artificial legal person independent of its members. In fact, as the corporate entity disappears completely from the picture, any corporate rights, duties or interests are in fact those of the corporators themselves (Morawetz 1886: 2). By denying the corporation any “real” existence separate from its members aggregate theory represents the pure “nominalist” view of the corporation. Viewed in this way the corporation is seen as something very similar to the contractual relationship between partners in a partnership (Schane 1987: 568).

The normative implications of aggregate theory are very important from a corporate governance perspective. Firstly, by identifying the company with the
contracting shareholders it legitimises the norm of shareholder supremacy in corporate decision-making. Since there is no real and distinct corporate entity, it is the shareholders’ interests, rights and duties, as expressed in the corporate contracts, that need to be observed and enforced. Although later versions\(^\text{11}\) of the theory have included other non-shareholder contractual relations—e.g. of creditors, managers, and of other company officers—shareholders have generally been regarded as the core constituency (Phillips 1994: 1066). This theoretical model fits well the middle 19\(^{th}\) century economic reality which was characterised by stable concentrated ownership and small companies controlled by their shareholders. The second important implication stemming of aggregate theory concerns the role of the state. Since, as stated above, the corporation is formed by contract between private individuals, the state automatically becomes an outsider with no legitimate influence. Thus, nominalist theorists have been categorically opposed to government regulation of corporate activity since that would be contrary to the principle of individual freedom of contract.

Nonetheless, around the end of the 19\(^{th}\) century the aggregate theory began to lose its normative influence (Bratton 1989: 1490). The emergence of the large managerial firm with constantly fluctuating and fragmented ownership as well as the acceptance of limited liability did not sit well with the aggregate model. The identification of the corporation with its members was increasingly untenable.\(^\text{12}\) It seemed that as the influence of shareholders was diminishing the corporation was acquiring a separate life of its own, this time as a real entity. Moreover, the corporation was losing its contractual nature also in a legal sense. As Hazen (1991: 284-285 and 299-302) and others have argued, the consent requirement for the

\(^{11}\) See the discussion on economic theories below.

\(^{12}\) See Machen (1910/1911: 259) claiming and mathematically proving that “any group whose membership is changing, is necessarily an entity separate and distinct from the constituent members.”
creation of a legally binding contract cannot be realistically fulfilled in the case of large managerial firms. An alternative theory not based on contractual considerations could accommodate these changes with more ease. Such an alternative was provided by corporate realism.

The main advocate of corporate realism was the German scholar Otto von Gierke (1900, 1977), who viewed the corporation as an entity which was completely independent from its members. The difference from Savigny's assertions was that Gierke's entity was not a legal fiction but a real person. The argument was that in all societies when individuals join together into groups and associations there is a trade off between individualism and collectivism. That is, in order for a group to persist, the individual has to make sacrifices. When this happens, the group's interests can be no longer identified with those of the individual ante association. Instead, the group acquires a will and goals of its own which do not necessarily fluctuate with membership changes. In fact, the opposite may be the most common situation; the individual will usually have to adapt in order to join the association. In this process the prescriptions of the law are irrelevant. Legal recognition is not necessary for the associated group's real existence to be established. Maitland's description of the corporation in his introduction to the translated version of Gierke's work illustrates this:

[The corporation is] no fiction, no symbol, no piece of the State's machinery, no collective name for individuals, but a living organism and a real person, with body and members and a will of its own. Itself can will, itself can act; it wills and acts by the men who are its organs as a man wills and acts by brain, mouth and hand (Gierke 1900: xxvi).\textsuperscript{13}

The normative value of these assertions is obvious since corporate realism provides theoretical legitimacy to managerial power. Being a real entity, the

\textsuperscript{13} In the original text as translated by Maitland Gierke uses the term "German Fellowship".
corporation can have its own interests and duties separately from its members, it can own property and employ a workforce, but most importantly it cannot itself be owned just as all other real persons cannot. There is a differentiation between corporate property and shareholder property. Shareholders cannot be regarded as the owners of the company which is then not run solely for their benefit. Instead the corporate entity defines its own objectives and uses all its available inputs to achieve them through its officers. Consequently, the shareholder supremacy norm advanced by the aggregate theory loses its validity. All this fits well the managerialist paradigm, and so it is not surprising that corporate realism became dominant with the emergence of the managerial firm (Bratton 1989: 1490-1493). However, with regard to the role of the state corporate realism is somewhat contradictory. While Gierke and his followers were prepared to advocate for more regulation in order to ascribe a public character to the corporation, others used corporate realism to deny any state involvement in what they saw as strictly private bodies (Hager 1989: 630-32).14

The theory has two major flaws. The first is that, although it offers plausible arguments about the existence of the firm as a real entity, it stops short of attempting to define the nature of the corporate entity’s interests. This is, in fact, one of the aggregate theory’s strengths since it precisely defines the corporate interests by identifying them with those of the shareholders. Realism convincingly refutes this assertion, but it does so by creating an uncertainty. In effect there is a shift of the theoretical uncertainty from the company’s nature to the company’s interest.

The second flaw derives from the realist assumption that the corporate person is similar to the human person, in that they both seek to achieve their objectives without any internal tensions or conflicts of interest. In other words, officers such as

14 See also Dodd’s approach below.
managers and other employees, being the company’s organs, are treated as a integral parts of the corporate entity and have no will, interests or objectives of their own. They only act in accordance to the corporate will whatever that may be. Consequently, the realist model excludes the possibility of opportunistic behaviour on the part of any of the individuals involved with the corporation either as members or as officers. Although plausible in an ideal world, this premise is hardly sustainable in reality. Individuals even within the structure of commercial associations do not subject their self-interest to the common objective unless the two somehow coincide. Thus, even if one could define the corporate interest with precision, corporate realism does not provide any support for the assertion that they will be promoted by the company’s organs which are usually identified with management. Inherently an accountability problem arises.

Despite these flaws, the economic success of managerial capitalism remained largely undisputed for several decades just as did the justifications provided for it by corporate realism. However, this temporarily changed with the Great Depression. It was in such a context of severe economic downturn that Berle and Means presented their thesis about the separation of ownership from control and the rise of unconstrained managerial power. These realisations pressed for answers to the complications of corporate realism presented above and sparked the famous debate between Adolf Berle himself and his fellow law professor Merrick Dodd. They summed up the whole problem in the question “for whom are corporate managers trustees?”

In his attempt to answer this question Dodd followed a novel pluralist approach as he sought to expand the theory of corporate realism to include corporate

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15 Galbraith (1961: 183), for instance, identified “bad corporate structure” as one of the causes of the 1929 crash.
16 See Dodd (1932, 1935) and Berle (1931, 1932).
social responsibility. He accepted that the corporation is a real entity distinct from its shareholders but similar to any other real person that entity has a social role and should be subjected to the principles of citizenship. Those principles may at times be contrary to pure self-interest by imposing social obligations. Thus, in the case of corporate citizens, purely economic self-interest, i.e. profit-maximisation, may be subjected to other social objectives. The adoption of a realist stance is crucial for the plausibility of this assertion. If the corporation was not seen as a real autonomous entity but was identified with the shareholders' aggregate then it would have been impossible to construct a corporate citizenship concept. Thus, when Dodd detached the corporate interest from shareholder interests, corporate social responsibility could be inserted. The implication from this is that social objectives can be integrated into the corporate interest so that ultimately there should be a balance between the two.

Having dealt with the definitional problem of the corporate interests in this manner, Dodd was then able to engage upon the accountability issue. Once again the theoretical basis for his claims was provided by corporate realism. Since managers of large corporations had to discharge their duties in accordance with a socially responsible entity that is distinct from its shareholders, they should also be expected to have “a sense of social responsibility toward employees, consumers, and the general public” (Dodd 1932). In other words, Dodd’s answer to the debate’s question was that managers are trustees for the corporation as a socially responsible person rather than for the shareholders as Berle believed (ibid. at 1161).

Dodd’s pluralist approach is very important from a corporate governance perspective because it entails important ramifications for the nature of ownership and its relationship with control. Similarly to Gierke’s realism, share ownership is distanced from the concept of control since the corporation pursues its own objectives
and not those of its shareholders. By directing the element of management accountability towards the corporation as an independent entity the shareholders' aggregate is stripped of its control function. Therefore, Dodd provides a clear justification for the separation of ownership from control. The whole concept of shareholder supremacy legitimised by the aggregate theory loses all its influence since managers can pursue goals that may even contradict it in order to achieve the principal corporate and social objectives. Moreover, although the original version of corporate realism was often used to oppose state regulation of corporate activity (Horwitz 1985: 221 et sec.), Dodd’s approach is diametrically different. As Millon observes:

[Dodd’s] objective was a legal regime that encouraged managers to use their broad powers not only for the benefit of shareholders, employees, and other participants in the corporation’s activities but also for the good of the general public [...] Here then was an argument for a public law of corporations [...] Far from assuring the triumph of big business, the natural entity theory itself contained implications that critics relied on to attack the large corporation’s new-found position of privileged economic power (Millon 1990: 220).

Dodd’s corporate social responsibility argument had many strengths which were also recognised by Berle and Means who in The Modern Corporation and Private Property acknowledged in principle the possibility and desirability of a solution based upon a pluralist approach similar to Dodd’s with:

a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity (Berle and Means 1932: 356).

In practice, however, Berle felt that such a solution entailed hidden accountability weaknesses because of the lack of an effective enforcement mechanism. His concern was that the amorphousness of the beneficiaries’ interests in the pluralist model
diluted managerial accountability and granted managers more unconstrained power. In his reply to Dodd’s proposition, Berle (1932) promoted the idea of a narrowly defined accountability mechanism with managers being trustees for the shareholders rather than the company itself. In this way he assimilated the corporate interest with the shareholders’ wealth maximisation objective by disregarding all the insights of corporate realism. In fact, though not expressly stated, the theory underlining Berle’s minimalist analysis is a version of the aggregate theory which also comprises a contractual relationship between shareholders and managers. Under that contract, the former entrusted their private property to the latter. The only issue to be dealt with is that of ensuring the enforcement of this contract by enhancing managerial accountability to the shareholders. Conceived in this way the corporation loses all the public characteristics attributed to it by Dodd’s version of corporate realism and becomes an aggregation of private (shareholder) interests. Consequently, the legitimation arguments for corporate social responsibility collapse in favour of the shareholder supremacy principle as an expression of individualism.

In sum, the debate between Dodd and Berle transformed the old legal debate on the nature of the corporation by placing the focus on the legitimacy of managerial power and the role of corporations in society. Although both theorists have as their staring point the de facto separation of share-ownership from control, their final propositions are antithetical. Dodd welcomed the ostracism of the shareholder from the centre of corporate control in order to give way to the possibility of “socialising” the corporate entity. On the other hand, for practical reasons Berle regarded the rise of managerial power as inherently evil and sought to find mechanisms to bridge the accountability vacuum, as he saw it, which exists in the managerial corporation. He believed that enforcing accountability would become an easier task if the corporate
objective were limited to shareholder wealth maximisation as opposed to Dodd’s vaguely defined social responsibility.

Such is the force and theoretical foundations of these two approaches that the battle between them continues to shape the corporate governance debate to this day. By the 1950s Dodd’s pluralism/realism appeared to win the argument and this was even acknowledged by Berle himself as he converted to pluralism in his later writings.\(^{17}\) The economic successes of managerial capitalism in major economies during the early post bellum reconstruction era provided empirical justifications for socially responsible corporate realism and managerial autonomy (see infra. chapter 2). It appeared that managerial self-interest coincided with societal objectives even without the imposition of mandatory company law constraints to establish corporate social responsibility.\(^{18}\) The objectives of managerial companies were an amalgamation of private and social interests similar to that envisaged by Dodd. Managerial autonomy from shareholder supremacy enabled the corporation to accommodate diverse interests such as those of employees, the customers or even the state and the general public, and to be seen as a social institution rather than an aggregation of private interests.

However, the minimalist/nominalist approach did not disappear. Instead, it was taken up, expanded and refined, this time by economists rather than lawyers, beginning with Coase in the 1930s and continuing with Jensen and Meckling in the 1970s, to become the dominant by the end of the 20th century. This was the era when

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17 See Berle (1954: 169; 1959: 90-91 and 100). Of course, critics of the social responsibility thesis were also present. The most prominent was Milton Friedman (1962: 122 and 133-36) who saw the shareholders as the real owners of the corporation as a *persona ficta*. He believed that allowing managers to promote social objectives amounted to giving them the right to impose social taxes on shareholders’ property without having the necessary political authority. See also Fischel (1982: 1269-70) arguing that the corporation is a legal fiction and as such it cannot owe a social responsibility duty.

18 Although in some European countries there was indeed some legal institutionalisation of non-shareholder interests like those of employees with the enactment of worker participation laws. The issue of concurrency between managerial objectives and the interests of other corporate constituencies including society will be further discussed below.
managerialism begun to lose its legitimacy first in the US and the UK\textsuperscript{19} and later in other countries and international fora. Aggregate economic theories slowly began to infiltrate and shape legal theory to such an extent that they can now offer a fully developed alternative to corporate realism. These developments in the economic analysis of the corporation are discussed next.

\section*{1.3.2. Economic Theories of the Firm}

To begin with, the main concern in economics is whether available resources are allocated in an efficient manner. So, while legal theories of the corporation are based on arguments that have their roots in legal tradition and moral values, economics views the issues related to nature of the firm through the prism of economic efficiency. Some have even argued that efficiency can be a moral principle in itself since it increases general welfare (Posner 1980: 500-502). But as a concept it is rather elusive. For example, Coleman (1998: 11-18) identifies at least four efficiency-related notions. However, the most commonly used version is Pareto efficiency/optimality, named after its originator, the 19\textsuperscript{th} century economist and sociologist Vilfredo Pareto. This notion describes the state of affairs where resources cannot be reallocated so as to make one person better off without making someone else worse off. Moreover, apart from allocative efficiency, economics is also concerned with the notion of productive efficiency. Simply put, this describes the maximisation of output from given inputs. These two aspects of economic efficiency

\textsuperscript{19} See the discussion in section 6 below. Such was the force of Dodd's social responsibility claim that some theorists even attempted to integrate it into aggregate theory. Chayes (1959: 25), for instance, based his social responsibility argument on an aggregate model with expanded membership. The aggregate membership included non-shareholder constituencies, such as employees, who were entitled to participate in corporate decision-making.
are interrelated since it is the efficient allocation of resources that makes efficient production possible. Economics uses such criteria as a rule of thumb in order to determine when a particular type of conduct or institution is justifiable. Therefore, any arguments about the firm's nature are based on economic efficiency grounds.

What is striking, however, is that at least until relatively recently, traditional (neoclassical) economic theory virtually ignored the existence of the firm and concentrated on market operations or individuals' actions instead. In neoclassical economic theory firms are simply considered as economic actors quite similar to individuals who transact in the market. This theory, based on the Walrasian and Marshallian tradition,\(^\text{20}\) refuses to look into the internal operations of the firm, which resembles an "empty box" (Jensen and Meckling 1976: 307), and thus has no complete analysis of the firm to offer.

Neoclassicists study the firm by using a number of theoretical assumptions.\(^\text{21}\) The first assumption is that the distribution of production factors within the firm is always coordinated according to the classical price theory which also applies to market coordination.\(^\text{22}\) This predicts that, if factor X is valued higher in A than in B, then X will move to A until the price difference disappears. In this way the market determines the prices and automatically marks out what the best allocation choice is. This implies that the role of management, if any, is a passive rather than an active one. Thus, in neoclassical economics there is no theorising about managerial coordination and the firm is assimilated to a factory without an administrative hierarchy (Chandler 1997: 490). Even where an administrative hierarchy exists, the

\(^{20}\) See Walras (1954) and Marshall (1920).

\(^{21}\) Some prominent exponents of the theory are Machlup (1946); Oliver (1947); Friedman (1953); Stigler (1947a); Some classic neoclassical models of the firm are have been developed by Hicks (1939) and Arrow and Debreu (1954).

\(^{22}\) The assumption is that natural prices of goods are reflected by market prices which are determined by the matching of supply and demand.
neoclassical assumption is that it merely coordinates factors in the same way that the price mechanism would. Alternatively, the theory assumes that the firm is owned by a single entrepreneur. Again this single owner makes all management decisions according to the price-theoretic assumption.

The second assumption, based on the classic axiom that all economic actors seek to maximise profit, is that the firm pursues the single objective of profit maximisation. This is achieved by applying the marginalist principle which assumes that the change in total revenue resulting from selling an additional unit of commodity (Marginal Revenue) equals the change in total cost resulting from a unit change in output (Marginal Cost). Profit maximisation is attained when Marginal Revenue equals Marginal Cost (MR=MC). This occurs in series of independent time-horizon periods which are determined by technological change, capital intensity of production, product life, and so on. Profit maximisation within all these independent short-term periods leads to profit maximisation in the long-term as well. That is, the relation between short-term and long-term profit is harmonious. Moreover, when pursuing their goals firms act atomistically without being conscious of other firms’ reactions.

Finally, the third main assumption of the neoclassical theory is that the firm operates in perfect certainty as it has full knowledge about all present and future circumstances that affect its operations. Irrespective of whether production factors are coordinated by an administrative hierarchy or by a single entrepreneur, the firm has unlimited information on production costs and revenues. The lack of informational asymmetries excludes any uncertainties and enables the firm to make all rational decisions in order to achieve its profit maximisation goal. In this way, all alternative

23 This is the well-known “global rationality” assumption of neoclassical economics.
strategies are evaluated and compared with certainty so that only the profit-maximising ones are “chosen”. In fact, as Loasby claims, firms and other economic agents’ choices are absolutely predetermined

If knowledge is perfect and the logic of choice complete and compelling then choice disappears; nothing is left but stimulus and response...if the future is certain there can be no choice. (Loasby 1976: 5)²⁴

The neoclassical theory of the firm is essentially a theory of equilibrium which is achieved in markets characterised by perfect competition.²⁵ It is in such markets that the price-theoretic assumption that firms are passive price-takers rather than active price-makers applies and where Pareto optimality is achieved. In the neoclassical equilibrium a single price prevails in the market according to which all rational profit-maximisers make their adjustments to their output in order to equate Marginal Cost with Marginal Revenue. Thus, profit-maximising firms achieve their goals by using the prices formed by the market according to the law of supply and demand.

It should be noted here that subsequent formulations of the neoclassical theory have allowed for the possibility that non-profit maximising firms may exist at least in the short-term. For instance, in a classic paper published in 1950 Alchian used the Darwinian natural selection methodology to claim that the achievement of long-term profit maximisation is crucial for the firm’s survival in a perfectly competitive market (Alchian 1950). Profit maximising firms enjoy an advantage over non-profit maximising firms, since they have the financial resources to grow faster than the latter who will be out-competed and eventually eliminated. The significance of

²⁴ See also Latsis (1976).
²⁵ Perfect competition describes a market where there are a large number of small firms who produce an identical (homogenous) product, where there are no entry-barriers for new competing firms and where all firms face the same costs.
Alchian's model is that, although it allows the possibility of firm-level divergence from profit-maximisation, the neoclassical objective applies at an industry-wide level through an evolutionary process and thus the neoclassical equilibrium holds. Profit maximisation is then not a choice objective but it is one externally imposed on the firm's owner as a necessary precondition for survival.26

The equilibrium assumptions of the neoclassical theory have some important implications for corporate governance. First, since both managerial hierarchy and sole entrepreneur ownership are treated as equivalent coordination mechanisms within the firm, the relationship between ownership and control and its organisational implications are rendered irrelevant. There is no difference between a non-owner manager and an owner-entrepreneur since both are simply assumed to make optimal decisions based on given (perfect) information. In such a theory where discretion is completely ruled out managerial innovation and motivation have no relevance. Irrespective of who is in control of the firm the profit-maximisation objective will be pursued. Secondly, the perfect markets assumption of the theory calls for the rejection of any non-market intervention. Since the allocation of resources in equilibrium is optimal, any regulatory or other interference would lead to inefficiency. Neoclassicism is therefore antithetical to the regulation of corporate activity by the state or any other regulator and in favour of a laissez-faire approach. Thus the role of the state in corporate control is totally eliminated and replaced by rational preferences, namely, the profit-maximisation drive.

Despite its undisputed influence in modern economic thinking, neoclassical theory has some obvious flaws. Particularly, the over-abstraction of the global rationality, certainty and perfect market assumptions which constitute the basis of the

26 On competitive selection see also section 2.4 below.
theory. The problems stem from the fact that the neoclassical theory is based on optimal equilibrium conditions. This means that if its preconditions are relaxed with the introduction of elements of uncertainty or deviations from the perfect market models, then the price-theoretic assumptions begin to lose their predictive power and the neoclassical theory its normative significance. While in a utopian world markets can be perfectly competitive and economic agents (individuals and firms) can make their decisions having perfect knowledge about all current and potential eventualities, in reality these conditions cannot be met.

As already mentioned, traditional neoclassical theory probably fits best the pre-managerial era when markets resembled to a large extent the teleological models of competition. It is in that era that the theoretical consensus about neo-classicism arose after all (Kirzner 1997), despite the fact that even then global rationality was far from a real circumstance. However, in an economy dominated by managerial firms the neoclassical theory loses much of its relevance. The size of managerial firms indicates that markets are imperfectly competitive (oligopolistic) and that Alchian's evolutionary argument cannot apply. In addition, the separation of ownership from control appears to be in odds with the owner-entrepreneur assumption and reveals the gap left by traditional theory's failure to deal with the structure of the firm. So it is not a coincidence that it was in the 1930s, the heyday of managerial capitalism, that an intense debate arose on whether neoclassical theory was satisfactory or a new more realistic approach should be developed to deal with the firm as an organisation that differs from markets or individuals.

The pioneering attempt to provide theoretical insights into the nature of the firm as a coordinator of resources was made by Coase. In his famous article “The Nature of the Firm” he sought to explain the firm's nature and existence by looking at
the reasons for intra-firm as opposed to market coordination (Coase 1937). If as neoclassical theory assumes there is no difference between the two, he asked, then why is it that firm coordination sometimes supersedes price-mechanism coordination in the market?

In order to deal with this question Coase focused on the single exchange transaction or more simply the contract between two economic agents. What he found was that the use of the price mechanism entails what he called transaction costs (Coase 1937: 391). Such costs can arise from drafting, negotiating and enforcing contracts because natural prices of goods are not automatically known to the transacting parties. The real world is one of uncertainty where, contrary to the global rationality assumption, economic agents do not and cannot have full knowledge about all relevant contingencies. Thus, Coase argued, in order to economise on the costs of using the market and therefore of production or allocation, transacting parties allow an “entrepreneur” to coordinate the distribution of resources by command. Within the firm contracts are not eliminated but are considerably reduced because they are replaced by co-operation. For the series of contracts between the entrepreneur and other agents required in market transacting one is substituted where the latter agrees to follow the directions of the former in return for some remuneration. So, Coase (1937: 393) defined the firm’s hierarchical structure as a “system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur”. Optimal firm-size is determined by balancing the

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27 In economic literature the word contract has broader meaning than in legal texts as it is used to describe an economic transaction.

28 These circumstances are responsible for what Simon (1957) has termed “bounded rationality”. By rejecting the neoclassical hypothesis of global rationality because the real world is one of uncertainty, incomplete knowledge and because the human brain has limited computational capacity economic agent’s rationality is unavoidably bounded.
costs arising from market and entrepreneur coordination so the firm expands until the point where both types of costs are equal. (ibid. at 394).

Coase’s insights gave a new spin to the theorisation about the firm because he demonstrated that firms do exist and they are different from markets or individuals. Although, as himself admitted fifty years after his seminal work, his intention was to compare coordination by organisations with that by the market mechanism (Coase 1988: 47), his transaction cost approach provided the theoretical platform for an analysis of the firm as a governance structure. The Coasean theory, however, did not catch on until several decades later when theorists, like Williamson, rediscovered and expanded it to form a new kind of economic analysis based on transaction costs.29

More influential at the time was the empirical disputation of traditional neoclassical thought that came from the renowned Oxford Economists Research Group.30 They presented evidence that real businessmen do not attempt to maximise profits according to the neoclassical marginalist principle and that oligopoly, rather than perfect competition, is the main market structure. In contrast to the neoclassical proposition, firms do not make decisions without regard to their competitors’ actions and reactions but are subjected to oligopolistic interdependencies. Firms are not price-takers but instead they make conscious decisions about pricing. They prefer price stability because of customers’ aversion to volatility, and so, contrary to the traditional theory’s predictions, prices are adjusted to output rather than vice versa. Perhaps most importantly, the Oxford economists found that profit-maximisation was not the only goal of firms, but other objectives like goodwill were also important. This constituted a direct empirical attack on the backbone of Walrasian neo-

29 See infra. note 45 and accompanying text.
30 See Hall and Hitch (1939). The publication of this paper gave rise to an intense debate on the profit-maximisation assumption between marginalists and anti-marginalists. See Machlup (1946) arguing that the neoclassical theory of the firm is not intended to yield predictions about individual firms it is only concerned about competitive market prices; Stigler (1947b); Friedman (1953); and Nagel (1963).
classicism which, due to its neglect of the firm and its nature, was unable to explain common business behaviour outside perfect market conditions.

This revisionist trend combined with the Berle and Means stipulation that managers were in control of large corporations set the stage for the theoretical examination of managerial behaviour in oligopolistic markets.\textsuperscript{31} In fact, *The Modern Corporation and Private Property* was the first work to imply that managerial firms did not pursue the profit maximisation objective. However, despite the undisputed theoretical influence of their thesis (Sawyer 1979: 89-90), Berle and Means did not attempt to develop an economic theory upon which to base this implication. They merely assumed that, due to the divorce of ownership from control, management teams do not pursue the objectives of the neoclassical firm. As Bratton (1989: 1495) observes, the concept of the neoclassical entrepreneur was split between management and capital. This split left a theoretical vacuum, arising from the fact that traditional economic theory treated the firm as a mere entrepreneur rather than as an organisation, that economists were keen to fill.\textsuperscript{32}

The first managerial theories of the firm, as they are known, begun to appear in the late 1950s and suggested a significant conflict between managerial objectives and profit maximisation as envisaged in equilibrium theory. The argument was that a conflict arises from the fact that in managerial firms decision-makers own no stock. So managerial theories, similarly to the neoclassical postulation, assume that shareholders are the owners of the firm who *would* maximise profit had they been in control. However, because managers are vested with the decision-making function, they pursue other goals that suit their own preferences. This implies that managerial

\textsuperscript{31} By oligopoly economists mean markets that are neither pure monopolies not perfectly competitive but anything in between. It is assumed that the economic agents in oligopolistic markets are large firms who produce identical or similar products. Entry barriers are also assumed to be present.

\textsuperscript{32} For an early critique of the neoclassical theory on this point see Papandreou (1952).
theories share with neoclassicism a common assumption: individuals, whether owners or managers, are assumed to be self-interested persons who to seek to maximise their own welfare. So given that there may be a divergence between shareholder and management preferences, the crucial element that determines whether the profit maximisation objective is pursued is managerial discretion. In other words, the basis of managerial theoretical models is the ability of managers to exercise their discretion and diverge from the neoclassical assumptions in order to maximise their own gains.

In an early attempt to examine managerial objectives and incorporate managerial preferences in the theory of the firm, Baumol (1967) hypothesised that managers are interested in sales revenue maximisation as opposed to profit. Of course, the two motives are not always conflicting for the obvious reason that profit is a by-product of sales revenue. So, the promotion of sales is a necessary precondition even for attaining the neoclassical objective. For example, because of declining sales consumers may shun a product when they feel it is falling in popularity, banks and money markets will be more reluctant to provide capital, distributors may be lost, and employment relations can deteriorate as firing rather than hiring can become the norm. However, Baumol’s proposition is that managers out of self-interest see sales revenue as an end in itself rather than just a means (ibid.: 46-47). His argument is based on the fact that managers’ salaries are more closely linked to sales rather than profit (e.g. sales commissions) and often companies are ranked according to their sales performance. Moreover, large sales give prestige to managers, while large profits are most likely appropriated by the shareholders. According to Baumol’s professional experience, the sales revenue maximisation bias is also reflected on managers’ stated preferences. Thus, firms use the sales objective as a “rule of thumb” even at the expense of maximum profit by setting output at a level where Marginal
Revenue is lower than Marginal Cost (MR<MC). In theory, sales maximisation may lead to zero or negative profitability if it requires prices that are so low that costs are not covered (ibid. at 48); hence the potential conflict between the two objectives.

Nevertheless, Baumol (ibid.: 49) suggests that, although sales revenue is the ultimate managerial goal, a compromise is reached where a certain minimum acceptable profit level is laid down. In other words, managerial discretion is not totally unconstrained. Sales' growth demands funds that are generated either internally through capital retentions or externally by borrowing or issuing equity. In the former situation the profit requirement is direct. If, on the other hand, the latter method is adopted, the minimum profit constraint is determined by external demands and expectations. Lenders are more willing to lend to a profitable firm. In the case of equity finance, the higher the profitability level the more funds capital markets will be willing to provide. At the same time, the firm must ensure that its shares remain attractive to the capital market by providing a rate of return that is satisfactory to the current and potential investor. If this rate falls below the minimum acceptable level managers run the risk of being ousted, since shareholders may sell their shares to a hostile takeover raider who may be attracted by a falling share-price and acquire the firm's control. Since such transactions in the market for corporate control are usually followed by a replacement of incumbent management, they are assumed to constitute a force constraining managerial discretion.33 The calculation of the difference between the minimum profit constraint and the maximum profit level provides a method of measuring managerial discretion; the larger the difference the greater the discretion managers enjoy.

33 The classic analysis of the market for corporate control is Manne (1965).
What can be seen as an expansion the sales-maximisation model was presented five years after Baumol’s exposition by Williamson (1964) who argued that managers use their discretion to maximise their own utility as opposed to that of shareholders. The concept of managerial utility comprises pecuniary and non-pecuniary elements such as salary, security, power and status, prestige and professional excellence (ibid: 32). While salary is easily measurable in monetary terms all the remaining elements are non-pecuniary and therefore their monetarisation is necessary for their inclusion in an economic theory of the firm. For this purpose Williamson developed the concept of “expense preference” to describe the satisfaction that managers get from certain types of expenditures. In particular, there is a positive managerial preference for staff expansion expenditures, emoluments and discretionary profits (ibid: 34-37). Regarding the first type, managers have a preference for staff increases which are to a certain extent equivalent to promotion since they contribute to power and often to salary. Emoluments are defined as the portion of salaries which is discretionary in the sense that its removal would not influence managers’ decision to keep their job. Such expenses can arise from company cars, luxurious offices, expense accounts and so on, and are believed to also add to managerial power, status and prestige. Finally, managerial utility can also derive from the attainment of profits above the minimum necessary for job security (discretionary profits). The implication here is that future expansion and therefore managerial satisfaction depend on such profits which are also a measure of success since they demonstrate the achievement of the firm’s goal. According to Williamson, although there is a distinction between the purposes of the firm as an organisation and the personal goals of managers, managerial utility can also derive from organisational achievement (ibid.: 36). This is a deviation from the approach to the minimum profit
constraint in Baumol’s model, where it is assumed that managers gain no utility from profit per se and therefore are prepared to sacrifice any profit above this minimum necessary for an increase in sales revenue (Sawyer 1979: 98-99). Nonetheless, managerial expense preference and the profit-maximisation objective are by no means aligned. In his careful case-studies Williamson shows that in a sharp fall of demand and therefore of profitability, the decline of managerial utility expenses is disproportionate to that of other expenditures. This, he argues, proves the ability of managers to exercise their discretion according to the expense-preference model.

Also in 1964, Marris presented a different approach to the behaviour of the managerial firm that focuses on growth as a management objective (Marris 1964). In this model, all the diverse objectives that can be pursued by managers are amalgamated into the single motive of “sustainable long-run growth in size measured by assets, employment or real output” (Marris 1998: 113). Although the starting point is similar to that in Williamson’s model in that managers are after prestige, power and security, Marris’ claim is that these objectives are attained by pursuing a growth rate that is faster than would be optimal for shareholders in terms of profitability. The assumption here is that beyond a certain point the growth rate and the return rate do not increase proportionately. Thus, in contrast to the neoclassical theory where growth is merely an indirect outcome of pursuing maximum profit, in Marris’ model the managerial firm free from shareholder control can set its growth rate independently from the neoclassical equilibrium objective. Growth, nevertheless, is costly and thus requires cash flow. Marris identifies retained earnings, i.e. profits non-distributed as dividends, as the most important source of cash flow. He then argues that retention and reinvestment can be justified from the maximisation point of view since it can ensure long-term profit maximisation. In this case, shareholders are
satisfied and the firm's stock is seen as an attractive investment causing the market valuation of the firm to rise. However, beyond certain point the substitution of an expectation for larger future profits/dividends for smaller current ones can cause shareholder dissatisfaction and depress the firm's market value. This is where managerial preference for maximum growth rates begins to contradict market valuation. Marris' prediction is that managerial discretion leads to the maximisation of growth rates subject to a minimum market valuation constraint. This constraint arises from the fact that as the market valuation falls the potential of the firm being taken over increases. Thus, managers need to find a balance between the maximum growth rate and the maximum market value in order to ensure their job security.

One observation that has to be made here is that all these managerial models are based on the fact that, just like product markets, capital markets are also imperfect. In other words, they assume that shareholders or potential takeover raiders do not have perfect knowledge about the firm's actual and future profitability. If stock markets were perfect in providing all necessary information about a firm's present and potential profitability, then any firms who pursue growth beyond the current profit maximisation rate would be taken over as they would depress their market value. Thus, the market for corporate control would be sufficient to ensure that no other objectives than current market value maximisation were pursued and the need for alternatives to the neoclassical paradigm would automatically disappear.

Obviously the analysis of firm behaviour in managerial theories is useful in understanding the ramifications from the separation of corporate ownership and control. Manager-controlled corporations are different from owner-controlled ones in that they are inherently prone to pursue objectives that are not only different from those of shareholders but can also be antagonistic to them. In a sense, by recognising
that managers and/or corporate organisational hierarchies can actually pursue their own objectives as those of the firm rather than of the shareholders, managerial theories introduce some elements of corporate realism into the economic theory of the firm. While ownership is detached from actual decision-making and control, management input becomes the centre-point and the main driving force of the firm as an end in itself. As a result, the shareholders’ interests are reduced to a mere constraint on the pursuit of the firm’s own goals as an organisation and as an entity that has its own separate existence.

Regarding the two component elements of corporate governance, managerial theories of the firm are mainly concerned with the nature of control and its microeconomic effects. As regards the nature of ownership they do not provide any analysis, since they simply assume that shareholders are owners without any further elaboration. What may seem an arbitrary assumption can be explained by the fact that the primary purpose of managerial theories is not to determine and justify the metaphysical nature of the corporation and its ownership but simply to explain managerial motivation. Another explanation can perhaps be that managerial theories are not intended to displace neoclassical theory altogether. Rather, their purpose is to fill the theoretical gaps that it leaves in the sphere of imperfect markets where the organisational nature of the firm becomes important in understanding economic activity. Nevertheless, the mere fact that managerial theories visualise the firm as something different from the profit-maximising economic agent constitutes a challenge to Walrasian neo-classicism and the universal applicability of its assumptions, just as the Coasian argument did to some extent.

However, as already mentioned, since the 1970s the popularity of managerial legitimacy has been waning mainly because of the mediocre performance of some of
those very corporations that once sustained it. Overcapacity in mature and unprofitable operations which managerial corporations had failed to reorganise and subsidised from profitable divisions have been the main cause of criticism (Jensen 1989, 1993). This context makes it easier to appreciate the efforts of theorists, such as Alchian and Demsetz or Jensen and Meckling, to explain the behaviour of the managerial firm in neoclassical terms and argue against managerialism.

Alchian and Demsetz’ starting point is similar to that in the Coase’s theory, namely the transaction within and outside the firm (Alchian and Demsetz 1972). However, they conclude that Coase’s argument that coordination within the firm is by command is unsatisfactory because it fails to explain where the entrepreneur’s authority to coordinate production comes from. In order to provide an answer to this problem, they deviate significantly from Coase’s theorisation by arguing that the firm should not be seen as a mechanism where coordination of resources is by command. On the contrary, they claim that there are no authority-based relations within the firm which in turn has

no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between two people...To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. (Ibid: 777)

By viewing the firm in this way, Alchian and Demsetz deny that there is any difference between transactions that take place in the market and those that are concluded within the firm. In essence the firm is itself a market and therefore the

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34 While Jensen allocates all the blame on managerial governance as a “failed” microeconomic model, this thesis presents a very different view which emphasises the adverse macroeconomic conditions in the global economy since 1970s. See chapter 2 below.

35 In fact, the emergence of this anti-managerialist trend that appeared during the 1970s was almost simultaneous to a similar movement that had begun to dominate the legal field at least in the US and the UK (Bratton 1989). See also the discussion below.
management function is reduced to a mere contract renegotiation process. No hierarchy or authority-based relationships exist within the firm. To illustrate this stipulation they focus on the employer-worker relationship. They argue that, although it may appear that management has an authority over the worker, in fact the relation is a symmetrical one based on a "quid pro quo" contract (ibid.: 783). Just as the employer orders the worker to perform certain acts, the worker "orders" the employer to pay him a wage in consideration. Similarly, the worker can "fire" the employer by leaving the job in the same way that the employer can also terminate the employment agreement. Thus, the firm is a nexus of explicit and implicit contracts and within it there is the continual renegotiation described in the extract above. Because there are no power differentials (hence the lack of hierarchy) every (re)negotiation leads to outcomes that are satisfactory for both contracting parties so that there is always an equilibrium reached. To take the employer-worker example again, if either party to the employment contract does not like the terms offered it will seek a better alternative elsewhere. Where this results in a shortage of employees, (perfect) labour market forces will compel employers to offer better terms of employment until equilibrium is reached.

The only thing that distinguishes firms from markets, according to Alchian and Demsetz, derives from the fact that team production by workers is involved. This, they argue, involves "metering" problems that make it difficult to determine workers' rewards according to their performance, i.e. their individual contributions to the collective effort. This is because individuals have the tendency to "shirk" when they work as part of a team (ibid.: 779). In order to overcome shirking in team production, firms assign a central agent, namely the shareholder, the role of monitoring. This monitoring party is himself discouraged to shirk by being made the ultimate risk-
bearer as "residual claimant" of the team's earnings after all the "fixed" claims of other contracting parties (e.g. creditors) are deducted. Thus, the residual claimant must be given "property rights" over the firm's net-cash-flows and the ability to renegotiate contracts in order to carry out his coordination function efficiently. The precondition for efficient coordination is the alignment of each individual's rewards with his output.

The importance of Alchian and Demsetz's model for corporate governance lies in the fact that it justifies the role of shareholders as profit-earning entrepreneurs by using efficiency considerations. In other words, it provides theoretical legitimacy to the economic assumption that shareholders should be regarded as the ultimate controllers of the firm and therefore as "owners" of the firm, or more precisely its net cash-flow. Not only are they the constituency that determines what objectives should be pursued by the firm if it is to be efficient, but they also have the necessary incentives to ensure that these objectives are actually pursued. The implication is that firms controlled by unconstrained managers are not efficient, because of the divergence between the objectives of managers and those of profit-maximising shareholders. Therefore, the argument goes, in order to promote efficiency and economic welfare, one would have to ensure that within the firm structure there are sufficient constraints on managerial discretion aligning management motivation to the

36 Alchian and Demsetz define firm ownership as the combination of the right to be a residual claimant-monitor of the team, to be the central party common to all contracts with input providers, to observe input behaviour, to alter the membership of the team, and to sell all these rights. So even though they talk about "ownership", they do not use the term with its legal meaning. (Alchian and Demsetz 1972: 783).

37 This has provided the theoretical basis for the view that corporations should be run solely in the interests of shareholders, to whom managers should be accountable. See Easterbrook, and Fischel (1983) at 403; Easterbrook and Fischel (1989); and Fischel (1982).
profit-maximisation objective which in turn leads to the maximisation of the firm’s market value.\textsuperscript{38}

This line of thought is also followed by Jensen and Meckling (1976) who extended the nexus-of-contracts theory by including explanations about managerial motivation. Their analysis is similar to that of Alchian and Demsetz in that they regard the firm as a nexus of equilibrating contracts similar to those concluded by self-interested economic agents in a market. To use their words, the firm is nothing more than

\[\text{a legal fiction that serves as a nexus for a set of contracting relationships [among individuals] and is also characterised by the existence of divisible residual claims on the organisation’s assets and cash flows, which can generally be sold without permission of other contracting individuals…Viewed in this way, it makes little or no sense to try to distinguish those things that are “inside” the firm from those things that are “outside” of it. (Ibid.: 311)}\]

However, their main contribution is their analysis of the motivational split between managers and owners by describing the relationship between them as one of agency. According to Jensen and Meckling, an agency relationship is a contract under which one or more individuals, the principal(s), engage another, the agent, to perform some service on their behalf by delegating to him some decision-making authority (\textit{ibid.} at 308). This relationship is based on an assumption that, because all individuals want to maximise their own utility, the agent will not always act in the interests of the principal. This divergence of interests gives rise to what they call \textit{agency costs}. These accrue from the principals’, i.e. the shareholders, efforts to align the interests of agents with their own as residual claimants, and are the sum of expenses for monitoring the agent’s performance, of expenditure incurred so that the agent

\textsuperscript{38} When dealing with this issue in this way the object of study changes from how to reconcile firm \textit{behaviour} with neoclassical marginalist principles to how to reconcile firm \textit{structure} with marginalist principles.
guarantees that he will act in the principal’s interests ("bonding"), and of any residual loss caused by any remaining divergence. In effect, monitoring expenses are the product of information asymmetry between the principal and the agent, since the former does not have knowledge about the efficient allocation of resources that is equal to that of the agent. Obtaining all necessary information in order to exercise monitoring is inherently costly. Principals, therefore, will be willing to incur such costs only if the benefits accruing to them from monitoring are higher. This depends on the extent of residual claims owned; the higher the claims, i.e. of shares owned, the more motivated the principal, i.e. the shareholder, will be to exercise monitoring.

Having described the owner-manager relationship as one of agency, Jensen and Meckling state that agency costs are in effect the costs of the separation of ownership and control or of shirking in Alchian and Demsetz’ terms. Consequently, they are related to the extent to which managers are also residual claimants; the higher the managers’ claims and, therefore, the higher their interest in the firm’s market value, the lower the agency costs. Where, on the other hand, managers have anything less than a controlling interest in the firm, as is the case in managerial firms, their residual claims are deemed insufficient to bridge the gap between ownership and control and as a result agency costs accrue.

Addressing this Jensen and Meckling suggest that constraints can arise from the market for managers within and outside the firm itself. Competition from other potential managers disciplines the incumbent management team who, as a result of the increased risk of losing their jobs, will be prevented from diverging from the market-value maximisation objective. The effectiveness of this constraint depends on
the cost of replacing the under-performing managers which in turn is related to the principal’s ability to measure performance.39

Moreover, Jensen and Meckling (1976) and subsequently Jensen (1986) argue that managerial discretion can also be constrained by the financial structure of the firm. Increased debt, for instance, has the effect of reducing cash flow and thus makes the risk of bankruptcy more imminent. The more intense competition in the product market is, the higher the risk of bankruptcy and the more effective this constraint will be. On the other hand, excess cash-flow - that is, cash for which there are no profitable investment opportunities left within the firm - reduces the threat of default and therefore increases agency costs resulting from the managerial discretion. For this reason, any excess cash flows should be re-distributed to the shareholders in the form of dividends or share-repurchases, so that managers are prevented from wasting it in “inefficient” organisational spending and excessive growth beyond the market-value maximisation point.

Obviously, the availability of relevant firm-specific information to the monitoring principal is the key for both these constraints to become operative. In the managerial firm, however, no shareholder has sufficient incentives for acquiring control-related information. The obvious problem that arises is how to ensure the operation of the above mechanisms in the absence of direct shareholder monitoring. Jensen and Meckling, just like managerial theorists, propose the market for corporate control solution through the hostile takeover transaction as the main managerial constraint. If, as it is assumed, capital markets are efficient – that is, if they are able to process all relevant information about the firm’s investment opportunities so that the market value of the firm reflects the present value of the firm’s expected future net

39 See also Fama (1980).
cash flows, including those from future investment opportunities - then managerial effort will be fully reflected in the stock prices as determined by the market (Jensen 1983; Fama and Jensen 1983; and Fama 1980). Poor managerial performance will lead to the undervaluation of the firm's stock in comparison to the market as a whole. The resulting reduction of the firm's market value is a measure for the "residual loss" element of agency costs. Consequently, the higher the agency costs in a firm the more likely it is that a bidder will attempt make a hostile takeover offer to the firm's shareholders. As a result managers will have the incentive to reduce agency costs in order to avoid their replacement after a change in ownership. They do so by implementing ex ante monitoring devices such as audits, independent directors, incentive compensation schemes etc. So ultimately it is managers who bear the costs of discretion, and the more efficient the market is, the stronger the managers' incentive to reduce agency costs will be. When firms do not structure their incentive contracts so as to minimise agency costs, the theory assumes that they will be selected out and disappear in a similar way to that described by Alchian (Alchian 1950; Jensen 1983: 331, Fama and Jensen 1983: 327). Therefore, optimal resource allocation within and without the firm is directly related to capital market efficiency; hence the emphasis placed by advocates of the agency paradigm on ensuring that market efficiency is maintained, for example by rejecting any factors that may hinder the operation of the market for corporate control.

What is important in the "nexus-of-contracts" and agency analysis is that in effect it introduces nominalism into the economic theory of the firm. It does so by dismantling the firm into a number of transactions between self-interested input-

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This is the efficient markets hypothesis which generally holds that a market is efficient if it is impossible to make economic profits by trading on available information. For a general literature review on this hypothesis see Fama (1970). Market efficiency also implies that, since the short-term price of a stock reflects the present value of the firm's long-term results, short-term values cannot be distinguished from long-term values. See Easterbrook and Fischel (1981).
providers and by focusing on the monitoring role of shareholders as residual owners of the revenue generated. Private bilateral contracts between actors prevail over managerial command and, therefore, market constraints determine the allocation of resources in an efficient manner. Managerial input is reduced into a commodity, an agency service, acquired by the principals at a certain cost (agency costs). In effect, management ceases to be an end, as predicted by managerial theories, and is reduced into a mere production means. By regarding intra-firm coordination as no different from market contracting the nexus-of-contracts/agency approach "progresses" from the Walrasian "black box" to a "no-box" analysis, i.e. the microeconomic institutional analysis of the firm remains strictly neoclassical.

The theory also contains some other important implications of a normative character. Firstly, because of the firm’s nexus-of-contracts nature, the role of law is only to provide "mandatory" contractual terms supplementing those privately agreed with the only purpose of reducing agency costs. So legal rules are the "products of a historical process in which there were strong incentives for individuals to minimise agency costs" (Jensen and Meckling 1976: 360). The implication here is that, since only market forces and individual choice determine contractual and legal rules efficiently, there is no need for mandatory corporate law. Secondly, related to the first point any corporate social responsibility assertions, such as those put forward by Dodd, are unacceptable for two reasons. Firstly, since the alignment of managerial

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41 As Jensen and Meckling (1976: 328) claim: "Finding that agency costs are non-zero...and concluding therefrom that the agency relationship is non-optimal, wasteful or inefficient is equivalent in every sense to comparing a world in which iron ore is a scarce commodity (and therefore costly) to a world in which it is freely available at zero resource cost, and concluding that the first world is 'non-optimal'".

42 On the argument that corporate law rules should not be mandatory so that individuals can exercise their contractual freedom and contract them out if they consider them inefficient see Bebcuck (1989), McChesney (1989), Fischel (1982: 1273).

43 Jensen and Meckling state this expressly: "The personalisation of the firm implied by asking questions such as, what should be the objective function of the firm? Or, Does the firm have a social responsibility? Is seriously misleading. The firm is not an individual. It is a legal fiction that serves as a
behaviour to shareholder interests as a precondition for the reduction of agency costs is one of the main premises of the nexus-of-contracts analysis, any inclusion of non-shareholder interests in managerial decision-making constitutes a diversion from the market value-maximisation objective and is therefore inefficient. Secondly, the nature of the firm as a mere fiction demolishes the foundations of Dodd's social responsibility argument which, as noted earlier, is built upon corporate realism.

From these inferences about the nature of the firm it becomes apparent that the nexus-of-contracts theory is to a large extent a reformulation of the aggregate theory in economic terms (Millon 1990: 232; Phillips 1994: 1090-1091; Bratton 1989: 1513-1515). The neoclassical nexus-of-contracts approach provided economic efficiency justifications for the old legal assertion that contract was the basis of the firm's fictitious nature. Seen in this way, it is not surprising that the theory has had an enormous influence in legal literature too. As Clarke (1989: 1705) observes, the "theory now dominates the thinking of most economists and most economically oriented corporate law scholars who focus at all on the theory of the corporation". But perhaps the main driving force behind the almost immediate acceptance of the neoclassical nexus-of-contracts/agency paradigm was the general discontent aimed at managerial power in the 1970s and 1980s.

Despite its influential assertions, the neoclassical version of the contractual theory of the firm has not found unanimous acceptance in academic thinking. The main source of dissent is its over-reliance on efficient markets and the global rationality of contracting parties when agreeing on the ex ante monitoring mechanisms.

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focus for a complex process in which the conflicting objectives of individuals... are brought into equilibrium within a framework of contractual relations." (Jensen and Meckling 1976: 311).

44 See, for example, Gordon (1989) and Easterbrook and Fischel (1989).
In a series of articles and books since 1975, Williamson has expanded Coase's claim that firms supersede markets to fully explain the firm's nature and behaviour on a transaction cost basis. Once again the initial point of reference is the contract. However, in contrast to the neoclassical model, Williamson accepts that markets are not perfect or efficient due to the presence of transaction costs. As discussed above, these arise during and from the process of negotiating as a result of the combination of bounded rationality and opportunism, and due to the impossibility/difficulty of predicting all future contingencies that may affect a contractual relation. Consequently, parties are unable to write complete contracts either because they are too costly or simply because it is humanly impossible. Contractual incompleteness imposes costs arising from renegotiations. Moreover, Williamson claims that transaction costs are particularly high where efficiency requires that one or both parties invest in transaction-specific assets. This is because asset specificity has "lock-in" effects that increase the vulnerability to the other party's opportunism. Thus, where one party makes a transaction-specific investment, it will expect that adequate governance structures, i.e. institutions, exist to safeguard its investment. These can be realignment incentives (e.g. termination penalties), a specialized governance structure to resolve disputes, trading regularities that support and signal intentions of continuity or in some cases full disclosure of transaction-specific information (Williamson 1984: 1204-1205). The hierarchical structure of the firm is assumed to provide such safeguards and is therefore itself seen

46 These can be costly simply because of the time and resources spent in the bargaining process or because in the presence of informational asymmetry one party may be cheated and thus suffer loss.
47 This is because, contrary to general purpose assets, such transaction-specific assets cannot be redeployed without significant cost if the contractual relation is terminated or otherwise upset. As Williamson states: "what was a competitive market with a large number of bidders at the outset is effectively transformed into one of bilateral monopoly thereafter." (Williamson 1984: 1202-1203).
48 On the nature and role of institutions see section 1.4 below
as a non-market governance mechanism. So, within the firm contracting parties have the incentives to make transaction-specific investments and thus minimise the efficiency loss that would arise had they settled for the less efficient alternative of arm’s length contracting in the market. This explains the economic significance of the firm and its survival against markets or other organisational forms in the adverse selection process.

Having recognised the firm as a governance mechanism, Williamson uses the transaction cost analysis in order to explain the potential role of corporate constituencies - such as labour, shareholders, managers, suppliers, creditors and customers, as well as the community's interest - in corporate governance through board-level representation (ibid.: 1207-1221). His conclusion is that all constituencies, except for shareholders as a group, have opportunities to renegotiate their contracts and thus establish adequate safeguards for their investments without board representation. On the other hand, (dispersed) shareholders bear the residual risk of the company’s failure or success and their claims are “located at the end of the queue should liquidation occur” (ibid.: 1210). For this reason, Williamson argues, the firm’s governance structure and the board in particular should be seen as a mechanism to safeguard shareholders’ investments from expropriation by other constituencies.49

Addressing managerial discretion, Williamson admits that it does exist and treats it as another type of transaction cost – after all he was one of the first to claim this. However, somewhat controversially he claims that the governance structure of the corporate hierarchy serves as an important constraint on managerial misconduct. More specifically, the managerial firm’s multidivisional structure (conglomerate),

49 So agency costs as defined by Jensen and Meckling (1976) can be regarded as just one type of transaction costs.
where quasi-autonomous divisions are coordinated by a central office, has improved managerial incentives for "longer-run strategic decision-making" (Williamson 1981). This is achieved because the central office acts as an internal capital market that reallocates funds from low-growth divisions to high-growth ones favouring profit over other goals. Williamson admits that the multidivisional form alone does not eliminate managerial discretion. However, he claims that it enhances the effectiveness of the market for corporate control because acquirers can "digest" their acquisition (Williamson 1984: 1225). Thus, although the divergence between managerial and shareholder incentives does not disappear, organisational structure can "relieve legitimate concerns with managerial discretion" (Williamson 1985: 322).

The neo-institutional transaction cost approach obviously departs from the neoclassical version of contractualism in certain significant ways. Most importantly, in Williamson's and other neo-institutional models markets are not assumed to be efficient. It is for this reason that the firm, not as another market but as a governance structure, comes into play to alleviate the impact of market failure by eliminating transaction costs so that an efficient equilibrium is still reached as a result of the right mix of markets and non-market governance structures. Thus, although, contrary to Jensen and Meckling's assertion, in Williamson's model the firm has both authority and fiat as a meaningful entity rather than a mere fiction, the same result is reached with regard to the ultimate purpose of the firm, namely current market value maximisation with shareholders enjoying a central role as residual claimants. In other words, both models provide arguments for the alignment of managerial decision-making with shareholder interests so as to reach an efficient equilibrium. However, whereas in the Jensenian agency version it is the firm's lack of real existence that excludes objectives other than market-value maximisation, in Williamson's neo-
institutional version of contractual theory corporate social responsibility claims are ruled out by the firm's organisational existence.

These contradictions in the theory of the firm have recently become more pronounced with the extension both of (neoclassical) contractual and of neo-institutional models so as to legitimate the inclusion of non-shareholder interests in corporate decision-making. The excesses of the 1980s in the market for corporate control, especially in the US, and the resulting 1987 crash may have contributed to the general discontent with the hostile takeover as a mechanism for managerial discipline where markets are imperfect.\(^50\)

Thus, in 1992 Hill and Jones (1992) reformulated Jensen and Meckling's agency model by excluding the element of market efficiency. Their results were startling since they found that market inefficiencies give rise to power differentials between the firm's stakeholders and managers and between stakeholders themselves that lead to a persistent disequilibrium at least in the short and medium run. Certain constituencies, such as management, exploit and entrench these power differentials to the detriment of stakeholders who lose their ability to enforce implicit or explicit contracts and as a result bear the residual risk. This gives rise to what they call "contracting costs" which amount to the utility loss to all stakeholders resulting from managerial autonomy. In response, stakeholders seek to develop institutional structures that will align managerial motivation to their interests and thus lead to more efficient results as the power differentials diminish. In this way, Hill and Jones provide a theoretical paradigm, a "stakeholder-agency theory", which legitimises managerial accountability to all stakeholder interests rather than just the shareholders. In effect, this model provides a justification for departing from the Jensenian

\(^{50}\) See section 3.2 below.
objective of current shareholder/market value maximisation. Therefore, so long as this diversion from shareholders’ interests is justified from an efficiency point of view, i.e. if it does not translate in managerial rent extraction, Hill and Jones’ argument can be characterised as managerialism in disguise. Where markets are not efficient optimal equilibrium is reached only when managers are able to balance diverse stakeholder interests efficiently.

There have also been similar extensions of Williamson’s model with the most important being that developed by Freeman and Evan (1990) who claim that even non-shareholder constituencies can make transaction-specific investments that cannot be safeguarded any better than shareholder inputs. Due to interdependencies that exist among stakeholder claims, it may be impossible for certain stakeholders to institute sufficient safeguards for their claims in bilateral agreements with the firm and therefore representation and voting rights are necessary. Moreover, Freeman and Evan do not share Williamson’s argument that shareholders have no renegotiation opportunities. They distinguish between small shareholders, who renegotiate their contracts on a daily or even quarterly basis, and shareholders with large blocks of stock that are not easily redeployable. Their claim is that it is only the latter type of shareholder that incur asset specificity and therefore deserve board representation. Thus, their main proposition is that the firm should be conceptualised as a “set of multilateral contracts” and that “governance rules could be devised to ensure that the interests of all parties are at least taken into consideration” (Freeman and Evan 1990: 352). In this way, Freeman and Evan use a transaction cost methodology similar to that of Williamson to integrate stakeholder interests into the theory of the firm. Thus,

Examples of such interdependencies are provided: “A dividend payout to stockholders may well reduce product quality to customers, and put pressure on suppliers for lower prices. Consumer arbitration panels, pollution control machinery, and so on, may favour several stakeholders at the expense of stockholders or lenders.” (Freeman and Evan 1990: 349).
just like Hill and Jones do using agency theory, they provide efficiency based justifications for a pluralist approach similar to that advocated by Dodd.

1.3.3. Two Competing Visions of the Firm and their Significance

The theories outlined above derive from two social science disciplines, namely law and economics, which differ significantly in the methods and criteria they use. While the former traditionally relies on moral principles and metaphysical or sociological arguments, in the latter as the standard rule of thumb in theorising is regarded the concept of efficiency. However, in the analysis above it is evident that, despite the divergence in the manner they approach the corporation (or the firm), both law and economics can produce similar results at least as far as the corporate entity and its governance power are concerned. For instance, the resemblance between fiction, aggregate and neoclassical contract theories on the one hand, and corporate realism and managerialism on the other is quite obvious. The former group can be relied upon to advocate nominalism, while the latter shows that the firm cannot be identified with its shareholders.

Thus, two main visions of the corporation emerge as solutions to the problems regarding its nature and governance, which correspond to two basic underlying concepts, namely shareholder supremacy and managerialism. Shareholder supremacy refers to the recognition that current shareholders are the owners and therefore the only legitimate controllers of the corporation which has to be run in accordance to their preferences. This nominalist vision of the corporation then refers to what can be called shareholder-oriented corporate governance which calls for the alignment of
managerial decision-making with the interests of shareholders. On the other hand, managerialism can be defined in a negative way as the non-alignment of managerial objectives with shareholder interests. This definition follows the use of the term in managerial theories but, just like all negative definitions, it is ambivalent because it raises the question whether there is any real difference between managerialism and the stakeholder approach of Dodd and others. The answer to this depends on whether managers use their discretion in order to promote the interests of all stakeholders including those of shareholders in an efficient way. In fact, Aoki (1984) has made such a claim by conceiving the role of management (the board) as one of balancing different interests within the firm. 52 This can only be so where managerial goals somehow coincide with the objectives of this balancing process. If this claim is valid then it is correct to associate managerialism with the balanced promotion of stakeholder interests as envisaged by Hill and Jones (1992) or Freeman and Evan (1990) and treat the two theoretical models as identical. This model is a realist one because the corporation is not identified with any particular group of stakeholders. Instead, diverse interests, which are often antithetical, are amalgamated through the managerial balancing process into what can be conceived as the interests of the company as a separate entity. The associational trade offs between shareholders’ individualism and collectivism found in Gierke’s realist argument 53 could then be extended to include similar trade offs between and among all types of stakeholders.

Where, however, the concurrence of managerial goals with the promotion of the corporate interest as defined here does not arise, then managers are able to (ab)use their discretion in order to promote their own self-interest to the detriment of all other

52 See also Blair and Stout (2001) for a similar claim.
53 See supra. note 13 and text.
stakeholders and of course the firm. In order to distinguish this latter state of affairs from the former scenario of efficient management the term “managerial slack” will henceforth be used. Managerial slack cannot be considered as a third vision of the corporation, because it simply constitutes an anomaly arising from the inefficiencies contemplated by the two visions outlined here rather than a separate theoretical model.

The crucial issue that makes these two visions of the corporation different in practice is the allocation of cash flow generated by the firm’s activities. As already mentioned, neoclassicists or anti-managerialists, such as Jensen and Meckling, argue that shareholder supremacy is a superior guiding principle because it reflects the ability of market forces to allocate resources efficiently. This means that cash flows must be invested only in order to maximize the market value of the firm, i.e. current shareholder wealth. Moreover, any excess cash flows that may accrue after this objective is attained do not belong to the firm, since, in their view, it doesn’t even have a real existence, and therefore should be returned to the firm’s residual claimants, the shareholders, either in the form of dividends or share buy-backs. As Rajan and Zingales state in a recent paper:

Unless there is a strong complementarity between assets in place and growth opportunities from a technological point of view, there is no reason why new opportunities should be undertaken within the legal shell represented by the existing company. (Rajan and Zingales 2001a)

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54 This is an allegation that Jensen has tried to make. See Jensen (2001).
55 Recently, however, Jensen has significantly moderated this claim by arguing that firms can only “seek” to maximise market value, an objective that can be combined with what he calls “enlightened stakeholder theory”. In this model Jensen (2001: 154) seems at least partially to concede on the efficient markets hypothesis issue particularly since he admits that short-term profit maximisation can destroy long-term market value. Moreover, contrary to his early arguments, he goes as far as to claim that “companies, management systems, and economic systems are also like organisms”.

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Excess cash retention by the firm is inefficient because it obstructs market allocation and, as a result, deprives other firms with profitable opportunities from obtaining the necessary finance to pursue them.

On the other hand, pro-managerialists\textsuperscript{56} do not necessarily oppose the retention of excess cash-flows by the firm so that they can be invested in projects that are related to the firm's future growth beyond the maximum point that is acceptable by the present shareholders or for the creation of cash reserves that can be used in difficult times and thus reduce the risk of failure. Thus, this view challenges the legitimacy of the claim that shareholders are the only claimants of excess cash flows on the ground that other stakeholders may also be residual risk bearers. In accordance with Freeman and Evan's argument, this is especially so where shareholders have diversified portfolios, so that their investment is not firm-specific. In this case, if a balance between stakeholder interests is to be achieved a minimum level of managerial discretion, i.e. diversion from shareholder/market value maximisation, is necessary and therefore legitimate.

At first sight these two visions of the corporation seem to be in competition with each other. However, at least from a theoretical perspective no claim can be made that the shareholder model can lead to a better result than the managerial model and \textit{vice versa}. The reason for this is that the two models are simply based on different sets of fundamental assumptions. For instance, Jensen's agency theory is founded upon the existence of efficient markets. Indeed, where markets are efficient informational asymmetries between shareholders and managers are contained (i.e. agency costs = 0) so that shareholders can always provide the firm with the necessary finance to pursue its profitable investment projects. Similarly, as Alchian and

\textsuperscript{56} For convenience purposes hereafter the terms "pro-managerialist" and "managerialist" will be used interchangeably.
Demsetz argue, in the absence of bargaining power differentials between stakeholders no opportunistic expropriation takes place.

However, as already mentioned, if the market efficiency assumption is dropped, then either managerial discretion accrues or the alignment of managers' objectives with those of a particular type of stakeholder such as the shareholders can lead to inefficiencies. For example, if markets are not perfect and thus short-term values do not reflect long-term expectations, the alignment of managerial objectives with (dispersed) shareholders' expectations can translate into a preference for short-term returns with disastrous consequences for other stakeholders and the firm's long-term viability. This phenomenon, which amounts to excessive rent extraction by shareholders and is usually referred to as "short-termism", has sensibly attracted the severe criticism of observers who do not adhere to the neoclassical paradigm. Therefore, where markets are imperfect so that they cannot allocate resources efficiently, the internalisation of corporate finance with the retention of cash flow, even if that's beyond the levels acceptable to current shareholders, is an efficient outcome because managers are in the best possible position to know what the firm's opportunities are and allocate resources accordingly. Managerial discretion, as defined here, is necessary in these cases for the exploitation of complementarities between the firm's assets and growth opportunities.

Thus, in imperfect markets a corporate governance model based on the principle of shareholder supremacy can hinder the sustainable growth of firms unless somehow shareholders have the ability and the incentives to bridge the informational gap between themselves and managers. This is the classic dilemma between stock liquidity and corporate control faced by shareholders and identified by Coffee (1991)

over a decade ago: the greater the preference of shareholders for liquidity, the lesser
their incentive to micro-manage the firm.\textsuperscript{58} The de facto separation of corporate
ownership from control is, therefore, the direct result of this dilemma. While in theory
the two models are equally sound, in practice their explanatory power is not
equivalent. This is because the neoclassical assumption that markets are perfect and
therefore efficient cannot be realistically fulfilled outside the theoretical laboratory.
The very emergence of the oligopolistic, manager-controlled firm demonstrates this
conclusively. Thus, from a microeconomic perspective, managerial discretion can be
regarded as a positive safeguard against detrimental shareholder supremacy in a
context of imperfect capital markets, bargaining power differentials and opportunistic
behaviour.

Apart from these microeconomic arguments against shareholder supremacy,
managerialists have also produced some additional macroeconomic justifications for
managerialism stemming from managers' preference for cash retention and output
growth maximisation. For instance, Baumol (1967: 75-79) has claimed that manager-
controlled firms have the tendency to produce goods more cheaply than
"neoclassical" ones, and that manager's aversion to risk can have a stabilising effect
for the economy.\textsuperscript{59} Regarding the latter element, it could be argued that the retention
of excess cash flow by the firm can indeed have a counter-cyclical effect. The build
up of reserves can be a useful cushion absorbing some of the adverse effects of
business cycles and financial shocks on investment, employees and so on. Moreover,
others have suggested that the managerial motive for output growth may translate into
faster macroeconomic growth rates. Odagiri (1981, 1992) and Marris (1998), for
instance, have argued that the higher the barriers to hostile takeovers, one of the main

\textsuperscript{58} This claim, however, is not unqualified since some shareholders with illiquid stock may still lack the
incentive to exercise corporate control. See infra. notes 104-105 and text.

\textsuperscript{59} Williamson, however, expresses a more mixed view (Williamson 1964: 169-710).
shareholder control mechanisms, the faster the growth-rates pursued by managers and the higher the growth rates for the whole economy. Chandler's account of the early 20th century managerial capitalism in major economies is also consistent with this view (Chandler 1990). He argues that the managerial firm emerged as the most successful corporate form because, freed from shareholder control, it was able to invest in developing its organisational and technological know-how in order to promote production efficiency and long-term growth as opposed to focusing current profits' maximisation (Chandler 1977: 10). In a Shumpeterian fashion, managerial firms changed the nature of competition from one that resembles the traditional textbook model that focuses on prices, to another where technological and organisational innovation are the key to success.

Thus, in effect, these pro-managerial claims take the argument further to justify managerial discretion as a source of economic welfare and consequently to legitimise the detachment of (share)ownership from control (Donaldson 1963; Manning 1958). In sum, a steadily growing firm creates more employment, promotes job security, pays better salaries, keeps shareholders satisfied in the long run and ultimately increases general welfare. In a way, managers' discretion allowed them to undertake a central coordinating role within the firm and deploy resources in a way that resolved conflicts among different resource providers and promoted efficiency. As skill formation became crucial for production efficiency, funding of university

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60 See also Lazonick (1992) and Buxbaum (1984: 522-24).
61 Schumpeter (1934, 1942) is widely regarded as the father of evolutionary economics.
62 See Coffee (1986), claiming that hostile-takeovers, the main constraining factor of managerial discretion, have serious adverse effects on non-shareholder constituencies and that there is a "natural alliance" between managers and those constituencies as the negative impact of such transactions is shared by both. See also Lazonick, (1992: 454 and 484) claiming that during the 1920s, the heyday of American managerialism, "as the major manufacturing corporations were paying their workers somewhat higher wages and expanding market share by reducing product prices to consumers, they were paying out well over 60% of net income as dividends to shareholders...[and] still had enough retained earnings to fund virtually all their fixed capital outlays", and that "managers generally used [corporate] assets and revenues first and foremost to make long-term commitments to employees who could contribute to the development and utilization of the enterprise's productive resources."
schools or setting up apprenticeship systems became a corporate norm (Lazonick and O’Sullivan 1997: 497-521). So, it is not surprising that even corporate social responsibility claims were associated with managerial discretion. Baumol et al. (1970) went as far as to argue that “corporate altruism” is essential for a sustainable capitalist economic system, just as Dodd had done in the 1930s. It is in this context that Henry Ford decided to sacrifice shareholders’ special dividends in order to devote more funds to the promotion of public purposes. As Hikino observes:

Within the microeconomic and institutional contexts that have existed since the Second Industrial Revolution, managerial capitalism has exhibited more dynamics than personal, family, and financial capitalism or centrally planned economies. (Hikino 1997: at 485)

The micro and macroeconomic justifications for managerial discretion provided by managerial theorists where the efficient markets hypothesis does not apply are attractive. In particular, the link between microeconomic goals and macroeconomic variables provided by Odagiri is extremely important if one is to assess the wider economic success of a corporate governance system. Indeed, as it will be shown in chapter 2 below, one of the aims of this thesis is to emphasise the complementary relationship between microeconomic factors and macroeconomic conditions - a relationship that is crucial for understanding corporate governance and assessing its effectiveness. However, while Odagiri’s model is micro-driven, i.e. managerialism drives macroeconomic growth- this thesis follows a two-way approach where firms’ choice of goals can push or slow down an economy just as macroeconomic factors, such as effective demand, can pull it or slow it down.

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63 Eventually this decision was successfully challenged in court by Ford’s shareholders. See Dodge v. Ford Motor Company (1919) 204 Mich. 459; 170 N.W. 668.
Moreover, the argument that managerial autonomy is the best guiding principle in imperfect markets needs to be qualified by the fact that managerial discretion can lead to (balanced) managerialism as much as to managerial slack. The former possibility where managerial discretion leads to the promotion of the corporate interest has already been explained above. However, in the latter scenario, freedom from the “rentier class” of shareholders would amount to slavery to the managerial class who would be in a position to abuse their power, e.g. by awarding themselves excessive salaries and other benefits, to the detriment of the firm and the economy at large (Marris 1998: 159). Furthermore, due to the existence of bargaining power differentials both within and outside the firm, opportunistic behaviour by one or more powerful stakeholders can be equally detrimental. Where one group of stakeholders is able to tilt the balance of corporate decision-making to its side by dominating management, i.e. by aligning managerial interests with the promotion of its own goals beyond what the corporate interest would justify, a detrimental expropriation of the firm’s cash flow occurs.

Having identified the two main theoretical visions of the corporation the next necessary step is to investigate what determines the nature of corporate governance in practice. Obviously, in the case of the managerial firm the analysis should seek to explore the factors determining the choice of managerial goals. This is the purpose of the next section.
1.4. A COMPARATIVE STATICS APPROACH TO THE DETERMINANT INSTITUTIONS OF CORPORATE GOVERNANCE

Certainly, in a perfect world where the neoclassical teleological assumptions apply the only determinant of corporate governance is the market. However, in reality managerial behaviour is shaped in an imperfect world where the bounded rationality of economic agents and uncertainty give rise to positive transaction costs. Therefore, the appropriate theory for analysing corporate governance practice should be one that can encompass the existence of imperfect markets. As a result, the preferred approach of this thesis for understanding real corporate governance phenomena is one that relies on institutional analysis rather than one based on neoclassical equilibria that are free from institutional interference.64 That is, in imperfect markets, whether corporate governance reflects shareholder supremacy, managerialism, or managerial slack is determined by the institutional structure within which it is embedded.

According to Alston’s methodological proposition, institutional analysis can proceed in two different ways (Alston 1996: 26). The first is one that focuses on the effects of existing institutional configurations on economic agents’ choices of action as a “comparative statics” exercise. The second method concentrates on the dynamic analysis of institutional sets by examining the causes of institutional change. While the latter approach is central for the purposes of this thesis, the remainder of this chapter is devoted to a static institutional analysis leaving the dynamic analysis for the next chapter. This is because, in order to identify the endogenous and exogenous dynamics as sources of a corporate governance system’s change, a prior understanding of the determinant role of institutions is necessary.

64 On the role of institutions in perfect markets see section 2.4.1 below.
Although institutionalist methodology has gradually gained wide acceptance over the years and now constitutes a significant element in economics and social science in general, there is no standard definition of institutions. For instance, Veblen (1919: 239), one of the pioneers of institutional analysis, saw institutions broadly as “settled habits of thought common to the generality of men”. While versions of this “common habits” approach can be found in several texts, others attempt to define institutions in more formal terms (Knight 1947; Katona 1951; Polanyi 1967). Thus, to North institutions are

the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic. ... In the jargon of the economist, institutions define and limit the set of choices. (North 1990: 3-4)

These behavioural constraints can be formal and informal. The former institutional type may include rules contained in constitutions, statute and common law, organisational by-laws, and even contracts. Informal institutions or norms, on the other hand, consist of accepted practices, customs and regularities that are not legally enforceable but which are, nevertheless, followed either for habitual reasons or because breaching them entails social and peer-group criticism as well as reputation costs. However, while they have an important influence on individuals’ choices, these constraints do not determine human behaviour completely (Hodgson 1988: 10-12). Contrary to the absolute neoclassical determinism, they simply set the limits of action and define the opportunity set of economic agents, which may be broad or narrow depending on the nature and effect of institutional constraints. As Parsons (1940: 190) states, institutions are “normative patterns which define what are felt to be, in

65 See also Hodgson (1988).
66 For a review of the literature see Hodgson (1988) at 124-134.
67 On the significance of this for institutional evolution see section 2.4 below.
the given society, proper, legitimate, or expected modes of action or of social relationship”. Since the behavioural choices of economic actors are not fully predetermined by the invisible hand of perfect markets, total uniformity is not the norm. Zysman summarises the determinant role of institutions as follows:

'[The] national institutional structure shapes the dynamics of the political economy and sets the boundaries within which government and corporate strategies are chosen...Certainly, there will be variety within a particular polity; but its common national features give character and provide limits to that diversity. (Zysman 1994: 271)

Institutions do not exist and operate in isolation from each other. On the contrary, viewed in a static way, they form coherent institutional webs the component elements of which are interconnected and complementary (Zysman 1994; Amable 1999). Complementarity can be vertical, i.e. between formal institutions and informal institutions, or horizontal, i.e. between institutions of the same type. For example, vertical complementarity occurs as legal rules often come into existence as a result of the crystallisation of routines, conventions, traditions etc. and are therefore closely linked to the context of norms and values from which they derive. Moreover, informal institutions can be extensions, elaborations and qualifications of formal rules (North 1990: 83). Horizontal complementarities come about as institutions, especially formal ones, are often shaped so as to be compatible and often to reinforce each other. Such complementarities are more common between groups of institutions that are assigned with the task of regulating particular areas of activity, such as finance, industrial relations, social security, education, crime, property ownership, justice, contract, etc. These institutional groups collectively form sub-systems which are also in a complementary relationship with each other as they make up a coherent system.
Having identified the nature and role of institutional constraints, an important distinction that must be made is that between institutions and organisations, such as firms, unions, and regulatory or government agencies (North 1990: 4-5; Amable 1999). While the latter may also provide a structure for human activity, just as institutions do, they are essentially the creators of the institutional sets within which they act rather than parts of it. That is, just like humans, organisations are the players and institutions are the rules. Since institutions are created by humans, often through organisations, this distinction is crucial for understanding not only the nature and role of particular institutional frameworks but also the interaction between rules and players. While organisations create institutions, at the same time they are shaped by the institutional sets within which they operate. Institutions determine the boundaries of organisations activities and, thus, shape their nature.

The focus of this thesis is on a particular type of player, namely the firm as an organisation which, as it was shown above, can either have an existence of its own or be a mere fictitious entity. In a similar manner to Dewey's "consequentialism" of the 19th century this thesis argues that to a large extent the nature of the corporation can be determined by its actions as these are shaped by the institutional environment. By operating as constraints that affect economic agents' choices of action, institutions can to a large extent determine corporate decisions. In the managerial corporation, each institution affecting the behaviour of managers, and, therefore, of the firm, has a particular dynamic which pulls firm behaviour towards a particular direction. For instance, an institution that constrains managerial discretion pulls the system towards

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68 Some authors, however, tend to blur this distinction. E.g. see Alston (1996).
69 This claim was part of the early 19th century debate between legal theorists on the role of theory in determining the nature of the corporation. Dewey's position was that the theories of the corporation outlined above lead to conflicting implications as each theory can be "used to serve opposing ends." Instead, he claimed that the corporation is a concept which can only be determined by the consequences of its actions within the particular circumstances each time; see Dewey (1926).
a market-oriented shareholder supremacy model, whereas another that constrains the operation of the market for corporate control pulls it towards managerialism. In this way, institutions determine not only how much discretion, if any, managers can enjoy but also how it will be used.

Thus, a corporate governance system must be described as a nexus of several such institutional forces. What then determines the nature of corporate governance is the resultant force of this nexus, which drives firm behaviour towards either the managerial paradigm or shareholder supremacy. So, while two separate national systems may bear several institutional differences, if the combined force of constraints limits managerial discretion considerably, then they can be categorised as versions of the neoclassical shareholder supremacy model. If, on the other hand, the institutional constraints as a whole leave significant discretion to managers, then the systems will essentially be versions of the managerial paradigm.

However, one implication of institutional complementarity is that identifying all the institutions that may affect managerial behaviour either directly or indirectly can be a colossal and almost impossible task. This is even more so in a comparative analysis due to the particular differences that exist between national institutional sets. Therefore, an alternative and more realistic methodology is one that is more generic than specific and which relies on the selection of particular elements or sub-systems that seem to have the largest influence on the strategic choices of the players.

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70 Of course, due to the unavoidable presence of positive transaction costs it is practically impossible to reach a neoclassical equilibrium. Therefore, managers will always enjoy some discretion. Institutional sets, however, can enhance the role of market contracting enough to minimise the level of managerial discretion and so promote shareholder supremacy as the prevailing governance principle.

71 For instance national institutional forces in major economic powers during a large part of the previous century supported and promoted managerial discretion and thus gave rise to different versions of managerialism. See section 1.2 above.

72 On the methodological difficulties of institutional analysis see Amable and Pettit (1999) and Amable (1999).
studied. However, it is necessary to note that due to systemic complementarity and complexity, identifying and defining the precise boundaries of such subsystems is not always possible and, as a result, some arbitrariness is unavoidably introduced. The general areas selected here as the most important in determining corporate governance are company law, the financial system, the industrial relations system, and macroeconomic and competition policy institutions. Due to the centrality of company law in regulating corporate activity it seems appropriate to examine its role first and as a separate heading.

1.4.1. The Indeterminate Nature of Fundamental Company Law Concepts and Its Implications

The vast majority of comparative company law studies concentrate on the differences rather than the similarities that exist between national legal rules governing corporate activity. However, the discussion that follows will argue that some of the most fundamental elements of company law are very similar in all major capitalist models so that any modern company lawyer takes them for granted even though historical analysis shows that they are products of a long evolutionary process. These elements have significant implications for corporate governance as they are directly linked to the elements of ownership and control and the relationship between them.

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73 Such a methodology resembles the "Régulation" approach, which concentrates on certain standard institutional themes which can even be loosely connected with the subject of analysis, rather than a more comprehensive analysis which would seek to identify all the institutions that are directly linked to the activities that are being studied. See, for instance, Aglietta (1979) and Boyer (1990).
74 By major capitalist models this thesis refers primarily to the UK, US, Germany, France and Japan.
Corporate personality and ownership

The notion of corporate legal personality and its implications are perhaps features that most company lawyers in all major jurisdictions now tend to perceive as given and inseparable from the very existence of company law. However, when they do so, they ignore the fact that this fundamental notion, the basis of company law as a legal subject, has emerged through an evolutionary process.

While in 19th century England the use of the trust enabled commercial associations to function without the need of legal personality,75 in the absence of the trust, lawyers in European continental jurisdiction had to invent a vehicle that would serve the needs of associations of entrepreneurs. Thus, the société en commandite with a legal personality distinct from its members who enjoyed limited liability became the dominant business form in Continental jurisdictions relatively early. The need to grant legal personality to such associations was more imminent on the Continent than in England where deeds of settlement and partnerships continued to dominate economic activity until well into the second half of the 19th century (Foster 2000).76 Nevertheless, commercial reality revealed the weaknesses of the English legal regime and inevitably led to the grant of limited liability and the recognition of the company’s autonomous legal persona even for small one-man companies.77 So although English company law had different origins from other Continental European ones and followed a different path of evolution for several decades, over time the

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75 See for instance Child v Hudson’s Bay Co (1723) 2 P. Wms 207; Harrison v Pryse (1740) Barn. Ch. 324; Taylor v Chichester Rly Co (1867) LR 2 Exch. 256.
76 When the Bubble Act of 1720 restricted dramatically the creation of joint stock companies in England, entrepreneurs used the deed of settlement to establish unincorporated associations in order to conduct their business operations. Those bodies were not separate legal entities and their assets were held by trustees who could act on the associations’ behalf. On the other hand, the debate on whether société en commandite should be introduced into English law was long and intense (Davies 1997: 40 et seq.).
fundamental notions of corporate personality and limited liability became an indispensable element of both systems and their former colonies.

A significant qualitative change in the nature of the share had immense influence on the development of those notions (Ireland 1996: 303). This change came with the growth of corporations, especially railway, mining and canal building companies, during the two industrial revolutions of the 19th century combined with the increase in the number of shares with free transferability. Investors met in stock markets and bought, sold and liquidated their shares in companies in the same way that bonds were exchanged without affecting the companies themselves. The share as a unit of property was separated from the company's assets and acquired a market value of its own. The link between share-ownership and corporate ownership was practically broken.

So, in the most influential capitalist economies registered companies came to be regarded as autonomous legal entities or persons which are separate and distinct from their shareholders. As a legal person a company can sue and be sued. It can own property and enter into contracts with third parties, including other companies. Generally, a company can conduct its business in its own name and on its own behalf. It has a separate existence from its shareholders who may change or cease to exist without necessarily affecting the corporation.

Perhaps one of the most important consequences of corporate legal personality is in the sphere of ownership, one of the two basic component elements of corporate governance identified in section 1.1 above. All major company law systems stop short of attributing to any natural or legal person(s) full legal ownership of a corporation. So while under the doctrine of corporate personality a company may own property under its own name, even a controlling shareholder interest in a company, say 51%-

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100% of all voting shares, will not give rise to a proprietary interest in the company’s assets. The only property a shareholder owns is the shares themselves and the bundle of rights that their ownership carries. This means that ownership of a company’s shares is a matter distinct from corporate ownership.

Another fundamental attribute of the incorporated company is the doctrine of shareholders’ limited liability. In fact, limited liability and corporate personality are the two sides of the same coin. It would be paradoxical to regard the corporation as a legal person distinct from its shareholders if the later were to be liable for the acts or liabilities of the former. Thus, company law allows for shareholders’ liability to be limited to the amount of capital they provided for the purchase of their shares. So in a sense limited liability reduces the economic status of a shareholder to that of a debenture holder. As Sealy observes:

The theoretical differences between being a creditor of the company and being a member are considerable from a legal point of view, but (at least in the case of a solvent and prosperous company) the practical consequences for investors, apart sometimes from tax considerations, are very similar [...] an investment in debentures or debenture stock is very similar to an investment in shares: both are securities in the corporate sector of the economy offering different kinds of risk and different kinds of return. (Sealy 1996: 381)

In fact, the creditor-shareholder comparison may be a useful one when investigating the issue of corporate legal ownership. In the same way that unsecured creditors can


79 There is vast obscurity regarding the legal definition of the share. In English company law, Pennington (1990: 56) writes, “[s]hares are simply bundles of contractual and statutory rights which the shareholder has against the company” (emphasis added). The French version provided by Ripert and Roblot (1989: para 1147) is even less enlightening since it describes a share as “the rights of a shareholder in a company with a share capital as opposed to his economic interest in it.” For the American definition see Ballantine (1946: para. 198) where a share is defined as “a profit sharing contract, one of a series of units of interest and participation, authorised by the charter of a corporation, by which capital is obtained in consideration of a proportional right to participate in dividend and their distributions.” In German company law a share is described as “the collective proprietary and membership rights inherent in a member’s participation in a company” (Godin-Welhelmi 1967: 12). The important thing here is that none of these definitions defines the share as a fraction of the company as a piece of property in the company itself (Pennington 1989).
become the controllers of an insolvent company without any absolute ownership right over the corporation itself, shareholders are the ultimate controllers of a solvent company without enjoying the status of a legal owner.

However, although a company has no owner in the strict legal sense, in most capitalist jurisdictions, company law recognises the centrality of the body of shareholders in corporate control and governance at the General Meeting. It is this body that approves significant transactions such as mergers and capital increases, has the last word over who will be a director, and even decide on the company's dissolution and liquidation. This situation, that has its roots in the partnership origins of company law, puts the constituency of shareholders as a group at the top of the legal model of the corporate hierarchy.

**Legal Separation of Share-Ownership and Control - Directors Duties**

Another common feature of company law systems is the legal separation of share ownership and control of day-to-day management. This is effected by the legally prescribed organisational structure of the company itself.

As stated above, at the top of the corporate hierarchy are the shareholders as a group that assembles at the General Meeting. The functions of the General Meeting are regulated in a very similar fashion in all major company law systems (Wymeersch 2000). For instance, General Meetings vote by majority, appoint the company's auditors and decide upon important corporate transactions. Similarly, all national company laws provide minimum safeguards against the exploitation of minority shareholders by the majority, and specify General Meeting procedures that have to be
followed at all times.\textsuperscript{80} All these fundamental features of modern company law were not always present. Principles like minority protection and "corporate suffrage" were virtually unknown in the early days of company law. The norm was great divergence both within and between jurisdictions.\textsuperscript{81} Over time, however, significant convergence towards both these principles occurred in all major company law systems.

What is more important, however, is that all company laws in one way or another call for the delegation of the powers and responsibilities of day-to-day management to a body which is separate from the General Meeting.\textsuperscript{82} So there is a significant delegation of corporate control from shareholders to a board of directors which is most commonly a unitary one, but it can also be a two-tier structure comprising a non-executive supervisory board and an executive management board (e.g. in Germany, Austria, the Netherlands, Denmark and Sweden).\textsuperscript{83} The main link between those boards and the shareholders is that directors are appointed by the General Meeting.\textsuperscript{84} This is the ultimate control function associated with share-ownership. When the body of shareholders are not happy with the incumbent board members they can dismiss or refuse to reappoint them as they think fit. While this is a considerable power over the company granted by company law, the General Meeting's powers are of a "residual" and "generic" character, since by law the main decision-making body is the board. The management functions of a company are transferred on to the directors making the board the centre of the company's power structure.

\textsuperscript{80} Although according to La Porta et al. (1999) common law countries have tended to have higher levels of minority protection than their civil law counterparts.
\textsuperscript{82} On the origins of the German delegation of control to management see Chandler (1990: 591). On Germany, Britain and France see Whittington and Mayer (2000).
\textsuperscript{83} The supervisory board stands between the General Meeting and the management board. See section 3.4.1. below for a description of the German two-tier board structure.
\textsuperscript{84} In two-tier systems up to half of the supervisory board members may now be appointed by employees and labour unions. The chairman is a shareholder appointee and has a casting vote in the case of stalemate.
This legally prescribed separation of (share-)ownership from control instantly raises the issue of accountability of those in control of the company’s affairs. So another standard feature of company law is the imposition of legal duties on directors with the purpose of ensuring that they meet certain standards of conduct and preventing abuses of power. There is great diversity in the methods employed and their possible effectiveness for the enforcement of directors’ duties. For instance, while most systems leave enforcement to adversarial private litigation, some company laws show a preference to internal negotiation and pressure from within the board structure. 85 However, there are very important similarities in the nature of those duties and their purpose in all major jurisdictions, they all contain a duty that board members have to act in the best interests of the company (Stengel 1998; Teubner 1985: 155). The duty is owed to the company itself as an autonomous entity and as a general rule it is the company that enforces it. 86

Certainly, the formulation of the duty raises the issue of what the interests of the company are. However, the law in most cases is insufficient to provide a clear answer to this so that in some cases the company’s interests have been described as an “elusive concept” (Farrar 1987: 55). Most major company law systems give a broad meaning to the duty. In the United States, for instance, the enactment of corporate constituency statutes and some landmark court decisions balanced shareholder supremacy with stakeholder objectives. 87 In Germany, the concept of Unternehmensinteresse (interest of the enterprise) developed by courts is also believed to integrate shareholder and non-shareholder interests (Kübler 1985: 439).

85 E.g. through supervisory board monitoring over the management board in the two-tier model.
86 Many jurisdictions allow derivative actions by shareholders. But even these actions are brought on behalf of the company. Personal shareholder actions are very rare and even then their subject matter is not a wrong done to the company but an infringement of the shareholders individual rights.
Similarly, in France *l'intérêt social* (interest of the company) includes a plurality of interests apart from those of the shareholders (Paillusseau 1991: 31-38).

English company law is rather exceptional since it has not entirely broken away from the 19th century shareholder-oriented model. The courts continue to hold that the interests of the company are equivalent to the interests of the present and future shareholders. On the surface this may seem to resolve the problem in favour of shareholder supremacy. In practice, however, even this formulation of the duty does not automatically preclude non-shareholder interests from being taken into account in directors' decision-making. In practice, the inclusion of future shareholders' interests expands the corporate interest enough to provide justifications for significant diversion from what current shareholders may perceive as their interests. Indeed, English businessmen tend to perceive the interests of non-shareholder constituencies as fully integrated in the interests of the company. As Lord Wedderburn observes:

>a director whose legal duty is to make an honest business judgment balancing all these interests will rarely be open to challenge unless he is a crook who has been careless with the minutes. The field is full of fudge. (Lord Wedderburn 1993: 231)

On the other hand, the enactment of s.309 of the Companies Act, which expressly provides for the inclusion of employees interests in corporate decision-making, seems to further dilute directors' accountability to current shareholders (Davies 1997: 603). So even the more traditional English version of the duty does not provide significant


disincentives for the inclusion of non-shareholder interests in what managers perceive as the corporate interest.

Doctrinal Indeterminacy as a Promoter of the Managerial Paradigm

As the preceding discussion has shown national company law systems have important similarities in the way they deal with corporate ownership and control and the relationship between them. What then requires examination is the extent to which company law can pull corporate governance towards the shareholder supremacy or the managerial paradigm.

One could logically expect that company law should provide some conclusive answers about the nature of ownership and control, given their significance as factors determining not only the true nature of the company but also its governance. More precisely, the law could clarify the status of the shareholder either as the owner of the company or as a mere financier similar to a creditor. By doing so it would not only determine the nature of corporate ownership but it would also settle the issue of who should be in control. Nevertheless, it does neither with sufficient certainty. Company law accepts the centrality of shareholders in corporate control by placing the general meeting at the top of the power hierarchy and by allowing it to have the final word on important matters. This closely resembles the shareholder supremacy view of the corporation. However, by stopping short of treating them as true legal owners company law also follows the managerialist paradigm.

It has to be noted here that in the case of a closely held corporation with shareholders who are interested in using the control tools provided by company law,
the legal separation of ownership and control can become practically irrelevant from the corporate governance perspective. If a shareholder or a group of them are eager to get involved in the management of the company, they can do so provided they own at least the majority of voting shares. For instance, this is usually the case in small family companies with few shareholders who see their company’s affairs as their own personal business. They appoint themselves as directors and thus turn the corporate organic structure into a mere formality prescribed by law. The general meeting and the board of directors are technically separate organs, but in practice they are not since they are comprised partially or entirely by the same persons. The situation may be similar in a wholly owned subsidiary which is controlled by its parent or a closely held company with homogenous\textsuperscript{90} shareholders.

This thesis, however, is concerned with the large management-controlled corporation which is characterised by a \textit{de facto} separation of ownership and control. In this type of company the role of company law is potentially crucial as it could provide concrete governance solutions. For example, if legal rules awarded shareholders clearly defined ownership rights over the company as a whole the corporate governance issue would become a marginal one. That is, it would be reduced into a legal enforcement debate which would merely concentrate on the effort of ensuring managerial accountability to shareholders in order to bridge the gap between ownership and control. Had this been the case, the \textit{raison d’être} of all the theories discussed in section 1.3 above would instantly disappear. In fact, shareholder supremacy would have prevailed as a guiding principle thus rendering any managerial legitimacy arguments hollow.

\textsuperscript{90} The term is used here to describe a group of shareholders with similar interests and views about the company’s affairs.
Perhaps company law's indeterminacy in respect of ownership would become irrelevant if there were a clear legal answer as to what the company's interests are. If those were equated to the interests of current shareholders then the ownership problem would be circumvented. It would be as if the shareholders were themselves the corporation thus resolving the ownership issue before even arising. However, this is not how the law is. As shown above, the corporate interest is a vague and flexible concept that can be stretched to cover non-shareholder interests. Directors owe their duties to the company and, subject to some limited exceptions where available, it is the company that enforces its rights and protects its interests. The incorporated company is indeed a legal person separate from the owners of stock.

Fortunately for academics and unfortunately for practitioners company law seems to be incomplete from a corporate governance perspective. It does not provide the necessary link between ownership and control so as to resolve the governance issue either directly, by awarding a legal ownership status to the shareholder, or indirectly, by giving a limited meaning to the corporate interest. Due to this incompleteness, company law resembles a pendulum that balances between shareholder supremacy and managerialism. As Iwai observes, due to its inability to determine the nature of the company, all company law provides is a 'menu' of corporate structures ranging from the purely "nominalistic" to the purely "realistic" from which a society can choose (Iwai 1999). In other words, national company law systems seem to share a common characteristic of indeterminacy. They stop short of determining the orientation of corporate governance, since they do not define conclusively the nature of corporate ownership and its relationship with control.

91 For a similar view on the flexibility of English company law see Parkinson (1993: 279-280).
The implications from this indeterminacy are significant. By avoiding the conclusive resolution of corporate governance issues, company law as an institution becomes flexible enough to allow diverse corporate policies according to the specific wishes of those in control of the company. This flexibility derives from the gap created by the simultaneous recognition of corporate personality with a vaguely defined interest and of the shareholder merely as a "virtual" but not legal owner of the company. In the case of large public corporations where managers are in control, incompleteness and flexibility automatically translate into increased discretion. So, to a great extent managerial discretion is institutionalised in company law subject of course to the use of the legal control tools supplied to the shareholders, which, however, may not always be available in practice.

From a comparative perspective, the significant similarity of basic company law doctrines along the lines of the managerial paradigm should be expected to reflect or be reflected by a corresponding similarity in corporate governance. Indeed, as section 1.2 has shown, for a large part of the 20th century versions of managerialism have been dominant in several major economies. However, this similarity did not persist. As section 3.2 below will argue, institutional developments that occurred in the UK and the US during the 1980s transformed corporate governance there even though company law remained fairly stable as a promoter of managerialism. This means that, while company law could be seen as a core factor affecting corporate governance, in practice its determining force as an isolated institution is minimal. In other words, the core of national company law rules alone may not be sufficient to account for the fundamental differences in the nature, the role and the governance of the corporation between national systems. Other institutions have an important role as determinants of corporate governance that can even "neutralise" the influence of
company law. This does not mean, however, that the institutional complementarity considerations discussed earlier have no validity. On the contrary, the "neutralisation" of company law is an illustration of institutional interaction and complementarity. This is because, when other institutions determine corporate governance, they do not override company law but fill those doctrinal gaps that are responsible for its indeterminacy.

1.4.2. Other Sub-Systems of Institutions and Their Determinant Influence

Having considered the function of company law as a promoter of the managerial paradigm, at least in the case of corporations that are *de facto* controlled by managers, the thesis now turns to examine the influence of other sub-systems on corporate governance. Of course, the analysis of constraints herein is by no means exhaustive since the subsystems and individual institutions that shape firms' and managers' choices are enormous. However, the institutional configurations analysed here are in this thesis view the most important in terms of determinative influence. Without resorting to a detailed analysis of specific institutions, the main aim here is to provide illustrations of the role of fundamental institutional subsystems and their complementarities as determinants of corporate governance outcomes. The areas selected here are considered as fundamental, because they are directly related either to the two most essential inputs of the firm, namely financial capital and labour, or to the nature of product market competition. These three institutional subsystems regulate the three most important sources of managerial constraints.
Broadly speaking a financial system comprises the processes through which savings are channelled to the real economy. Schmidt et al. define a financial system as the “interaction between the supply of, and the demand for, the provision of capital and other finance-related services” (Schmidt et al. 2001). They distinguish between a financial system and the financial sector, with the latter being a component of the former. However, they also claim that corporate governance is also part of the financial system. This is not entirely consistent with the view presented here which conceives corporate governance as the product of complex and diverse institutional arrangements, which include but also go beyond the financial system, and not as part of them. This divergence of opinion demonstrates how institutional complementarity makes the distinction between sub-systems a very difficult task. It also shows how the relationship between institutional structures and economic actors is based on interaction so that the former determines the latter and vice versa. Nonetheless, following the distinction between institutions and players and since corporate decision-making in the view of this thesis is better defined as a player’s action rather than as a constraint, corporate governance should be differentiated from the financial system, or any other institutional sub-system.

Financial allocation channels are numerous and diverse the most important of which are banks, securities markets, pension funds and other non-bank financial intermediaries which collectively comprise the financial sector. In modern economies

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92 They define the financial sector as “the part, or sector, of an economy which offers the economic units in the other sectors opportunities to invest and to obtain financing, together with associated advisory and intermediation services. Its principal constituent elements are banks, other financial intermediaries and the financial markets, in particular the securities exchanges as organised financial markets” (Schmidt et al. 2001).

93 Supra. notes 66-68 and text.
the regulatory environment in financial markets constitutes an extremely complex system of interwoven institutions which range from rules governing foreign exchange, savings, securities markets and investor protection, taxation, etc. All these institutions combined determine the ways in which financial capital is mobilized and ultimately distributed to the corporate sector and, therefore, shape the financial system as a whole. Different historical contingencies require different institutional responses which in turn determine what types of channels are ultimately chosen for funding industrial investment. Thus, while all capitalist financial systems are similar, in that financial sectors therein consist of various allocation mechanisms, the role of particular channels differs.

In order to explain this divergence between financial systems it is important to emphasise the existence of relationships between savers, the financial sector and non-financial firms as channels of information flows (Schmidt et al. 2001). The role of information is of crucial importance since it affects the nature, distribution and volume of transaction costs by defining the boundaries of each economic actor's rationality (Leland and Pyle 1977). It is at this level that institutions come into play as they determine the types of financial relations by "guiding" the flows of information between economic actors. For instance, institutions that facilitate the flow of information from a corporation towards public investors can decrease the level uncertainty in securities markets and consequently reduce the transaction costs of securities finance. Mandatory disclosure rules are one such type of institutions.94 Other rules, however, may hinder such public information flows. When sufficient public information is lacking, close and private rather than arm's length market-based financial relationships will emerge, as high transaction and agency costs will deter

94 For a detailed analysis of specific institutions see Black (2001).
economic actors from using securities markets. Under such circumstances, financial intermediaries, the most important of which are banks,\textsuperscript{95} may be able to resolve informational asymmetries by pooling funds and thus internalising financial transactions. So, two fundamental parameters that characterise financial systems are the degree of financial \textit{intermediation}, on the one hand, and \textit{securitisation} on the other. The former shows the importance of non-market mechanisms in channelling financial resources, while the latter is evidence for the relevance of market-based financial relationships.

Since the inevitability of at least some transaction costs in financial contracting makes the presence of some intermediation a characteristic of any financial system, it is inevitable that completely securitised systems cannot exist in the real world. Nevertheless, while securities markets and financial intermediaries are present everywhere, their significance and role are not equal in all financial systems as they depend on the manner in which institutional sets resolve informational asymmetries. Thus, where financial systems as a whole tend to reduce the costs of securities finance, securities markets should acquire a central role in the allocation of capital. In contrast, if systems hamper public flows of information, the importance of financial intermediation, and so the role of banks, should increase. In other words, institutional differences can give rise to two main types of financial systems. The first, which can be called “market-based”, is built around large and liquid public securities markets that constitute its centre. The second, which can be termed “bank-based”, is a financial system in which banks as financial intermediaries constitute the dominant channels through which financial capital reaches the non-financial corporate sector.

\textsuperscript{95} While other financial institutions, such as insurance companies, investment funds and pension funds may also have an intermediation role, banks are considered to be “unique” in their function as financial intermediaries (James 1987; Diamond 1984).
From the above discussion it is evident that the institutional constraints regulating the costs of using the securities markets are of central importance in determining whether a financial system is bank-based or market-based. Such institutions are numerous and diverse both in terms of function and of nature. While some observers attach more importance to legal rules (La Porta et al. 1997, 1998, 2000; Shleifer and Vishny 1997), others claim that legal enforceability is not a necessary condition for a particular institution to exert determinant influence and that self-governance mechanisms can be at least as effective (Coffee 2001; Cheffins 2001). Irrespectively of what their type is, institutions promoting and supporting the role of securities markets have two specific functions. The first is to resolve information asymmetries between public investors and the corporate sector by increasing the volume of valuable information that is publicly available. Such institutions include mandatory disclosure rules for listed corporations and accounting standards, but also quality screening of securities issues by private investment banks, stockbrokers and rating agencies. Increased information flows facilitate the calculation of risk by those interested in investing in securities and related instruments and so they reduce uncertainty. Thus, the more public information such institutions produce, the less the transaction costs and the more efficient the markets.

The second function is to reduce the ability of those who possess non-public, privileged information to behave opportunistically to the detriment of market investors. Institutions such as insider trading prohibitions, takeover regulations and various other minority shareholder protection rules can minimise private rents that accrue from establishing close financial relationships. As a result, the transaction costs for arm’s-length investors arising from relational investors’ opportunistic behaviour decline. In the absence of private rents accruing form relational financial
contracts both types of investors are placed in a similar position vis-à-vis the corporate sector. Thus, the incentives for non-market financial relations diminish and the role of securities markets as an allocation mechanism of financial capital is enhanced while that of intermediation declines.

Furthermore, apart from those institutions that directly regulate information flows, numerous other constraints may also exist that determine the role of securities markets in the financial system. For example, particular regulatory controls and government policies may be specifically designed to hinder the development of securities markets to the advantage of the banking sector and vice versa (Coffee 2001 and Cheffins 2001). The imposition of such institutional constraints can directly interfere with the competitive position of each type of financial resources allocation mechanism and thus determine the orientation of the financial sector. The manner of such interference varies significantly both in form and in influence from interest rate policies, minimum reserve requirements or tax burdens to direct restrictions on the scale and scope of operations that financial institutions can undertake. Of course, the effect and orientation of such direct measures in the financial sector can only be expected to be complementary to those of the information-related institutional constraints described above.

On the surplus side of a financial system a number of institutional factors shape both the extent and the choice of savings according to the particular needs of each country. A particularly significant element of national savings is the system of

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96 For an analysis of this view from a political perspective see Roe (2000).
97 The interest rates are directly related not only to banks' profitability but also determine the attractiveness of bank saving as opposed to investment in other assets such as securities.
98 If these requirements are too high banks will be in a direct disadvantage, since they either have to shift the higher costs to their clients or face a decline in profits.
99 Most importantly, capital gains tax rates are one of the costs of securities transactions and thus have a direct impact on the liquidity of securities markets.
100 See, for instance, the impact of the Glass-Steagal Act upon the US banking sector until its repeal.
pension provisions. Generally, there are two types of pension systems. The first and, at least until now, the most common is the "pay-as-you-go" system where the working population undertakes to fund the retirement of pensioners by making compulsory contributions to state and corporate pension schemes in return for a guaranteed income ("defined-benefit") they will receive when their turn to retire comes. The important aspect of this system is that pension income distribution is simultaneous to the active population's contributions so that no significant asset accumulation takes place. The second type is the "funded" system where wage earners make their own retirement provisions by contributing specified amounts ("defined-contributions") to public or private pension funds. Those pension funds invest the capital contributed in securities and other assets so that, when the pension policy of a particular beneficiary matures, the accumulated capital will depend on the asset prices at that time. Whether the pay-as-you-go or the funded system is the prevailing pension system depends on institutional factors, such as tax incentives and other pension-related regulations, that discourage or encourage households to invest in pension funds and similar savings vehicles – e.g. mutual funds, unit trusts etc.

What is important for the purposes of this discussion is that the way savings and most importantly pension provisions are organised has a major influence in role securities markets have in the financial system. Where the funded system is chosen, then a very large portion of household savings is directly channelled to securities markets. Pension funds and other institutional investors promote securitisation rather than intermediation (Davies 1996). They are market-oriented financial institutions since most of their investment goes to securities and related instruments rather than taking the form of direct loans to corporations as banks do. At the same time, they rely on developed and liquid securities markets because they need to diversify their
investments so that they can minimise their risk and avoid becoming locked in particular securities by over-investing in them. Thus, pension funds, similarly to other institutional investors, do not commit themselves to close financial relationships but prefer their investments to be as liquid as possible so that they can dispose them "silently" in the market without affecting prices.

It is due to these factors that Schmidt and Tyrell (2001) conclude that the design of pension provisions as an integral part of a financial system is directly related to whether a system is market-based or not. Where the financial system is designed to channel savings to securities markets via pension funds and other institutional investment vehicles, banks have a disadvantage in attracting savings, due to the higher long-term yields of stocks and bonds in comparison to bank deposits. Therefore, their role as providers of long-term finance diminishes as securitisation progresses. So, pay-as-you-go pensions are complementary to financial intermediation since they shield banks from competition and thus warrant their role as long-term financiers of economic activity. Similarly, those institutions that promote a financial system's market-orientation are complementary to the institutional arrangements that sustain a funded pension system and the securitisation of savings more generally. However, it is important to note that in the latter case complementarity does not imply that securitisation cannot exist without a funded pension system. Rather, it is the reverse causational sequence that reflects more accurately the link between developed securities markets and funded pensions. The institutional arrangements mentioned earlier that relate to information flows and investor protection can be sufficient for the development securities markets. This, however, does not undermine the important role of pension funds and other market-oriented collective savings vehicles as providers of liquidity.
In sum, two main types of financial systems can be identified. The first is the market-based system where securities constitute attractive investment opportunities for the surplus sector and an important source of long-term finance for the corporate sector. The function of banks in corporate finance is thus limited to providing diversified short-term loans that do not require the establishment of committed relationships with their clients. Moreover, institutional arrangements facilitate information flows in securities markets and thus reduce the costs of market transacting. So, generally, in the market-based system relationships between the financial sector and non-financial corporations are not necessarily committed and long-term but arm’s-length and determined by market forces.

The second type of financial system is bank-based with securities markets that do not play a significant role either in pooling savings or in corporate finance. Instead, banks are dominant as channels of long-term financial flows from the surplus sector to the corporate sector. Since information does not become a public good and therefore transaction costs in securities markets are high, the financial sector needs to expend resources to acquire it privately. Long-term and committed relationships between financial institutions and corporations are necessary for two reasons. Firstly, the acquisition of private information from the client requires significant relation-specific investment by the bank that, according to transaction cost theory, entails significant lock-in effects. Such relation-specific investment is possible only because the bank can use the acquired information for its own private benefit without sharing it with competitors. Secondly, the corporate sector is also interested in maintaining such financial relationships in order to prevent the opportunistic use by the banks of the private information it releases and to gain easy and stable access to the main external source of financial capital.
What is the significance of such differences in financial systems for corporate governance? To a large extent the answer to this lies in the differences in corporate finance that exist between the two types of financial systems. This is because there is a clear relation between corporate finance and patterns of share-ownership. The presence of liquid securities markets means that financial claims are small and therefore dispersed. Otherwise they would not be liquid, since concentration of financial claims and the lock-in effects that characterise committed financial relationships are two sides of the same coin. Thus, subject to the forces of other institutional subsystems, in a market-based financial system one expects to find a pattern of highly fragmented ownership of stock, whereas in a bank-based system shareholdings of listed corporations should be more concentrated and illiquid.\footnote{This is a well-established view which is clearly supported by empirical evidence. E.g. see Berglöf (1990).}

This divergence in ownership structures between the two financial system types is highly significant for corporate governance because it is directly related to the corporate control channels that are available to shareholders. There are two such channels for dissatisfied shareholders, namely “voice” and “exit” (Hirschman 1970). The former describes the situation where there is direct intervention with managerial decision-making either formally through the General Meeting or informally by face-to-face contact with managers. Shareholder exit, on the other hand, occurs where shareholders vote with their feet by selling their shares either directly to a takeover bidder or on the stock market and thus subject incumbent managers to the disciplinary forces of the market for corporate control. The important difference between the two types of control is that voice entails costs on the part of shareholders while exit is virtually costless.
The choice of control mechanism is determined by a combination of two factors: the costs of exercising direct control ("voice") and the problem of collective action. In essence, these two factors are closely interlinked. The costs that accrue from exercising direct control constitute the resources expended by shareholders for obtaining sufficient firm-specific information as well as for assessing and improving managerial efficiency. Whether a shareholder has sufficient incentives to incur such costs depends on his private gains as a result of the improvement in managerial performance. So, where private gains for all shareholders do not exceed their private costs, no individual shareholder will have the necessary incentives to exercise control, even if that were beneficial on a collective basis. It is at this point that the collective action problem becomes relevant.\(^\text{102}\) The possibility of collective action is directly dependent on the degree of shareholder diffusion (Rock 1991). Provided that any improvement in corporate performance is reflected in the company’s share price and/or dividends, private gains for the monitoring shareholder are directly related to the size of his shareholding. The higher his stake in the company the more he will capitalise on his monitoring expenditure and vice versa. So, concentrated share-ownership automatically increases the likelihood of direct shareholder control whereas, if ownership is highly dispersed, the only available option to shareholders is "exit" and the only financial mechanism for managerial discipline is the hostile-takeover.

Thus, to the extent that the financial system can determine the structure of share-ownership it has an immediate impact on the choice of corporate control. The bank-based system, on the one hand, creates significant incentives for financial capital providers, i.e. creditors and shareholders, to commit themselves to acquiring

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**102** For more extensive theoretical analyses of collective action see Olson (1971) and Axelrod (1984). For applications to the shareholder behaviour see Easterbrook and Fischel (1991: ch.3) and Rock (1991: 453).
information about the value of the company's operations and thus become insiders. On the other hand, in the market-based system such incentives are virtually absent and financiers remain uncommitted outsiders to the firm.

The crucial issue here is whether there is any difference between the insider and the outsider system of corporate control regarding the incentives they create for managers. From a theoretical perspective, the answer to this depends on the combination of two things: the motives of shareholders and the degree of market efficiency. If the neoclassical assumption that individuals are rational is accepted, the motives of all types of shareholders are homogenous, that is, all shareholders expect the maximisation of profit and the distribution of excess cash-flows. Then, in the insider system the divergence between shareholders' and managers' interests—i.e. the agency problem, to use Jensen and Meckling's terminology—does not arise, since in effect there is no divorce between ownership and control. In the outsider system, on the other hand, ownership and control are truly separated just as Berle and Means observed in the 1930s about large American corporations. The extent of managerial discretion is then dependent on the stock-market efficiency variable. If stock-markets are efficient so that share prices reflect with relative accuracy the value of corporate operations, then the constraints from the market for corporate control will be adequate to eliminate managerial discretion. In this case the insider and the outsider control systems can be seen as equivalent microeconomic alternatives just as Jensen and Meckling predict.

However, in reality neither the neoclassical version of rationality nor the market efficiency hypothesis hold. Regarding the former, different types of shareholders can have diverse and often conflicting expectations from managers. For instance, a founder shareholder whose whole income is tied to one company is more
risk averse than a diversified investment fund and, therefore, more willing to retain excess capital within the company so that it can be used in difficult times or even for his personal benefit. Similarly, where corporate cross-shareholdings exist, industrial strategy considerations will tend to prevail over financial returns on equity. Moreover, a shareholder who is also a creditor to the company in question, as banks often are, may be more interested in securing the prompt repayment of loans plus interest rather than the maximisation of shareholder returns. Again such a creditor-shareholder will be more risk averse than a diversified non-creditor shareholder and will allow the accumulation of undistributed excess cash flow.

Due to this divergence between the expectations of different shareholder types, even where share-ownership is concentrated, current shareholder value maximisation as a general characteristic of shareholder supremacy may not be the prevalent corporate objective. On the contrary, as the share loses the attributes of a pure financial instrument to become something resembling a "club membership" fee, shareholder commitment as a characteristic of the bank-based system can even translate into enhanced managerial discretion. Since, in the absence of a liquid stock market, equity finance loses significance, bank-based systems seem to encourage the use of shareholdings for purposes other than financial income. Thus, one should expect that shareholder value as a measurement of shareholder supremacy should be less relevant in such systems. That being so, strategic inter-firm cooperation, financial relationship building, and private rent extraction will be more

103 Even investment fund expectations can differ depending on their investment policies. This is illustrated in the growth of ethical investment funds. See for instance Lewis and Webley (1994: 171-183) and Mackenzie and Lewis (1999).
104 In this case the founding shareholder's motives would be no different from those of unconstrained managers. Other cultural constraints, such as family heritage considerations, may also be important determinants of such shareholders' behaviour (Learmount and Roberts: 2001).
105 This claim is further supported by the empirical evidence gathered from Germany in chapter 3 below.
important as an objective of owning shares where securities markets are not a central part of the financial system. In contrast, in market-based financial systems, where stock markets are more important as a source of corporate finance, return on equity should be the prevalent criterion for investing in shares.

Nonetheless, whether this is in itself enough to pull corporate governance towards a shareholder supremacy paradigm is not immediately clear. What still needs to be determined is whether outside shareholders in the market-based financial system have the ability to impose their expectations on managers. Since the only control channel for such shareholders is the market for corporate control, the crucial element is market efficiency. As mentioned earlier, market-based financial systems rely heavily on institutional arrangements that facilitate public information flows which reduce the costs of market transacting. What this means, however, is not that markets are totally efficient so that transaction costs are zero, but that they are more efficient than those in bank-based systems. Therefore, the existence of developed and liquid stock markets does not settle the issue of corporate control automatically in favour of shareholder-supremacy.

Even where control-related information is largely available, high transaction costs can arise if investors lack the ability to process and use it in order to make efficient investment decisions. This will be the case either because they do not have the sophistication to do so or because they lack the time required for such an exercise or due to a combination of both. In particular, individual shareholders who are not professional investors will be in such a position. For this type of shareholder transaction costs can be so significant that "exit" is as unavailable as the "voice" option. For instance, even in a hostile-takeover bid, where shareholders can directly show their approval or rejection of management, in many cases individual investors
would find it difficult to decide whether the best option is to sell their stock or follow management and reject the bid. Unless there are clearly visible signs of managerial failure – e.g. repeated unsatisfactory dividend distributions and continuous share price drops – individual investors should be expected to follow management decisions, in which case the market for corporate control will not restrain managerial discretion much. As a result, individual investors can become locked in committed financial relationships with the companies they have invested in, but without the ability to exercise direct monitoring, since they lack the incentive and the resources to obtain inside information. So, subject to the impact of other non-financial constraints, where diffuse ownership is combined with extensive individual shareholdings the Berle and Means thesis should be expected to apply.

However, the situation can be reversed where the dominant type of investor in the stock market are professional investors, such as pension and other investment fund managers. These institutional investors are different from individuals in that they have the sophistication and the resources necessary to process and utilise the information that is publicly available in the market. So, in effect, their presence significantly reduces the transaction costs individual investors have to bear. They are also different in that not only do they require liquidity and diversification, but they also expect shareholder value maximisation; in other words, their investment policies are strictly driven by financial considerations. While the combination of these two characteristics makes institutional investors inherently uncommitted shareholders, the fact that they face less transaction costs also allows them to participate in

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106 In recent years, however, a minority of institutional investors –mostly Anglo-American public pension funds– have been facing the lock-in effects of concentrated ownership, despite their broad diversification strategies, as their assets have grown to unprecedented levels. For those institutions the “voice” option or what is most commonly called “institutional activism” is often the only economically rational option. Some index funds also resort to corporate monitoring as a way to “beat” the market. The literature on the subject is substantial. See Black (1992), Coffee (1991), Stapledon (1996), Brancato (1997), Galanis (1997).
corporate control contests more actively (Gorton 1999). Consequently, the "institutionalisation" of financial assets, and corporate stocks in particular, increases the role of the market for corporate control as a disciplinary mechanism for managers and therefore is directly related to shareholder-oriented corporate governance. Thus, where a financial system combines a liquid stock market with a funded pension system – two elements that, as it was shown earlier, are not unrelated – a strong tendency in created towards shareholder supremacy as the prevailing principle in managerial decision-making.

*Industrial Relations System*

While the financial system undoubtedly has significant determinative power over corporate governance by affecting the mode and force of shareholder influence in corporate decision-making, the industrial relations system can also give rise to managerial constraints by determining the governance role of labour, a production input as essential as financial capital. While industrial relations have gained broad recognition as an area of academic study, explicit and universally accepted definitions for what an industrial relations system actually is do not exist. For Hyman (1975: 12) the subject is defined as "the process of control over work relations (emphasis added)," thus emphasising the power and conflict factors between interested parties which give rise to complex informal institutional arrangements governing personal and collective employment relations (Kochan 1980). Others, however, adopt a narrower definition that concentrates on a web of generally applicable rules that resolve conflict in employment (Dunlop 1958; Bain and Clegg 1974). For instance, in
his influential work Dunlop (1958: 7) identifies workers, managers and the state as the core players in industrial relations who interact to establish the institutions that determine the relationships between them. Building upon this approach, Flanders (1965: 10) defines the industrial relations system as the set of all those institutions that can vary from statutory rules to collective agreements, arbitration awards, social conventions, accepted practice, and even managerial decisions.

For the purposes of this thesis, the institutional approach is preferable for two reasons. Firstly, in a static analysis, like the present one, the process of institution building is irrelevant, since the quest is to identify institutional constraints and analyse their effect on the behaviour of labour and management. Secondly, placing the emphasis on rules rather than power differentials facilitates the comparative analysis of industrial relations systems, since it is differences in institutional arrangements resulting from historical contingencies (Zeitlin 1987) that are responsible for industrial relations systems’ diversity (Roche 1986, and Streek 1988). By regulating transaction costs in labour markets, industrial relations systems determine the relationship between labour and the firm. Of course, the aim here is not to analyse the effect of specific institutions but to provide a general analysis of how an industrial relations system as a whole determines the role of labour in corporate governance.

To begin with, in their endeavour to fulfil their human capital needs companies have two basic choices: they can either tap the external labour market to find the skills they require or develop their workforce internally through firm-specific training. The difference between these two choices is substantial not only regarding the nature and volume of resources deployed but also in respect of the type of
employment relationships they create. The crucial elements that influence industrial relations choices are asset-specificity and opportunism.

The former element describes the degree to which each party to the employment contract makes investments that are specific to the particular relationship. On the employer’s side such investments can be the provision of on-the-job training, active reliance on the continuation of the employment relationship, redundancy pay promises, vested pensions and other benefits that enhance job satisfaction. What the employer relies on while making all these investments is that the employee will not unilaterally withdraw. Similarly, an employee can invest in a particular employment relationship by developing firm-specific skills and knowledge, by accepting to work more than he is being paid for, and by tying his present and future welfare to a particular company, e.g. by moving to a specific location and making non-transferable pension contributions. Since all these investments are relation-specific, if the employment contract is terminated, they automatically become liabilities. The implication is that the larger such investments are, the greater the costs arising from the employment contract’s termination, because relation-specific assets are not re-deployable. Consequently, each party that invests in such assets limits his exit option. Where both employers and employees face high exit costs, the likely effect is that the employment contract will be a long-term one based on mutual commitment and trust. In other words, the two parties exclude the possibility of resorting to the external labour market by internalising it.

The costs arising to the employer from the lost production during the search for a replacement employee, and to the employee due to the lost wages as a result of the redundancy will also be added to these liabilities.

Where relation-specific investment is only unilateral, then the party making such investment will be vulnerable to the other side’s opportunistic behaviour. In the absence of governance mechanisms safeguarding the disadvantaged party the result is conflict and inefficiency.

Scientific precision requires that this type of internal resource allocation be distinguished from market transacting since it is not governed the price mechanism (Hodgson 1988: 176). However, the
The choice between external and internal labour markets has important organisational effects. Firstly, long-term commitment goes side-by-side with cooperative relationships between managers as the firm’s controllers and employees in order to deal with potential adverse economic conditions. In such situations it is employees who face the higher risk of not capitalising on their investment by not receiving what is implicitly promised to them.\(^{10}\) It is at this point that the fear of employer opportunism substantiates, since, unless employees have sufficient information about the firm’s real economic situation, they may assume that their employer is breaching their implied agreement and discontinue their firm-specific investments. Resolving informational asymmetries between managers and the workforce when such circumstances arise is crucial in order to prevent the relationship from collapsing due to increased worker scepticism about whether to trust their employers (Williamson 1984: 1209; and Hart 1983: 23). So, the necessary governance mechanisms for resolving disputes must be in place, which can vary from formalised employee consultation to board representation, both carrying the corresponding degree of influence in corporate governance.

Moreover, since in internal labour market systems the threat of dismissal in case of underperformance cannot be used by the employer to motivate the workforce, other alternative motivational mechanisms are required. These usually take the form of internal promotion-assessment schemes based on seniority and productivity as the main criteria, profit sharing arrangements and higher wages than those that can be obtained in the external labour market. Such institutions, however, make the sustainability of operating internal labour markets highly dependent on continuous

\(^{10}\) For instance, they may not get the training, salary and other benefits they expect or they may even lose their job if circumstances are very negative.
growth, because the size of the organisational hierarchy determines the promotion opportunities available (Rubery and Wilkinson 1994: 49). The establishment of internal labour markets, therefore, creates an inherent bias towards growth-maximisation similar to that identified by managerial theorists. Thus, one can expect that those firms that choose such industrial relations policies are more prone to invest their cash flow in organisational expansion\textsuperscript{111} rather than distribute it to shareholders.

On the other hand, where the external labour market option is chosen as a source of human capital, industrial relations will be diametrically different from those associated with internal labour market systems. Firstly, since no significant relation-specific investment takes place, the possibility of unilateral opportunism within the firm is minimal. In the absence of the significant lock-in effects that characterise internal labour markets, each party that is unsatisfied with the employment contract has the exit option more easily available. For instance, where the employer believes that the employee under-performs, he can replace him at a relatively low cost. Similarly, an unsatisfied employee will leave his job and look for another in a different company more easily if his skills are transferable and, therefore, do not become a liability outside the firm in question. Thus, since neither party is sufficiently interested in maintaining the longevity and stability of the employment contract no information or power sharing mechanisms are necessary. The relatively unrestricted availability of exit is sufficient to ensure that neither party to the employment contract loses out as a result of unilateral withdrawal. Thus, in firms where external labour markets are the prevalent source of human capital, industrial relations will be of an adversarial nature as opposed to a cooperative one. Moreover,

\textsuperscript{111} Expansion may also include close cooperation with other similar firms resulting to group structures that encourage labour mobility between affiliated firms. This has been a common occurrence in Japan. See Odagiri (1992: 57) and other case-studies mentioned therein.
since no internal promotion mechanisms are needed these firms are more prone to shareholder distribution than investing their cash flow in organisational growth.

These differences between the two labour systems gain more substance in restructurings such as cost-cuttings and hostile-takeovers, two things that are often combined, because it is in such situations that the conflict between labour and shareholder interests becomes more apparent. As regards the former, employers that rely on internal labour market systems cannot easily use workforce reductions in order to cut their costs, because they would lose their ability to recoup their relation-specific investments. Moreover, they also face informal constraints, since extensive redundancies will be damaging for their reputation as “good” committed employers and, consequently, their ability to attract the right employees in the future would be curtailed. For this reason, when cost-cuttings require the reduction of labour costs those companies that internalise labour markets face more pressure to find less drastic alternatives that are less disadvantageous to employees than companies which use external labour markers.\(^{112}\) Thus, labour market internalisation imposes constraints on managerial choices by creating a bias in favour of employee interests. Where this bias cuts into the expectation of shareholders that excess cash-flow is distributed to them instead of being used to “subsidise” employment relations, a clear conflict arises. For instance, the company may have to favour employee satisfaction over dividend distributions, in which case shareholders will be asked to bear a higher share of the costs of the restructuring than they would have to, had the company not implemented internal labour market processes.

The significance and extent of this conflict between shareholder and employee interests is then directly dependent on the shareholders’ investment horizon. If

\(^{112}\) Such less drastic measures can include overtime cuts, temporary lay-offs during which the employee receive a reduced salary, transfers of employees from unprofitable to profitable divisions or even affiliate companies, or even postpone dividend distributions. See Odagiri (1992: 56-64).
shareholders are committed, because it is beneficial for the company and for them in the long-term, they will be more willing to sacrifice some of their current earnings in order to ensure long-term profitability.\textsuperscript{113} If, on the other hand, they are more interested in receiving current returns than in capitalising on the company’s long-term prospects, i.e. if they are not locked into their financial relationship with the company, the conflict becomes substantial and insurmountable. As the degree of shareholder commitment is determined by the financial system, labour market internalisation is thus positively related to the degree of financial intermediation. Hence, the relationship between the industrial relations system and the financial system is a complementary one.

In the case of a hostile-takeover the divergence between the interests of employees and of shareholders becomes even more striking. Usually, in the absence of minimum safeguards the most disadvantaged corporate constituency after the completion of a takeover transaction are employees who often have to face redundancies as a result of operational overlaps between the merged entities or of cost-cutting policies so that post merger financial liabilities can be met.\textsuperscript{114} Of course for employees who have not made any relation-specific investments and who can expect to be absorbed by other companies if they lose their job, the costs will be relatively low. However, where at least one of the companies involved in a takeover operates an internal labour market system, the effects on the employees will be much greater. In effect, the completion of the transaction will constitute a wealth transfer from the workforce to the shareholders, since the latter will not accept an offer for their shares unless they receive a premium (Coffee 1986: 7). Thus, where labour

\textsuperscript{113} On the relationship between financial commitment and investment in human resources see Lazonick and West (1995) and Lazonick and O’Sullivan (1996).

\textsuperscript{114} See Coffee (1986: 7) claiming that employment security and hostile or friendly takeover activity cannot easily co-exist.
markets are internalised the interests of employees and managers may coincide as both are the ultimate losers on the completion of a hostile-takeover.\textsuperscript{115} Of course, once again the factor of shareholder commitment discussed above will be a decisive one on whether the industrial relations system and the financial system are complementary.

Having shown that firms' industrial relations choices have significant implications for managerial decision-making by determining whether discretion is used in favour of employees or not, what requires examination are the factors that determine such choices in the first place. In other words, it needs to be clarified what external institutional constraints affect companies employment policies. Firstly, as already mentioned, institutional constraints from the financial system are crucial in the formulation of a firm's employment system. The interaction between shareholder commitment, the degree of which is directly dependent on financial regulation, and industrial relations has already been mentioned.\textsuperscript{116} As a more specific illustration of the interaction between the two sub-systems, takeover regulation, essentially part of the investor protection regime, regulates the ability of managers to resist unsolicited bids. It, therefore, constitutes an institutional factor indirectly affecting industrial relations and subsequently determining the governance role of employees.

The skill-development system in a society can also affect firms' choice between internal and external markets. The extent to which formal education institutions and organisations - e.g. schools, universities, etc. - within a society are capable of providing a pool of specialised skilled labour from which firms can select their workforce will determine the levels of investment in intra-firm training (Rubery

\textsuperscript{115} Where, of course, managers are awarded stock-options or are protected by golden parachutes this coincidence will not materialise. Such measures, therefore, are incompatible with the sustainability of labour market internalisation policies.

\textsuperscript{116} Franks and Mayer (1990) have also made a similar claim on the complementarity between insider ownership and labour market internalisation.
and Wilkinson 1994: 51). Thus, where the skills required by firms are readily available in external labour markets, the incentive for hiring unskilled employees with the intention of providing them with in-house training will be low. However, where the supply of skills does not match the demand in terms of quality or quantity or both then firms will have increased incentives to provide additional training themselves (Osterman 1984).

Furthermore, employment law and other employment-related rules also impose significant constraints on firms’ industrial relations choices. A great variety of legal rules covering among other things issues such as job protection, part-time work, union recognition and power, collective bargaining, employee consultation and participation, and pension transferability regulate the availability of exit from employment contracts and shape industrial relations. Where such regulations as a whole raise considerably the costs of firing employees, they constitute externally imposed lock-in factors which are common to all companies operating within the same set of rules. Such regulatory environments, therefore, limit the discretion that firms have in the formulation of their internal employment policies and create pressures for labour market internalisation with the corresponding implications for corporate governance as explained above.

Finally, other firms’ labour policies may also give rise to external constraints by affecting labour supply and demand conditions. For instance, if most employers, especially large corporations whose choices carry more social weight, operate internal market systems, a firm that prefers the external market option will face more difficulties in finding and attracting the skills it needs. This illustrates how vertical complementarities between such informal constraints and formal employment rules operate.
Inspite of all these institutional constraints that determine industrial relations systems, employers are still left with sufficient room to manoeuvre. At the micro-level a company will usually combine labour market internalisation and externalisation depending on its particular needs. For instance, for jobs that do not require any firm-specific skills, and therefore no additional internal training, tapping the external labour market can be more preferable. In contrast, a core of jobs that needs to be carried out by employees with firm-specific training will require more committed relationships that external markets cannot provide.

However, the external institutional constraints mentioned here can be sufficient to determine whether a system as a whole creates pressures towards one direction or another. Thus, industrial relations systems can generally be dichotomised between those where labour market internalisation and employment commitment prevail, and those where external markets and lack of commitment are most common. The mechanics of the former type of system pull corporate governance towards what can be called “labour-oriented” managerialism, where a coalition between managers and employees constitutes the most important source of decision-making power. The latter type of industrial relations system can better sustain and be sustained by a more outside shareholder-oriented governance model.

**Macroeconomic Structure: Competition Policy and Effective Demand**

The important role of competition as a determinant of managerial choice and performance has been widely recognised in the literature on corporate governance and the theory of the firm. For instance, Gilson and Roe (1993: 891-895) state that
"the most elegant monitoring mechanism is intense product market competition". Firstly, as already mentioned in section 1.3.2 above, according to the neo-classical model the existence of perfectly competitive markets can be sufficient to ensure that the profit-maximisation hypothesis applies. The threat of bankruptcy is more imminent where competition is fierce. In a classic formal examination of the relationship between competition and managerial discipline, Hart (1983) has shown that competition *per se* is negatively related to managerial slack. Similarly, Mayer (1997) claims that the degree of product market competition may function as a control over management decisions in that it provides clear performance benchmarks and "swift retribution for erring managers."

However, Jensen (1993: 850) believes that the role of product market competition has been overstated. While he recognises its potential effect, he only sees it as a mechanism of last resort, since, he claims, not only is it a slow constraining force but also a weak one if all competitors incur agency costs. Nevertheless, according to managerial theory, where managers are not fully constrained, firms will primarily pursue growth, and since the pursuit of growth usually translates into sales maximisation, managerial firms will compete for market share and, thus, the presence of agency costs becomes of little relevance. This point has been emphasised by Odagiri who views competition as complementary to the growth maximization objective and, therefore, not merely confined to its neoclassical conception. However, to be sustainable, this type of competition requires either the continuous

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117 See also Fama (1980).
118 See Odagiri (1992: 316) claiming that for managers to feel the pressure of product markets competition does not necessarily have to be based on output prices.
increase of existing markets' capacity or the penetration and, if possible, the creation of new markets usually through innovation.\footnote{119}

At first sight this may seem as if managerial discretion can co-exist with strong competition. However, a closer look reveals that, if Odagiri's product market conditions are met, one ends up with something approximating the marginal situation described in section 1.3.2 where growth maximisation is proportional to profit maximisation. This is precisely Kester's view:

So long as growth opportunities were abundant and product and factor market rivalry was fierce, corporate managers were likely to deploy resources in a highly disciplined way. High rates of real growth, moreover, can do much to attenuate disputes among corporate stakeholders by relieving pressures to compare one [company's] gains to those of another from a zero-sum perspective... [Outside Shareholders] may tolerate agency costs associated with the separation of ownership from control ... if the offsetting gains from bearing such costs are greater efficiency in production arising from higher levels of relationship-specific investment and substantially reduced transaction costs arising from a greater use of flexible, implicit contracts; the mitigation of hazards associated with relationship-specific investment; reliance on non-legal dispute resolution techniques instead of costly legal adjudication; and so forth. (Kester 1996: 127)

However, the above statement contains a contradiction: if managerial discretion leads to greater efficiency in production, the issue of agency costs is irrelevant not because shareholders "tolerate" it, but because it simply does not arise. In other words, managerialism is an efficient corporate system.

The difference between Odagiri's competitive model and that of Hart seems to be that the former is associated with relatively high growth rates of market capacity without which excessive discretionary cash flows would accumulate, whereas the

\footnote{119 This in effect constitutes a type of Schumpeterian competition based on continuous product, technological and organisational innovation in a process of "creative destruction". (Schumpeter 1942: 84). This has led some economists to talk about a tradeoff between the neoclassical static efficiency and the Schumpeterian dynamic efficiency (Nelson and Winter 1982: ch.14; Klein 1977). However, commenting on neoclassical and Schumpeterian competition, Langlois (1986: 11-12). claims that in fact the distinction is not between two different forms of competition but between two views of it; one that sees competition as a state of affairs and another that regards it as a process.}
latter is a model that simply concentrates on the competitive allocation of resources according to a given or perhaps low rate of market growth. Indeed, expanding market capacity and new market creation, the ability of firms to increase the scale and scope of their operations, have been fundamental elements in Chandler’s story about the success of managerial capitalism (Chandler 1990). Chandler’s account is also consistent with other theoretical studies presenting a causal link between innovation and large oligopolistic firms.120

Given these theoretical insights into the role of competition as a factor constraining managerial slack, institutional arrangements that determine the structure of product markets as well as the nature and effects of competition can have a significant influence on corporate governance.121 While competition policy usually has a narrow meaning that merely comprises antitrust regulation,122 here the term is defined more broadly in order to encompass all those institutions that shape the nature of competition as a determinant of corporate governance. Such institutions can vary from express or implied cartel agreements between firms and antitrust regulation to export and import barriers. By defining the structure of product markets, all these institutions determine the competitive conditions within national borders as well as outside of them.

The main purpose of cartel agreements is to insulate firms from the effects of competition either between them or from potential rivals. Of course, the extent, structure and sustainability of cartels fluctuate according to the wishes of participating companies as well as the influence of other institutions. For instance, a

120 See Fisher and Temin (1973), claiming that large firms tend to innovate more that small ones.
121 See Demsetz (1974) on the important role of legal institutions in determining competition and market structure.
122 Hoekman and Kostecki (1995: 252) define competition policy as 'the set of rules and disciplines maintained by governments relating either to agreements between firms that restrict competition or the abuse of dominant position.'
cartel may be a loose agreement establishing rules for production quotas and prices in order to control the price mechanism and shift competition to other functions such as innovation. Such an arrangement is inherently vulnerable to unilateral opportunism, especially if the individual firm's benefits from breaching the agreement are larger than the costs of rival retaliation. However, a cartel may also be more rigid and stable by including formal and often state-supported governance structures and enforcement mechanisms or even the exchange of shareholdings and company board members, something that has the effect of increasing the costs of breaching the agreement and thus ensuring its stability. In sum, cartelisation can be seen as a mechanism of avoiding the effect of "neoclassical" competition. Moreover, due to the co-operative nature of inter-firm relations where markets are dominated by cartels and cartel-like agreements, hostile takeovers cannot be expected to occur. This is especially so where cooperative relationships crystallise as cross-shareholding arrangements which are a form of stable and committed ownership with minimal financial expectations in terms of distributed profits. For these reasons, different forms of cartelisation can constitute a classic tool of managerial entrenchment.

However, the ability of corporations to create anti-competitive agreements depends heavily on whether antitrust regulation is permissive or not (Whitley 1999: 18; Chandler 1990: 71-78). Where there are strict regulations prohibiting anti-competitive practices, cooperative relationships between firms are difficult to establish or maintain and, as a result, the possibility of managerial insulation from either product or stock market control mechanisms is reduced. In contrast, if competition regulation does not prevent or even supports cartelisation then, obviously, one could not easily expect that product market conditions will provide serious constraints on managerial discretion. Of course, this will also depend on the
growth potential of product markets since, where Odagiri’s competitive conditions are met, the impact of anti-trust regulation becomes less relevant.

In order for this latter “expansionist” competitive model to operate, however, institutional arrangements must at least not restrict the growth potential of product markets. For instance, where trade barriers of any sort and at any level segregate or restrain markets, to the extent that this is not offset by innovation the growth preference of managerial firms will create a tendency towards overcapacity and inefficiency. In other words, market share maximisation will be negatively related to the profit maximisation objective as firms will have to grow against each other with the obvious consequence being destructive price wars or cartelisation without the element of innovation competition.

Thus, managerialism can lead to better results only where institutional sets facilitate or promote the expansion of existing markets or the creation of new ones. In Keynesian terms, managerialist growth preference can be sustainable and indeed lead to increasing welfare only where there is sufficient *effective demand* to absorb growing output. For this reason, financial systems that have a tendency to insulate managers from the direct or indirect control of shareholders seeking profit maximisation can operate better with institutional macro-level arrangements that guarantee growing demand. Where this type of complementarity exists managerial discretion has positive effects since managers’ interests tend to coincide with those of all stakeholders amalgamated in the corporate interest as defined in section 1.3.3 above (pp.55-56). In the opposite case where this coincidence of interests does not hold, managerial discretion turns into slack because managers will be able to abuse of
the firm's resources according to their own free will and for their own benefit. 123

Thus, where, for example, trade barriers are significant, or where macro-economic policy cannot guarantee that effective demand is sufficient, strict anti-trust rules and efficient capital markets may be necessary to ensure that product market competition as well as direct or indirect shareholder monitoring provide sufficient constraints on managerial slack. 124

Finally, complementarities also exist between competition and industrial relations. As discussed above, a system that contains incentives for labour market internalisation can only be sustainable in the long term if there is sufficient corporate growth potential. It is due to this inherent growth-maximisation bias in this type of industrial relations system, that the market/demand growth factor described here becomes a crucial variable if managerial corporate resource allocation is to be efficient.

1.4.3. Efficiency, 'Workability' and Institutional Complementarity

The analysis so far has demonstrated the significant role of institutional contexts in determining corporate governance, as their function is to regulate transaction and agency costs. Generally, where institutional sets as a whole have the effect of reducing overall transaction costs for economic actors the effect is that corporate governance is more efficient. Outside the theoretical laboratory, where uncertainty and bounded rationality are the norm due to market imperfections, it is

123 This is the situation feared by Jensen when he dismisses managerialism altogether. See Jensen (2001) and supra. note 55 and text.
124 Whether this is practicably feasible, however, is questionable for the same reasons that a Coasean transaction cost-free market is far from a real one.
difficult to imagine an institutional system that is Pareto-optimal. For example, the market-based system relies heavily on the efficient market for corporate control hypothesis which, as already mentioned, cannot hold in its absolute form. So some inefficiencies, such as agency costs or shareholder rent extraction, will unavoidably accrue; e.g. where the market for corporate control is not perfect either managers can abuse their discretion or uncommitted and thus imperfectly informed shareholders may be given too much influence which they can use to extract present cash-flows that could otherwise be invested in projects that would maximise profitability and growth in the long term. Of course, as already noted, neoclassical theory does not distinguish between short-term and long-term profitability. However, this distinction is very real where markets are imperfect. Hence, one should expect that in this type of corporate governance system inherent inefficiencies will tend to translate into short-termism and under-investment due to (institutional) investor pressure for maximisation of short-term returns (Bushee 1999; Laverty 1996; Jacobs 1991; Lowenstein 1988). Similarly, as the insider model relies on the power of banks, large shareholders and employees for the control of managerial decision-making, outsiders such as small minority shareholders may become the expropriated party. This is because insiders will usually have expectations that go beyond the maximisation of current shareholder financial returns and will use their informational advantage to extract private rents to the detriment of outside shareholders (Bebcuck and Zingales 1996; Shleifer and Vishny 1986).

It is due to such unavoidable externalities which are endemic in either system that a Pareto-optimal equilibrium is not realistically achievable. Although some corporate governance institutions may be efficient others are not, so that at least some stakeholders are bound lose out while others gain. What is realistically possible,
however, is to establish an institutional system that is near-efficient, in the sense that transaction costs are relatively limited, as institutional inefficiencies are largely offset by efficiencies. In order to describe this characteristic of a corporate governance system, Schmidt (1997) uses the term 'workability' which implies that, although a system is sub-optimal, as a whole, stakeholders' transaction costs are relatively low and, therefore, there is a better welfare result in comparison to other systems where transaction costs are relatively high. This gives workable systems a 'comparative institutional advantage' against those corporate governance systems which are unworkable (Soskice 1999: 102).

Regarding the workability of a corporate governance system the concept of institutional complementarity is crucial. As the above discussion has demonstrated, institutions in one subsystem are only operable if institutional configurations in other subsystems are compatible. For instance, due to its dependence on employer and employee commitment, labour market internalisation cannot be sustainable in the long term if shareholders are uncommitted and have a short-term market value orientation. Employees will be unwilling and employers will be unable to commit themselves to stable relationships between them; otherwise hostile takeovers, direct shareholder intervention or a combination of both would result in inefficient wealth transfers to the shareholders. Thus, a market-oriented financial system, especially if it is dominated by institutional investors, can only be compatible with well-developed external labour markets combined with a good general training system ensuring that the workforce acquires the necessary skills. Moreover, product markets must not be dominated by monopolies or oligopolies, as the ensuing cooperative relations between firms would distort the disciplinary effect of the market for corporate control.

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125 Of course, as North (1990: 109) claims, the gap between 'better' and 'efficient' outcomes is still vast.
and of price competition on managers. Where one of these three complementary institutional elements is missing, the whole system of corporate governance will be incoherent and thus create a comparative institutional disadvantage with obvious negative effects on corporate performance and general welfare.

In sum, two general workable equilibria can be identified corresponding to the two main theoretical visions of the firm outlined above. The first is an outsider model of corporate governance which relies on a market-based financial system with powerful institutional shareholders enhancing stock market efficiency, on flexible labour markets, on a good training system, and on a strict competition policy regime that prevents managers from forming inter-corporate alliances to insulate themselves from the market for corporate control discipline. The strong limitations on managerial discretion and, therefore, on the firm growth propensity imposed by this model make it particularly suitable for macro-economic conditions characterised by relatively slowly expanding markets where effective demand is low relative to production output. The availability of the exit option in both the labour and the financial markets makes the system relatively flexible so as to accommodate price competition by allowing or even encouraging rapid and radical cost-cutting and restructuring strategies of firms. That is, in the outside shareholder-oriented system the emphasis is on flexible arm’s length, market-based transactions, so that the firm tends to lose its organisational nature and resemble the nexus-of-contracts model developed by Alchian and Demsetz or Jensen and Meckling. In accordance with the old tradition of nominalism, as the firm’s entity disappears, its assets, i.e. what remains after all

126 The term equilibrium is qualified by the word ‘workable’ in order to differentiate from the Pareto-optimal equilibrium. See below.
127 See Cunningham (1999) at 1144 emphasising the flexibility and adaptability of the outside shareholder model.
contractual obligations are met, become the property of the shareholders to whom managers should be directly accountable.

The second workable equilibrium is an insider or outsider model based on enhanced managerial discretion, and which comprises a financial system that enhances long-term commitment between financial and productive capital, an industrial relations system that facilitates labour market internalisation by providing formal and informal mechanisms for cooperation and conflict resolution between employers and employees, and a competition policy regime that allows inter-firm competition on the basis of technological and organisational innovation as opposed to output prices. As already mentioned, the workability of this system relies heavily on expanding markets and effective demand that is sufficient to absorb the relatively higher growth of output. The restrictions imposed on the exit option for stakeholders limit the cost-cutting and restructuring potential of firms and the ability of the model to withstand slow macro-economic growth and severe price competition. Moreover, free from shareholder domination the emphasis in this manager-dominated model is on organisation building as there is a tendency to remove transactions from the market and place them within the firm as a governance hierarchy. Assets such as excess cash flow can be generated that are externally redeployable but nevertheless stay in the firm as corporate property to be invested internally. Moreover, other firm-specific assets, such as organisational commitment and know-how, are also created that are not externally redeployable because they tend lose their value outside the firm. In this fashion, the firm resembles the entity of corporate realism which is not identified with its shareholders but is itself an owner and controller of its assets.

The two models outlined here, the managerial and the shareholder-oriented, are both workable as combinations of complementary institutional sub-systems. This
has led several contemporary observers to put forward the “equal fitness” argument, i.e. that at any time or place the adoption of either model is a corporate governance choice that is equally competitive – though not pareto-optimal. This point will be taken up and elaborated on in section 2.4 below. For now, however, it is sufficient to state that the equal competitive fitness claim is neither theoretically nor empirically sustainable. From a theoretical perspective, the fact that the two models are workable only within specific macroeconomic conditions that are different for each model – one relies on higher effective demand and growth conditions than the other – renders comparison between them solely at a micro-level misleading. Their competitive fitness can be empirically tested only if the two models are placed within the same macroeconomic environment. But this would again lead to pre-determined and thus distorted results because the macroeconomic component of one workable model would be altered and would therefore render it automatically unworkable and inferior. So instead of treating the managerial and shareholder corporate governance systems are equally fit, one should regard each of them as fit only within its appropriate macroeconomic context.

1.5. THE NATIONAL DIMENSIONS OF CORPORATE GOVERNANCE

So far, either expressly or impliedly, this paper has placed its focus on systemic differences that exist at national level. This constitutes a de facto recognition that an institutional system’s dimensions are determined by national borders. While this is normal practice in comparative institutional analysis, it is somewhat arbitrary. Therefore, it would be necessary to elaborate on the idea that the basic point of
reference for institutional systems should be the state. To put it differently, one has to explain why national models of corporate governance arise as distinct and homogenous units of analysis.

The key here is the concept of isomorphism which Hawley (1968: 328-337) defines as “a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions.” To understand what drives isomorphism in corporate governance one has to begin with examining the environmental forces that shape the nature and behaviour of firms. Firstly, the use of the word “constrain” in Hawley’s definition can be perceived as a direct reference to institutional factors such as those described above. When these forces are common among a number of firms, then it is clear that organisational similarities will arise. So, existing and new firms who place themselves under the umbrella of a particular institutional context automatically acquire several common characteristics, the elements of a particular governance model, so as to constitute a recognisable group. This mechanism of institutional determination is what DiMaggio and Powell (1991: 68) term “coercive isomorphism”.

Secondly, a governance model can be promoted through imitation as some firms, due to their own incapacity to innovate, model themselves by adopting the organisational innovations of others who appear more successful or compatible with the common institutional environment. DiMaggio and Powell (ibid. at 69) call this “mimetic isomorphism”. It is important to emphasise that in this process, competitive or co-operative interaction between firms is crucial for the dissemination of organisational know-how. This means that mimetic isomorphism is more intense within a single marketplace. Since it is constraints, such as trade barriers, capital

Admittedly, from a political science perspective there is a great definitional difference between a state and a nation. However, for the purposes of this thesis the two terms will be regarded as equivalent.
controls, currency differences, that to a great extent determine the boundaries of markets, the influence of institutional factors is once again very significant.\textsuperscript{129}

Thus, it is shared institutional systems that, by promoting homogeneity in organisational structures, make firms not only look similar but also follow similar evolutionary paths so that generalisations about a model’s evolution are possible.\textsuperscript{130} Thus, the boundaries of a corporate governance model are broadly defined by the economic area that falls within the influence of an individual institutional structure.

Given the above considerations, to make the standard link between corporate governance models and states one has to establish that the boundaries of institutional sets tend to coincide with national boundaries. In a world where national governments constitute the central “producers” of institutions this is not a particularly difficult link to establish. Certainly, private organisations are also important either as suppliers of institutions, such as contractual agreements, or as bargaining parties in political processes. However, so long as the legal system, as the core of an institutional framework, is the result of national government action, the coincidence between the boundaries of institutional systems and national territory should remain strong. So, coercive isomorphism is more intense within national borders due to the existence of national laws that are uniformly applied. Similarly, mimetic isomorphism is also more intense within national borders due to the higher interaction between agents within a national marketplace. Thus, the more nationally determined institutional sets are, the more firms within each national market will tend to acquire those similar characteristics that differentiate them from foreign firms so that corporate governance models remain nationally embedded. In this case, competition remains national and therefore institutional differences between national systems lose their relevance. At

\textsuperscript{129} Of course, this does not mean that the influence of geographical and other factors is not important here.
\textsuperscript{130} The complex issue of institutional evolution will be discussed more extensively in chapter 2.
least in theory, so long a system is workable, institutional differences between different countries will have no effect and multiple nationally determined institutional equilibria can exist simultaneously.

Logically this leaves open the possibility that differences in national corporate governance systems can become important if institutional barriers segregating national markets are removed. In this case, as firms actively or passively detach themselves from national institutional environments, the mechanisms of isomorphism lose their national character. This results in competition between corporate governance models within a common economic context and thus places the competitive fitness arguments outlined above at the centre of the study of corporate governance. This possibility along with its consequences will be further pursued and developed in the remaining chapters.
CHAPTER 2
GLOBALISATION AND NATIONAL CORPORATE GOVERNANCE SYSTEMS: THE DYNAMICS OF INSTITUTIONAL DIVERSITY AND CONVERGENCE

2.1 INTRODUCTION: CONCEPTUAL ISSUES AND CHAPTER OUTLINE

Having established that within one (national) marketplace common institutional constraints can subject otherwise diverse firms to the forces of isomorphism, the purpose of this chapter is to examine the interaction between globalisation and national institutional structures determining corporate governance. Before doing so, however, some conceptual clarifications are essential.

Since 1983, when Levitt (1983: 92) used it for the first time, the term "globalisation" has become a popular buzzword that has appeared in countless texts. Nonetheless, it remains one of the most obscurely defined words despite numerous efforts to explain its meaning. This definitional problem is further aggravated by the lack of consensus even about the nature of globalisation as some regard it as a theory, others as a historical epoch or new paradigm, and others as a process (Reich 1998).

In this study the latter view is adopted, as it seems to be the most accurate for a number of reasons. Firstly, globalisation cannot be a theory because it does not contain and prove any hypotheses that would help us understand or explain any phenomenon. On the contrary, it is itself that requires a theory or theories to explain it as a socio-economic phenomenon. Secondly, globalisation cannot be regarded as a specific historical epoch or a new paradigm, because as the following section will show, it is a phenomenon that has occurred on at least two different occasions and it can also be reversed as well as reoccur in the future. Finally, the grammatical ending
of the word itself signifies that it is a process rather than a static state of affairs. Globalisation should therefore be distinguished from the term "globalism". As Rosenau observes:

Globalisation is not the same as globalism, which points to aspirations for an end state of affairs wherein values are shared by or pertinent to all the world's five billion people, their environment, their roles as citizens, consumers or producers with an interest in collective action designed to solve common problems. (Rosenau 1996: 3-4, emphasis added)

The term should also be distinguished from the process of internationalisation. This term, which is also a process, contains the word "nation" as one of its main ingredients whereas globalisation does not. This is because internationalisation describes a world of nations which increasingly act and interact with each other as separate and autonomous units, either directly or through their citizens. Globalisation on the other hand, does not contain this national element. This is because it is a view of the world in which national units are going through a process of becoming increasingly integrated, until they eventually disappear as separate entities and are replaced by the holistic state of affairs that globalism describes; that is, globalisation contains the element of loss of national (economic) autonomy. However, internationalisation and globalisation are processes that are closely linked with each other, because, as it will be shown below, the former can ultimately lead to the latter. That is, increasing international activity and interaction can cause and promote global integration. This perhaps explains why the two terms are often used interchangeably. However, the concepts of "globalism" and "internationalism", as the outcomes of globalisation and internationalisation respectively, must be regarded as mutually exclusive.

131 On the distinction between an "inter-nationalised" and a "globalised" world economy see Hirst and Thompson (1999: 140-141).
Certainly, the facets of internationalisation and globalisation are extremely complex and diverse since they reflect the complexity and diversity of all aspects of human activity. Without rejecting the significance of all other aspects of the two processes, this study focuses only on the economic activities that nations and the agents operating within and without them undertake. There are two reasons for this, one practical and one contextual. Firstly, the limited space of a Ph.D. thesis does not allow for the detailed consideration of all aspects of globalisation, i.e. economic, cultural, political, etc. Secondly and most importantly, in the field of corporate governance economic factors are by far the most dominant in the creation of determinant institutions such as those analysed in the preceding chapter.

Since globalisation is a process rather than a static state of affairs, in this chapter the analysis of corporate governance institutions will be predominantly dynamic. The hypothesis presented is that as a global market emerges shared institutional constraints therein can give rise to identifiable forces of global corporate governance isomorphism which interact with those created by national institutional systems as defined in chapter 1 above. After a brief account of the key facts and figures of economic globalisation, sections 2.3 will attempt to assess the macroeconomic and microeconomic implications of the phenomenon in order to determine the emerging dynamics as sources of change in corporate governance institutions. It will be argued that, through a process characterised by increasing direct and indirect competitive interaction between national institutional frameworks, these dynamics create pressures that are not favourable to managerial governance models, especially those which rely on insider relationships. In the increasingly liberal economic environment of the current globalisation wave, the strengths of managerial models not only wane but also become sources of inefficiency. The globalisation of
finance, trade and production are conducive to corporate governance arrangements that favour outside shareholders over other stakeholders without, however, resolving the inefficiencies that result from market imperfections.

Section 2.4 will then turn to examine the potential dynamic responses of national corporate governance systems as determined by the latter's internal institutional forces. For completeness purposes, two paradigms will be discussed: one that adopts the neoclassical postulations of perfect markets and zero transaction costs, and one that includes market imperfections. It will be argued that the more realistic analysis within the latter theoretical paradigm leads to two possible responses of corporate governance systems: global convergence towards an inferior outside shareholder model or persistent diversity with equally inferior systems co-existing within a global macroeconomic context which is unfavourable to growth. Since the final outcome of any responses of corporate governance systems will depend on their internal dynamics, only case-by-case empirical studies can produce conclusive results about the direction of global corporate governance. Such evidence will be gathered and interpreted in chapter 3 below from the German corporate governance system.

2.2. KEY FACTS AND DATA OF ECONOMIC GLOBALISATION

2.2.1. The First Internationalisation-Globalisation Wave and Its Collapse

The academic and popular literature on current economic affairs confers a common impression that the current wave of globalisation, which began after the end of World War II, is an unprecedented phenomenon. However, an overview of
economic history shows that what the world has been experiencing during the last few decades is not unprecedented. In fact, it seems that to a certain extent history is repeating itself one century after the previous globalisation wave of the early 1900s, which eventually ended with the Great Depression and the return to protectionism in the 1930s. Among those observers who have studied world economic trends from this perspective Baldwin and Martin (1999) have presented evidence showing that, in some respects, global economic integration was more intense a century ago that it has been until relatively recently.

For instance, in the 1860s and 1870s numerous predominantly bilateral treaties established a largely liberal international trade regime. Although there was a reversal of trade liberalisation between developed countries in the last two decades of the 19th century by 1910 world trade as a proportion of GDP was impressively high with the only exception being the US (see Tables 2.1 and 2.2). Generally, the trend was for developing countries to specialise in exports of raw materials and imports of manufactures, while developed countries followed the opposite pattern (Bairoch and Kozul-Wright 1996).

Table 2.1. Total Trade as a Percentage of GDP for Selected Developed Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>circa 1870</th>
<th>circa 1910</th>
<th>circa 1950</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>41</td>
<td>44</td>
<td>30</td>
<td>57</td>
</tr>
<tr>
<td>France</td>
<td>33</td>
<td>35</td>
<td>23</td>
<td>43</td>
</tr>
<tr>
<td>Germany</td>
<td>37</td>
<td>38</td>
<td>27</td>
<td>46</td>
</tr>
<tr>
<td>Italy</td>
<td>21</td>
<td>28</td>
<td>21</td>
<td>49</td>
</tr>
<tr>
<td>Denmark</td>
<td>52</td>
<td>69</td>
<td>53</td>
<td>64</td>
</tr>
<tr>
<td>Norway</td>
<td>56</td>
<td>69</td>
<td>77</td>
<td>71</td>
</tr>
<tr>
<td>Sweden</td>
<td>28</td>
<td>40</td>
<td>30</td>
<td>77</td>
</tr>
<tr>
<td>US</td>
<td>14</td>
<td>11</td>
<td>9</td>
<td>24</td>
</tr>
<tr>
<td>Canada</td>
<td>30</td>
<td>30</td>
<td>37</td>
<td>71</td>
</tr>
<tr>
<td>Australia</td>
<td>40</td>
<td>39</td>
<td>37</td>
<td>40</td>
</tr>
<tr>
<td>Japan</td>
<td>10</td>
<td>30</td>
<td>19</td>
<td>17</td>
</tr>
</tbody>
</table>

Source: Baldwin and Martin (1999), Table 11.
Table 2.2. Merchandise Exports as a Percentage of GDP (Three Year Annual Average, except for 1950)

<table>
<thead>
<tr>
<th>Western Developed Countries*</th>
<th>US</th>
<th>W. Europe</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1870 n.a.</td>
<td>5.4</td>
<td>13.6</td>
<td>n.a.</td>
</tr>
<tr>
<td>1890 11.7</td>
<td>6.7</td>
<td>14.9</td>
<td>5.1</td>
</tr>
<tr>
<td>1913 12.9</td>
<td>6.4</td>
<td>18.3</td>
<td>12.5</td>
</tr>
<tr>
<td>1929 9.8</td>
<td>5.0</td>
<td>14.5</td>
<td>13.6</td>
</tr>
<tr>
<td>1938 6.2</td>
<td>3.7</td>
<td>7.1</td>
<td>13.0</td>
</tr>
<tr>
<td>1950 7.8</td>
<td>3.8</td>
<td>13.4</td>
<td>6.8</td>
</tr>
<tr>
<td>1970 10.2</td>
<td>4.0</td>
<td>17.4</td>
<td>9.7</td>
</tr>
<tr>
<td>1992 14.3</td>
<td>7.5</td>
<td>21.7</td>
<td>8.8</td>
</tr>
</tbody>
</table>

* Western Europe (excl. Yugoslavia), US, Canada, Australia, New Zealand and Japan.


Moreover, much of that trade was intra-firm trade, i.e. trade occurring within a single firm comprised of a parent and its foreign and domestic subsidiaries, as foreign direct investment (FDI) grew significantly during the pre-World War I era accounting for one third of total foreign investment flows and over 9 per cent of world output as of 1913 (ibid.). Most of these high FDI levels resulted either directly or indirectly from firms’ efforts to gain access and exploit natural resources in developing countries. However, FDI flows towards developed countries, albeit fewer than those directed to developing countries, were often in the manufacturing sector therein, mainly as a result of rising tariffs around the 1900s (Kenwood and Lougheed 1994: at 35). As Dunning (1983) reports, in 1914, 55 percent of the FDI stock was in the primary product sector, 20 percent in railroads (a sector linked to natural resources exploitation), 15 percent in manufacturing and only 10 percent in services. Cross-border financial flows were also exceptionally large during the first globalisation

132 On the theoretical explanations of FDI see infra. section 2.3.2.
133 While the distinction between FDI and pure financial (portfolio) flows is not always clear, there seems to be a general understanding that the former contain an element of long-term control over the investment which the latter do not. UNCTAD defines FDI as “an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign
wave, indicating that financial markets were highly integrated. Generally, as Table 2.3 shows, global capital mobility for several major countries measured by the absolute value of the average current account to GDP ratios reached particularly high levels during the pre-World War I years.

A major contributing factor was the institutional environment that was provided by the "Gold-Sterling Standard" as a fixed exchange rate system of that era. That was a monetary system where most cross-border transactions were denominated in sterling as a world currency based on direct convertibility into gold. The hegemonic role of Victorian Britain as an enforcer of Pax Britannica and the position of the City of London as the world’s clearing house were instrumental for the sustainability of the system (Ingham 1994: 32-39). Although Britain ran a trade-balance deficit, the proceeds from the City’s financial activity and the large inflows of short-term capital maintained a significant balance-of-payments surplus which supported the world’s main currency (ibid.). In this environment capital flows grew rapidly seeking the highest returns mainly from long-term investments in railways, infrastructure, and industry (Baldwin and Martin 1999: 16-21). The Gold-Sterling standard was more of an international than a global system. As Ingham observes, while it was not planned, it was the creation of complementary state and private strategies pursuing separate interests that existed in Britain during the 19th century (Ingham 1994: 38).

direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)" (UNCTAD 1999: Annex B at 465).
Table 2.3. Capital Flows 1870-1996 (Average Absolute Value of Current Account as Percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>US</th>
<th>CAN</th>
<th>FRA</th>
<th>GER</th>
<th>ITA</th>
<th>JPN</th>
<th>ARG</th>
<th>DNK</th>
<th>NOR</th>
<th>SWE</th>
<th>AUS</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>1870-1889</td>
<td>4.6</td>
<td>0.7</td>
<td>7.0</td>
<td>2.4</td>
<td>1.7</td>
<td>1.2</td>
<td>0.6</td>
<td>18.7</td>
<td>1.9</td>
<td>1.6</td>
<td>3.2</td>
<td>8.2</td>
<td>3.7</td>
</tr>
<tr>
<td>1890-1913</td>
<td>4.6</td>
<td>1.0</td>
<td>7.0</td>
<td>1.3</td>
<td>1.5</td>
<td>1.8</td>
<td>2.4</td>
<td>6.2</td>
<td>2.9</td>
<td>4.2</td>
<td>2.3</td>
<td>4.1</td>
<td>3.3</td>
</tr>
<tr>
<td>1919-1926</td>
<td>2.7</td>
<td>1.7</td>
<td>2.5</td>
<td>2.8</td>
<td>2.4</td>
<td>4.2</td>
<td>2.1</td>
<td>4.9</td>
<td>1.2</td>
<td>4.9</td>
<td>2.0</td>
<td>4.2</td>
<td>3.1</td>
</tr>
<tr>
<td>1927-1931</td>
<td>1.9</td>
<td>0.7</td>
<td>2.7</td>
<td>1.4</td>
<td>2.0</td>
<td>1.5</td>
<td>0.6</td>
<td>3.7</td>
<td>0.7</td>
<td>2.0</td>
<td>1.8</td>
<td>5.9</td>
<td>2.1</td>
</tr>
<tr>
<td>1932-1939</td>
<td>1.1</td>
<td>0.4</td>
<td>2.6</td>
<td>1.0</td>
<td>0.6</td>
<td>0.7</td>
<td>1.0</td>
<td>1.6</td>
<td>0.8</td>
<td>1.1</td>
<td>1.5</td>
<td>1.7</td>
<td>1.2</td>
</tr>
<tr>
<td>1947-1959</td>
<td>1.2</td>
<td>0.6</td>
<td>2.3</td>
<td>1.5</td>
<td>2.0</td>
<td>1.4</td>
<td>1.3</td>
<td>2.3</td>
<td>1.4</td>
<td>3.1</td>
<td>1.1</td>
<td>3.4</td>
<td>1.8</td>
</tr>
<tr>
<td>1960-1973</td>
<td>0.8</td>
<td>0.5</td>
<td>1.2</td>
<td>0.6</td>
<td>1.0</td>
<td>2.1</td>
<td>1.0</td>
<td>1.9</td>
<td>2.4</td>
<td>0.7</td>
<td>2.3</td>
<td>1.3</td>
<td>1.8</td>
</tr>
<tr>
<td>1974-1989</td>
<td>1.5</td>
<td>1.4</td>
<td>1.7</td>
<td>0.8</td>
<td>2.1</td>
<td>1.3</td>
<td>1.8</td>
<td>1.9</td>
<td>3.2</td>
<td>5.2</td>
<td>1.5</td>
<td>3.6</td>
<td>2.2</td>
</tr>
<tr>
<td>1989-1996</td>
<td>2.6</td>
<td>1.2</td>
<td>4.0</td>
<td>0.7</td>
<td>2.7</td>
<td>1.6</td>
<td>2.1</td>
<td>2.0</td>
<td>1.8</td>
<td>2.9</td>
<td>2.0</td>
<td>4.5</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: Obstfeld and Taylor (1997), Table 2.1.

However, after the devastation of World War I the international system was destabilised and gradually abandoned in favour of a floating exchange rate regime. An attempt by the British government to re-join the Gold Standard in 1926 was doomed to failure because Britain’s loss of its hegemonic role, due to its continuous economic decline and increasing trade deficit, made fixing sterling at its pre-World War I parity unsustainable. In the absence of a stable management regime, the world monetary system was flooded with speculative financial flows which stifled economic growth and challenged governments’ efforts to control exchange parities. In effect, there was a passage from an managed international system to a denationalised global disorder. Eventually, the Great Depression of 1929 and the sterling’s departure from its peg in 1931 signified the violent end not only of the Gold-Sterling standard but also of the first globalisation wave. Nations turned to protectionism and the imposition of capital controls in their hope to regain their autonomy from global financial markets and solve their huge socio-economic problems (see Tables 2.2 and 2.3 above).\(^{134}\)

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\(^{134}\) For an overview of the events see Obstfeld and Taylor (1997).
2.2.2. From Post-War Internationalisation to Contemporary Globalisation

After the brief account of the pre-War World War I events above this section will now seek to provide a more detailed description of economic developments in world markets during the second half of the 20th century. It will be shown how international cooperation at the end of World War II led to the institutionalisation of an international regime for capital flows and trade. It will then be argued that some flaws inherent to that economic regime led to its partial collapse and the emergence of the current globalisation process.

**Internationalisation Under the Bretton Woods-GATT Regime**

It took the devastation of a five-year long world war for powerful (winner) nations to act collectively for the establishment of an international economic order of managed world trade and finance that would undo the international trend of uncontrolled protectionism. This task was undertaken by the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire in July 1944. The major figures at the convention were Harry Dexter White and John Maynard Keynes, representing the US and Britain respectively, who had been developing their ambitious plans for the world economy since the early 1940s on the basis of exchange rate stability and international cooperation. There were, however, significant differences between the two sides’ proposals; White’s plan placed the emphasis on price stability, while Keynes’ primary goal was fostering economic growth. Eventually, the final set of agreements, collectively known as the Bretton Woods agreement, mostly reflected the views of the US, which had emerged from the
two wars as the largest economic and military power. Although it initially had an economy largely insulated from world markets, the US was able to be the world’s economic hegemon due to its role as the largest creditor nation with a significant balance-of-payments surplus.

Generally, the main principle underlying the Bretton Woods agreement was the promotion of free trade in goods and services but with the simultaneous imposition of restrictions on capital flows (Rajan and Zingales 2001). The world monetary system was based on a Gold-Dollar exchange standard where the American currency was fixed to gold while all other currencies were pegged to the dollar with only a very narrow margin of fluctuation. Managed currency readjustments were allowed in cases where parities were not sustainable in the long term. The management of payments difficulties by governments was to be facilitated by two international agencies, the International Monetary Fund (IMF) and the International Bank for the Reconstruction and Development (IBRD) which later became the World Bank. The former was responsible for the provision of financial relief to countries facing short-term payments difficulties and the latter’s mission was to promote and fund the long-term development of less-developed economies. Moreover, the Bretton Woods agreement legitimated the imposition of controls on capital movements that were not related to trade and most countries used this right in order to prevent speculative attacks on their currencies and retain control over their macroeconomic policies. Curbing speculation was seen as the antidote to the causes of the Gold-Sterling Standard’s collapse and of the Great Depression.

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135 To be precise, the Bretton Woods agreement simply provided for the flexible fixing of exchange rates. However, due to the dominant role of the US in the world economy the dollar emerged as the key currency for world payments (Stubbs and Underhill 1994: 151).

136 The US also created the Marshall Plan which was aimed at the reconstruction of Europe after WWII - the funding provided by the Plan by far exceeded that of the World Bank.
As regards trade, the General Agreement on Tariffs and Trade (GATT) was established independently from the Bretton Woods system in 1947 to regulate and promote the liberalisation of international trade through the reduction of tariff barriers. After consecutive rounds of renegotiations and the almost universal expansion of signatory countries over the following decades a dramatic reduction in tariff barriers was achieved and eventually the World Trade Organisation (WTO) was formed in 1995 as the main international agency regulating international trade matters. Table 2.4 summarises the effect of GATT agreements on tariff rates in manufactured products which by 2000 averaged around a mere 3.9 percent. More specifically, Figure 2.1 shows the impact of successive international negotiations on US trade, traditionally one of the most protectionist among developed countries. As a result of these reductions on tariff barriers, total cross-border trade as a percentage of GDP has now exceeded the pre-World War I levels for almost all major economies (Table 2.1 above). All this evidence indicates that with the liberalisation of world trade the globalisation of product markets has now progressed more than ever before. The creation of regional free trade areas, the most important of which are the European Union (EU), the North American Free Trade Agreement (NAFTA) and the Association of South East Asian Nations (ASEAN), have also been important contributing factors to the liberalisation of trade. Arguably, this latter type of agreements has resulted to an observable regional bias, a "triadisation", in world trade, though the opening up of regional trade blocs in recent years is gradually offsetting this effect (Ietto-Gillies et al. 1997: 99-100).
Table 2.4. Average Tariff Rates on Manufactured Products in Major economies (Percent of Value)

<table>
<thead>
<tr>
<th></th>
<th>1913</th>
<th>1950</th>
<th>1990</th>
<th>2000*</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>21</td>
<td>18</td>
<td>5.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Germany</td>
<td>20</td>
<td>26</td>
<td>5.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Italy</td>
<td>18</td>
<td>25</td>
<td>5.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Japan</td>
<td>30</td>
<td>-</td>
<td>5.3</td>
<td>3.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>15</td>
<td>11</td>
<td>5.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Sweden</td>
<td>20</td>
<td>9</td>
<td>4.4</td>
<td>3.9</td>
</tr>
<tr>
<td>Britain</td>
<td>-</td>
<td>23</td>
<td>5.9</td>
<td>3.9</td>
</tr>
<tr>
<td>United States</td>
<td>44</td>
<td>14</td>
<td>4.8</td>
<td>3.9</td>
</tr>
</tbody>
</table>

* Based on full implementation of 1994 Uruguay agreement.

Source: Hill (1998), Table 1.1.

Figure 2.1. Weighted Average US Tariff Rate After GATT Rounds (Pre-Geneva = 100)

Source: Siebert and Klodt (1999), Figure 3.

Regarding the nature of international trade the post-World War II era can be divided into two main phases. During the first, i.e. between 1959 and 1979, trade flows were mainly between developed economies with developing ones only playing a small role mostly limited to exporting primary goods. In the second phase, from 1980 onwards, developing countries increased their share of total international trade as a result of a significant increase in their role as exporters of labour-intensive
manufactured goods.\textsuperscript{137} As Baldwin and Martin (1999: 33) report, the share of manufactured goods imports from developing countries for all OECD countries rose from a mere 6 percent in 1970 to 13 percent in the late 1990s. By 1994, manufacturing exports accounted for over 66 percent of total exports from developing countries, up from just 23.5 percent in 1980 (Baker, Epstein and Pollin 1998a: 7).

Generally, the Bretton Woods-GATT regime should be characterised as international, rather than global, since it was a product of government planning and was directly instituted through international government cooperation; it was a regime created by nations for nations, who retained considerable autonomy in the formulation of their economic policies either on their own or with the help of the IMF and the World Bank. The system promoted the managed liberalisation of trade, on the one hand, but at the same time, departed from liberal orthodoxy, by restricting short-term financial flows within national borders. As Keynes himself observed:

\begin{quote}
Not merely as a feature of the transition but as a permanent arrangement, the plan accords every member government the explicit right to control all capital movements. What used to be heresy in now endorsed as orthodoxy. (reported in Moggridge 1980: 149)
\end{quote}

\textit{Current Globalisation Wave}

As it will be seen in section 2.3.1 below, the Bretton Woods-GATT system was extremely successful in promoting stability and economic growth which reached unprecedented levels for almost three decades after World War II. However, it also contained some latent flaws which eventually surfaced as the causes of the system’s final collapse. Firstly, the unilateral character of the regime with the US as its main

\textsuperscript{137} This new trend will be further explained in section 2.3.2 below.
guarantor was potentially problematic, as it meant that the perpetuation of American hegemony was necessary. Moreover, due to a failure of the negotiating parties to reach an agreement, the issue of payments imbalances was not sufficiently dealt with, despite Keynes’ assertions that the accumulation of surplus by some countries could be as detrimental for the world economic system as the accrual of deficits (Walter 1991: 154-156). The US, as a surplus country and a major creditor, did not want to compromise its advantage and pursued their ambition of bringing the international economic system under their control (Stubbs and Underhill 1994).

Ironically, the very mechanisms that the US supported in order to perpetuate its economic dominance had the opposite effect. As the European economies recovered and grew stronger, they began to challenge the US economic superiority. By the late 1950s the US balance-of-payments surplus had been eliminated and had turned into a deficit which continued to expand well into the 1960s. By 1968 the US current account also went into deficit and the first signs of a devaluation of the dollar began to appear. Growing military spending for Cold War purposes further exacerbated the problem as American competitiveness vis-à-vis other western countries and Japan eroded. The absence of a mechanism for dealing with payments imbalances proved to be the Achilles heel of the Bretton Woods system as implemented under US hegemony. The American government was then faced with a dilemma of adjusting the dollar’s parity to its real value or maintaining its status as the world’s currency.

The situation was further complicated by the fact that the strict capital controls that Keynes advocated were never fully implemented. Most importantly, the British

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138 On this issue see section 2.3.1 below on pp. 155-156.
139 Stubbs and Underhill (1994: 150-151) go as far as to claim that the Bretton Woods agreement was never fully implemented since the IMF and the World Bank were under-resourced and largely substituted by the Marshall plan so that the world economy was ultimately run by the US Treasury and the Federal Reserve.
government's aspirations to revive the role of the City as an international financial centre by allowing the operation of offshore markets dealing in dollars and other currencies gave rise to unregulated financial flows. These markets, known as the Eurodollar markets, first appeared in the 1950s and have grown enormously since then. The supply was there as the Soviet Union and other Eastern Bloc countries, fearing a blocking of dollar balances in the US in the event of hostilities, moved their overseas dollar holdings into London. Similar moves were made by other governments as well as companies engaged in international activities earning dollars. The motive for the latter was that the lack of regulation in the City's offshore markets permitted banks to pay higher rates of interest which were also not subject to the levels of taxation charged onshore (Hill 1998: 331-332). The demand was also there since American and other companies sought to finance their international operations with cheap offshore money as the lack of regulation allowed banks to charge borrowers less than they did in regulated markets (ibid). Additionally, developing countries were keen to tap this source of cheap money. Thus, by the late 1960s the value of the Eurodollar market had already grown to $40 billion from a modest $11 billion in 1964 (Martin 1994: 257). But even these amounts were dwarfed by the huge inflows of petrodollars that OPEC countries accumulated after the oil crises which in turn fueled the further growth of the Eurodollar market in the following years which reached $4.5 trillion by 1988 (Hill 1998: 330). This was truly global capital which not only existed outside national regulatory regimes but also challenged the latter's very existence since it made regulatory arbitrage possible.

The emergence of these global capital flows made exchange rate movements not only larger and more unpredictable, but increasingly uncontrollable even by the

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140 For a more extensive discussion on the emergence of the Euromarkets see Pilbeam (1998).
strongest central banks. The combination of speculative financial flows and the unsustainable parity of the dollar meant that the end of the fixed exchange rate regime was a matter of time. Indeed, in August 1971 the Nixon administration abandoned the gold-dollar standard and allowed the dollar to float. Other countries, challenged by currency speculators, soon followed the same path, so that by 1973 a new financial (dis)order of floating exchange rates was established and the Eurodollar market expanded to become the Eurocurrency market. This signified the passage from the international financial order of the first three post-war decades the current wave of globalisation.

With the availability of global finance offshore, financial and non-financial firms could easily sidestep national financial systems so that restrictions on capital movements became unsustainable as they were subjected to the pressures of arbitrage. The abolition of capital controls was therefore inevitable. The first of the major countries to lift these measures were Canada, Germany and Switzerland in 1973, who were then followed by the US in 1974, Britain in 1979 and Japan in 1980. The liberalisation of capital controls led to an explosion of short-term financial flows as a result of exchange rate speculation. The value of average daily foreign exchange transactions rose from just $10-20 billion in 1973 to $80 billion in 1980 and to the then inconceivable $1490 billion in 1998, that is about one hundred times the total value of world trade in the same year (Figure 2.2).
While foreign exchange markets now seem to be truly globalised, the globalisation of securities markets has also progressed rapidly since the 1980s with the growth of the Eurobond and Foreign bond markets, with the former accounting for the lion’s share. Just as with Eurocurrency markets, immunity from government regulation, tax advantages and adaptability to exchange rate expectations are the most attractive features of Eurobond finance for corporate and sovereign borrowers. Over the years, the market has expanded not only in volume but also in scope with the introduction of a broad range of securities instruments such as warrants, global depository receipts, international floating rate notes and Euro-commercial paper. Thus, by 2000 the total value of international debt securities’ net issues amounted to $1243.5 billion (BIS 2002). Moreover, since the demise of the Bretton Woods system a whole host of derivative financial instruments has been created for the purpose of managing investment risks resulting from floating exchange rates. As of December 2000 the gross value of over-the-counter derivative contracts was $3,183 billion (ibid.). However, the global integration of equity markets has been comparatively slow, but it has nevertheless accelerated from the mid 1980s (Ayuso and Blanco)

141 Eurobonds are bonds issued in countries other than the one in whose currency they are denominated. Foreign bonds are sold outside the issuer’s country but are denominated in currency of the countries where they are issued.

142
2000). As of 2000 the total value of cross-border equity issues was $316.7 billion (Figure 2.3). Overall, cross-border investment in securities has reached extremely high levels with its value by far exceeding most major countries’ GDP (Table 2.5).

![Figure 2.3: Value of Announced Cross-border Equity Issues (Billion Dollars)](image)

Source: BIS, BIS Quarterly Review, (several issues).

**Table 2.5. Gross purchases and sales of securities between residents and non-residents in six major OECD countries (% of GDP)**

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
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<th></th>
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<tbody>
<tr>
<td>US</td>
<td>4</td>
<td>9</td>
<td>35</td>
<td>101</td>
<td>89</td>
<td>96</td>
<td>107</td>
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<td>8</td>
<td>62</td>
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<td>65</td>
<td>84*</td>
</tr>
<tr>
<td>Germany</td>
<td>5</td>
<td>7</td>
<td>33</td>
<td>66</td>
<td>57</td>
<td>55</td>
<td>85</td>
<td>171</td>
<td>159</td>
<td>172</td>
<td>200</td>
</tr>
<tr>
<td>France</td>
<td>5</td>
<td>21</td>
<td>52</td>
<td>54</td>
<td>79</td>
<td>122</td>
<td>187</td>
<td>201</td>
<td>187</td>
<td>227**</td>
<td>200</td>
</tr>
<tr>
<td>Italy</td>
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<td>1</td>
<td>4</td>
<td>18</td>
<td>27</td>
<td>60</td>
<td>92</td>
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<td>253</td>
<td>468</td>
</tr>
<tr>
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<td>3</td>
<td>9</td>
<td>27</td>
<td>55</td>
<td>65</td>
<td>81</td>
<td>113</td>
<td>153</td>
<td>212</td>
<td>189</td>
<td>258</td>
</tr>
</tbody>
</table>

* Based on settlement data
** January-September at an annual rate
Source: BIS (1998), table V.1.

The dominant force behind global financial flows and integration are institutional investors who have been constantly increasing the share of total household assets under their control since the 1960s. The stress on pay-as-you-go
pension systems, due to a combination of higher unemployment and lower tax revenues with increasing pressures on governments to cut their spending\textsuperscript{142} and the retirement of the baby-boomer cohort during the past two decades, has produced a rising demand for retirement products managed by professional investors. Additionally, the advancement of financial deregulation since the abolition of capital controls has intensified competition in the savings business between institutional investors and banks who have now turned from savings and loans to capital market transaction fees and commissions as their main source of revenue. As a result, the growth of institutionalised holdings has seen a dramatic rise in all OECD countries, especially during the past ten years (Table 2.6). For instance, in countries such as the UK, the US and the Netherlands the value of assets managed by institutional investors is more than double the value of GDP. The OECD has estimated that in 1999 total institutional assets exceeded $37 trillion, of which about 80 percent was invested in bonds and equities (Figure 2.4).

*Table 2.6. Financial assets of institutional investors in OECD Countries (Percent of GDP)*

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>61.6</td>
<td>71.9</td>
<td>65.9</td>
<td>86.2</td>
<td>92.4</td>
<td>105.2</td>
<td>115.6</td>
<td>127.9</td>
<td>131.2</td>
</tr>
<tr>
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<td>24.1</td>
<td>28.5</td>
<td>30.4</td>
<td>35.0</td>
<td>40.3</td>
<td>47.0</td>
<td>54.6</td>
<td>68.4</td>
<td>68.4</td>
</tr>
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<td>47.2</td>
<td>57.6</td>
<td>56.0</td>
<td>58.1</td>
<td>64.5</td>
<td>73.3</td>
<td>88.1</td>
<td>101.9</td>
<td>101.9</td>
</tr>
<tr>
<td>Canada</td>
<td>68.6</td>
<td>76.8</td>
<td>80.2</td>
<td>83.1</td>
<td>92.1</td>
<td>100.3</td>
<td>108.8</td>
<td>112.7</td>
<td>111.3</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>..</td>
<td>22.8</td>
<td>17.3</td>
<td>17.8</td>
<td>21.4</td>
<td>19.0</td>
<td>16.8</td>
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<td>Denmark</td>
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<td>62.2</td>
<td>65.1</td>
<td>70.6</td>
<td>77.5</td>
<td>84.8</td>
<td>98.0</td>
<td>98.0</td>
</tr>
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<td>Finland</td>
<td>41.1</td>
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<td>49.3</td>
<td>49.6</td>
<td>61.7</td>
<td>65.6</td>
<td>77.1</td>
<td>92.1</td>
<td>92.1</td>
</tr>
<tr>
<td>France</td>
<td>61.9</td>
<td>73.9</td>
<td>71.8</td>
<td>77.7</td>
<td>86.6</td>
<td>97.0</td>
<td>107.3</td>
<td>125.4</td>
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<td>Germany</td>
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<td>38.9</td>
<td>41.3</td>
<td>45.3</td>
<td>50.6</td>
<td>58.7</td>
<td>66.1</td>
<td>76.8</td>
<td>79.7</td>
</tr>
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<td>Greece</td>
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<td>8.4</td>
<td>12.8</td>
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<td>26.6</td>
<td>29.9</td>
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<td>7.5</td>
<td>8.9</td>
<td>10.7</td>
<td>12.8</td>
</tr>
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<td>62.4</td>
<td>66.7</td>
<td>71.7</td>
<td>79.6</td>
<td>86.6</td>
<td>96.3</td>
<td>111.3</td>
<td>110.1</td>
</tr>
<tr>
<td>Italy</td>
<td>21.8</td>
<td>28.2</td>
<td>32.2</td>
<td>32.0</td>
<td>39.0</td>
<td>53.9</td>
<td>79.6</td>
<td>96.9</td>
<td>96.9</td>
</tr>
<tr>
<td>Japan</td>
<td>78.0</td>
<td>83.4</td>
<td>81.6</td>
<td>89.3</td>
<td>89.3</td>
<td>87.6</td>
<td>91.7</td>
<td>100.5</td>
<td>100.5</td>
</tr>
<tr>
<td>Korea</td>
<td>51.8</td>
<td>55.2</td>
<td>53.7</td>
<td>54.7</td>
<td>57.3</td>
<td>63.3</td>
<td>88.1</td>
<td>88.5</td>
<td>72.6</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1574.3</td>
<td>2119.1</td>
<td>1945.6</td>
<td>2020.6</td>
<td>2057.0</td>
<td>2612.7</td>
<td>3049.0</td>
<td>4172.3</td>
<td>1442</td>
</tr>
</tbody>
</table>

\textsuperscript{142} These are pressures largely created by globalisation. See *infra* section 2.3.1.
Thus, in the absence of capital controls, the growth of institutional investment has become the driver behind the globalisation of securities markets as a matter of necessity. National prudential regulations can certainly differ with some restricting global portfolio diversification more than others. Similarly, some investment products
can be specialised and thus invest in specific countries or regions. However, with the vast expansion of assets under institutional control, the globalisation of portfolios, especially for index funds, has become a necessary strategy for prudent fund managers who must now view the world as one large market.\footnote{143}

The same also holds for firms and this is indicated by the remarkable growth of FDI levels since the 1980s as an indication of the increasing role of Transnational Corporations (TNCs) in the world economy.\footnote{144} During the 1960s and 1970s the growth rate of FDI more or less followed that of exports. However, since the mid 1980s the former has accelerated dramatically so that by 1995 the world stock of FDI as a percentage of output has even exceeded the 1913 levels (Table 2.7).

| Table 2.7. Foreign Direct Investment Relative to Output, Capital Formation and Exports |
|---------------------------------|--------|--------|--------|--------|--------|
| World FDI Stock as % of World Output | 9.0    | 4.4    | 4.5    | 5.4    | 7.2    | 10.1   |
| World FDI inflows as % of World Gross Fixed Capital Formation | -      | 1.1    | 1.4    | 1.8    | 2.9    | 5.2    |
| World sales of Foreign Affiliates as % of World Exports | -      | 8.4    | 9.7    | 9.9    | 12.2   | -      |

\textit{Source:} Baker, Epstein and Pollin (1998), Table 5A.

While the overall numerical difference between the two eras is not significant (only 1.1 percent), a closer look at the quality of contemporary FDI shows that, contrary to the trends during the first globalisation wave, the vast majority of flows are now between developed countries which are the top hosts of FDI (Table 2.8). Certainly, the data in Figure 2.5 and Table 2.9 also show that FDI levels towards

\footnote{143 On international portfolio diversification by institutional investors see Davis (1991); Bartram and Dufey (2001).}

\footnote{144 On the causes and effects of TNC activity see infra. section 2.3.2.}
developing countries as a percentage of GDP, especially in South East Asia, Latin America and Central and Eastern Europe, has been growing faster than those towards developed countries in recent years. The performance of China is indeed impressive. However, this element does not signify a return to the old FDI trend of the 1900s due to a very important qualitative difference: contemporary investment in factors located in developing countries is predominantly directed to the manufacturing sector rather than primary resources. This is also reflected in the increase of manufacturing exports originating from such countries. As section 2.3.2 below shows, since the 1980s TNCs have been pursuing the reorganisation of their manufacturing production activities along global lines. Finally, since the 1990s FDI has been mostly taking place in the form of mergers and acquisitions (M&A), an issue that will also be further explored later.

Table 2.8. Leading Host Economies for FDI Based on Cumulative Inflows 1985-95

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>FDI $ Billion</th>
<th>FDI Per Capita (in US Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>477.5</td>
<td>1830</td>
</tr>
<tr>
<td>2</td>
<td>United Kingdom</td>
<td>199.6</td>
<td>3410</td>
</tr>
<tr>
<td>3</td>
<td>France</td>
<td>138.0</td>
<td>2380</td>
</tr>
<tr>
<td>4</td>
<td>China</td>
<td>130.2</td>
<td>110</td>
</tr>
<tr>
<td>5</td>
<td>Spain</td>
<td>90.9</td>
<td>2320</td>
</tr>
<tr>
<td>6</td>
<td>Belgium-Luxembourg</td>
<td>72.4</td>
<td>6900</td>
</tr>
<tr>
<td>7</td>
<td>Netherlands</td>
<td>68.1</td>
<td>4410</td>
</tr>
<tr>
<td>8</td>
<td>Australia</td>
<td>62.6</td>
<td>3470</td>
</tr>
<tr>
<td>9</td>
<td>Canada</td>
<td>60.9</td>
<td>2060</td>
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<tr>
<td>10</td>
<td>Mexico</td>
<td>44.1</td>
<td>470</td>
</tr>
<tr>
<td>11</td>
<td>Singapore</td>
<td>40.8</td>
<td>13650</td>
</tr>
<tr>
<td>12</td>
<td>Sweden</td>
<td>37.7</td>
<td>4270</td>
</tr>
<tr>
<td>13</td>
<td>Italy</td>
<td>36.3</td>
<td>630</td>
</tr>
<tr>
<td>14</td>
<td>Malaysia</td>
<td>30.7</td>
<td>1520</td>
</tr>
<tr>
<td>15</td>
<td>Germany</td>
<td>25.9</td>
<td>320</td>
</tr>
<tr>
<td>16</td>
<td>Switzerland</td>
<td>25.2</td>
<td>3580</td>
</tr>
<tr>
<td>17</td>
<td>Argentina</td>
<td>23.5</td>
<td>680</td>
</tr>
<tr>
<td>18</td>
<td>Brazil</td>
<td>20.3</td>
<td>130</td>
</tr>
<tr>
<td>19</td>
<td>Hong Kong</td>
<td>17.9</td>
<td>2890</td>
</tr>
<tr>
<td>20</td>
<td>Denmark</td>
<td>15.7</td>
<td>3000</td>
</tr>
</tbody>
</table>

Note: Economies in bold are also among the 20 leading home economies for FDI. 
Source: WTO (1996), Table IV.1.
Figure 2.5. Changes in Annual Inflows of FDI from 1988 to 1993  
(Billion Dollars)

Source: UNCTAD (1994), Table 1.5.

Table 2.9. Inward and Outward FDI stock (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>World Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inward</td>
<td>5.0</td>
<td>6.9</td>
<td>8.7</td>
<td>9.9</td>
<td>11.7</td>
</tr>
<tr>
<td>Outward</td>
<td>5.3</td>
<td>6.3</td>
<td>8.4</td>
<td>10.2</td>
<td>11.9</td>
</tr>
<tr>
<td>Developed Countries Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inward</td>
<td>4.8</td>
<td>6.1</td>
<td>8.4</td>
<td>9.0</td>
<td>10.5</td>
</tr>
<tr>
<td>Outward</td>
<td>6.4</td>
<td>7.4</td>
<td>9.9</td>
<td>11.7</td>
<td>13.9</td>
</tr>
<tr>
<td>Developing Countries Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inward</td>
<td>5.9</td>
<td>9.8</td>
<td>10.5</td>
<td>14.1</td>
<td>16.6</td>
</tr>
<tr>
<td>Outward</td>
<td>0.8</td>
<td>1.4</td>
<td>2.3</td>
<td>4.7</td>
<td>5.8</td>
</tr>
<tr>
<td>of which: Latin Am. &amp; Carib.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inward</td>
<td>6.4</td>
<td>10.5</td>
<td>10.1</td>
<td>15.1</td>
<td>17.2</td>
</tr>
<tr>
<td>Outward</td>
<td>0.4</td>
<td>1.1</td>
<td>1.2</td>
<td>1.7</td>
<td>2.3</td>
</tr>
<tr>
<td>S, E &amp; SE Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inward</td>
<td>9.9</td>
<td>11.1</td>
<td>11.6</td>
<td>14.8</td>
<td>18.4</td>
</tr>
<tr>
<td>Outward</td>
<td>1.4</td>
<td>1.4</td>
<td>2.8</td>
<td>7.3</td>
<td>9.3</td>
</tr>
<tr>
<td>C &amp; E Europe</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inward</td>
<td>-</td>
<td>-</td>
<td>1.5</td>
<td>5.5</td>
<td>8.3</td>
</tr>
<tr>
<td>Outward</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.7</td>
<td>1.2</td>
</tr>
</tbody>
</table>


Certainly, critics of the globalisation thesis have disputed the significance of current economic trends on the basis that in the early 1900s total capital flows were larger than they are now and that trade figures are not much greater either (see Tables
Moreover, they point at the “triadisation” effect to indicate the lack of global integration. While these claims may have had some validity a couple of decades ago, the differences between the current economic developments and the first globalisation wave are significant. A close look at the data reveals some fundamental differences between the two eras, which suggest that world markets may be more integrated today than ever before even if they still have a long way to go before they become truly global.

Firstly, as Balwin and Martin (1999: 20) observe, short-term capital movements are much more important today and by far exceed long-term investment, with foreign exchange markets closely resembling globalism as a state of affairs. The lack of an effective mechanism for regulating exchange rates since the collapse of the Bretton Woods exchange rate regime and the resulting liberalisation of capital controls are the main factors behind this. Secondly, the increased share of manufactured goods' exports from developing countries mainly attributed to FDI in manufacturing from developed economies is also an unprecedented characteristic of the current globalisation wave due to complex macro- and micro-economic factors. According to Hoogvelt (1997), these developments are the essence of the current wave of globalisation, which lies in the deepening of capitalist integration in recent years. Thus, the rest of this chapter will show that, even that which critics may still regard as the limited integration of world markets, is already beginning to put national institutional arrangements determining corporate governance under pressure to conform along specific lines. The purpose of the following section is to identify, explain and assess these pressures from continuing economic globalisation.

2.3. MACROECONOMIC AND MICROECONOMIC IMPLICATIONS OF GLOBALISATION

2.3.1. Global Financial Flows, International Trade and Effective Demand

The emergence of the international economic order in the second half of the 20th century is a classic illustration of how academic theory and real events interact in the institutionalisation process. As already mentioned, the experiences of the Great Depression and World War II gave rise to an unprecedented consensus for the establishment of a stable international system, along Keynesian interventionist lines, which would provide the foundations for the reconstruction of devastated economies worldwide. The institutional arrangements that emerged from the Bretton Woods agreements ensured that a stable macroeconomic environment was in place to ensure continuous investment and growth. Within that international order, national governments were able to implement expansionary policies which ensured that effective demand was sufficient to absorb increasing industrial output. The result was four decades of unprecedented economic growth and wealth creation often referred to as the "golden age of capitalism" (Marglin and Schor 1990).

Post-war economic progress resembled the Kaldorian model146 of "circular cumulative growth" where sustained demand supports increases in industrial output which then boosts profits. Provided firms can retain and use their earnings,147 higher profitability translates into increased investment in organisational and production technologies and results in an increase of productivity and output. It is at this second stage that the effect of government demand-management policies is crucial for the

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147 Kaldor as well as others have emphasised the central role of retained earnings in financing industrial investment. See Kaldor (1985); and Currie (1981).
completion and perpetuation of this “virtuous circle” of cumulative economic growth. If sufficient demand is ensured to absorb increased output, a new cycle can begin which will further promote growth and economic welfare. Contrary to the neoclassical orthodoxy of Say’s Law, i.e. that supply creates its own demand, Kaldor followed the Keynesian approach to identify effective demand not only as the key to sustainable economic growth but also as the weak link which markets cannot always provide automatically without outside intervention; hence the important role of government as a regulator of effective demand mainly through the implementation of full employment policies and public investment spending. High employment rates with appropriately adjusted148 real wages as a source of income and production cost (Kalecki 1971: chs.1-8) should sustain a sequence of rising industrial growth leading to consumption, leading to profitability, leading to investment, leading to industrial growth. However, in the absence of effective corrective mechanisms, demand slumps can lead to “vicious circles” of diminishing output, investment, growth and demand with equivalent welfare consequences (Myrdal 1957).

Indeed, the post-war era saw national governments in most industrialised countries pursuing expansionary monetary and fiscal policies with the aim of sustaining effective demand. Structural differences between national economic systems led to variations in both the methods and the extent of such policies (Epstein and Schor 1990: 127-131). For instance, systems which enhance labour power and create close ties between finance and industry are associated with more expansionary macro-policies,149 whereas central bank independence and high international significance of national currencies are linked to more restrictive tactics (ibid.).

148 Appropriately adjusted wages are wages that are positively linked to productivity. See Marglin (1990: 17).
However, more or less the general trend at least until the 1970s was for monetary and fiscal policies to aim for demand-led growth based on full employment. Characteristically, until the mid-1970s the objectives of US macropolicy were set according to a mandate in the Employment Act 1946 which called for the fostering of "conditions under which there will be useful employment opportunities ... for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power" (Meyer 2000). Such employment-growth policies, combined with an expansion of welfare state provisions, maintained high levels of consumption so that somewhat miraculously the major concern was for some countries how to ease effective demand rather than increase it (Glyn et al. 1990: 60).

Crucial for the sustainability of such national policies was the relative macroeconomic stability at the international stage. Despite its flaws, which unravelled during the late 1960s, the international economic order largely established by the Bretton Woods agreement was instrumental for the effectiveness of state-level Keynesian interventions. The key element was the restriction on capital mobility across borders which allowed national authorities sufficient financial autonomy to pursue their full employment and welfare state policies designed to maintain sufficient levels of effective demand. Moreover, in the absence of exchange rate fluctuations national authorities were able to adjust interest rates according to investment and growth targets. The IMF provided guarantees against short-term balance-of-payments problems and the World Bank often supplemented by the Marshall Plan funding programme ensured that high levels of long-term investment in reconstruction and development were maintained. Even if few national crises occurred, they were short-lived and not contagious (Epstein and Schor 1990: 137). Moreover, rising industrial output also led to the increase of international trade from

152
the 1950s onwards with substantial increases after each successive GATT agreement. However, as Glyn et al. (1990: 51) report, high domestic demand ensured that at least until the mid 1960s growth was mostly domestically based.

In sum, as the data in Table 2.10 show, the stable macroeconomic environment during the golden age led to the achievement of unprecedented real growth rates for the world economy with low unemployment and an average of 4 per cent inflation. An unprecedented consensus between capital and labour was achieved where both sides were winners as increased profitability meant satisfactory earnings for shareholders as well as for employees. Stable macroeconomic growth conditions nationally and internationally and a managerial microeconomic model based on the coincidence between stakeholder interests were complementary elements of a highly successful system versions of which were found in most major economies. As macroeconomic stability allowed for real interest rates to be kept at historically low levels, cash flow retention and internal reinvestment by firms provided higher returns for shareholders than its distribution and external investment in deposits, bonds, and other instruments. So, provided demand was sufficient, high growth rates of firms suited not only managers, shareholders and employees, but also society as unemployment was kept low and general welfare increased.

Table 2.10. Post-War Economic Performance

<table>
<thead>
<tr>
<th>Real GDP Growth Rates (% Annual Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>World</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>1950-73</td>
</tr>
<tr>
<td>1966-73</td>
</tr>
<tr>
<td>1974-80</td>
</tr>
<tr>
<td>1981-90</td>
</tr>
<tr>
<td>1991-93</td>
</tr>
<tr>
<td>1994-95</td>
</tr>
</tbody>
</table>

* Excluding Eastern and Central Europe and former USSR countries
### Average Growth Rates of Advanced Capitalist Countries Since 1820 (% Annual Change)

<table>
<thead>
<tr>
<th>Period</th>
<th>GDP</th>
<th>GDP per capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>1820-1870</td>
<td>2.2</td>
<td>1.0</td>
</tr>
<tr>
<td>1870-1913</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>1913-1950</td>
<td>1.9</td>
<td>1.2</td>
</tr>
<tr>
<td>1950-1973</td>
<td>4.9</td>
<td>3.8</td>
</tr>
<tr>
<td>1973-1979</td>
<td>2.5</td>
<td>2.0</td>
</tr>
</tbody>
</table>

### Consumer Prices (% Annual Change)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.7</td>
<td>8.2</td>
<td>8.2</td>
</tr>
<tr>
<td>UK</td>
<td>4.6</td>
<td>15.4</td>
<td>10.7</td>
</tr>
<tr>
<td>France</td>
<td>5.0</td>
<td>10.7</td>
<td>12.1</td>
</tr>
<tr>
<td>Germany</td>
<td>2.7</td>
<td>4.7</td>
<td>5.1</td>
</tr>
<tr>
<td>Italy</td>
<td>3.9</td>
<td>16.3</td>
<td>17.5</td>
</tr>
<tr>
<td>Japan</td>
<td>5.2</td>
<td>10.0</td>
<td>4.3</td>
</tr>
</tbody>
</table>

### Average Unemployment in OECD Countries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>4.3</td>
<td>4.6</td>
<td>3.5</td>
<td>7.3</td>
<td>8.8</td>
</tr>
<tr>
<td>UK</td>
<td>2.1</td>
<td>2.7</td>
<td>4.4</td>
<td>9.9</td>
<td>9.1</td>
</tr>
<tr>
<td>France</td>
<td>1.8</td>
<td>1.7</td>
<td>3.8</td>
<td>9.0</td>
<td>10.7</td>
</tr>
<tr>
<td>Germany</td>
<td>4.6</td>
<td>0.7</td>
<td>2.3</td>
<td>6.0</td>
<td>6.3</td>
</tr>
<tr>
<td>Italy</td>
<td>7.0*</td>
<td>3.9</td>
<td>4.4</td>
<td>7.0</td>
<td>10.7</td>
</tr>
<tr>
<td>Japan</td>
<td>2.2</td>
<td>1.3</td>
<td>1.7</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Australia</td>
<td>1.1</td>
<td>2.1</td>
<td>3.8</td>
<td>7.5</td>
<td>9.4</td>
</tr>
<tr>
<td>Belgium</td>
<td>4.3</td>
<td>2.3</td>
<td>4.8</td>
<td>10.8</td>
<td>8.3</td>
</tr>
<tr>
<td>Canada</td>
<td>3.9</td>
<td>4.7</td>
<td>6.6</td>
<td>9.3</td>
<td>10.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.1</td>
<td>1.2</td>
<td>3.9</td>
<td>9.7</td>
<td>6.6</td>
</tr>
<tr>
<td>Spain</td>
<td>2.2</td>
<td>2.4</td>
<td>4.3</td>
<td>17.7</td>
<td>19.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>1.9</td>
<td>1.3</td>
<td>1.7</td>
<td>2.1</td>
<td>6.6</td>
</tr>
<tr>
<td>OECD av.</td>
<td>2.9</td>
<td>2.2</td>
<td>3.5</td>
<td>7.3</td>
<td>8.8</td>
</tr>
</tbody>
</table>

*1953-59

### Volume of Exports (% Annual Change)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>6.3</td>
<td>4.9</td>
<td>-1.6</td>
</tr>
<tr>
<td>UK</td>
<td>3.9</td>
<td>4.7</td>
<td>-0.1</td>
</tr>
<tr>
<td>France</td>
<td>8.2</td>
<td>6.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Germany</td>
<td>12.4</td>
<td>4.7</td>
<td>4.1</td>
</tr>
<tr>
<td>Italy</td>
<td>11.7</td>
<td>7.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Japan</td>
<td>15.4</td>
<td>7.6</td>
<td>10.2</td>
</tr>
</tbody>
</table>

Source: Marglin and Schor (1990: 42 and 47); Davidson (2000); Baker (1998), Table 1A.
However, the collapse of the fixed exchange rate system between 1971 and 1973 due to the reasons outlined earlier signalled the beginning of a new era for the international economic order. According to Eatwell, when governments and Bretton Woods agencies stopped bearing the full costs of currency management with the imposition of capital controls, foreign exchange risk was privatised (Eatwell 1996). Floating exchange rates not only created vast profit opportunities for currency speculators, but also made hedging against volatility risks a necessity for both financial and non-financial corporations. In order to deal with these new private demands governments had to remove exchange controls and financial regulations that restricted capital flows and were therefore seen as ‘inefficient’ by the new players in financial markets. The globalisation of finance led to the construction of “the modern infrastructure of speculation” (ibid.) as the majority of transactions in global financial markets are now not intended to finance trade or production but to capture gains from speculative predictions about currency movements.

The growing size of capital flows has now made actual and potential movements in exchange rates much larger, more unpredictable, and uncontrollable. With so much capital available for speculation, apparent exchange rate problems can quickly turn into full-scale crises. Indeed, by 1973 speculators had challenged and defeated almost every central bank, including the US Federal Reserve (Moffit 1983: 71-92). The globalisation of capital has the potential to both cause and exacerbate fundamental disequilibria with no practical means of resolving these problems. Consequently, significant constraints have been imposed on national authorities’ discretion to formulate macroeconomic policies (Simmons 1999: 63; Keohane 1996). As Martin (1994: 268) states, global financial integration has led to a loss of national autonomy, at least in the sphere of macroeconomic policy-making.
Policymakers now need to maintain their market “credibility” and in doing so they are forced to consider the reaction of international financial markets to each and every policy move, otherwise they risk being punished by capital outflows, currency depreciation and ultimately financial crisis. Failure to meet market demands imposes a premium on the interest costs governments have to pay for financing their programmes. This dynamic has completely shifted macroeconomic priorities from the objective of fostering employment and demand to maintaining given exchange rate parities or the levels of money supply. Governments now face what has become known as the Fleming-Mundell “trilemma” between the policy objectives of full capital mobility, a fixed exchange rate, and expansionary policies, of which only two can be pursued simultaneously if a crisis is to be avoided (Fleming 1962; Mundell 1960, 1963). So, once commitment to capital mobility is made, or rather imposed by the markets, the growth objective becomes antagonistic to currency stability. As the main remaining regulatory tool for balancing between the two goals are short-term interest rates (Felix 1996), global liberalisation of capital markets exacerbates interest rate volatility which then increases business uncertainty. Most importantly, due to the extent and impact of currency speculation, in their attempt to maintain a desired exchange rate, governments lose control over long-term interest rates which are now largely determined by global financial markets.

Market discipline would of course have been a blessing rather than a problem if markets were efficient. In fact, conventional neoclassical analysis based on the efficient markets hypothesis provides support for this very claim about the “healthy”

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150 In fact, contrary to their original remits under the Bretton Woods agreements, the IMF and the World Bank have also become major forces behind financial deregulation due to the conditional nature of their loans.

151 It was precisely the attempt by the British government to pursue all three objectives that led to the 20 per cent devaluation of the pound against the German mark and its forceful exit from the Exchange Rate Mechanism on “Black Wednesday” 16 September 1992.
discipline on governments' irrational spending (Woodall 1995). With worldwide financial market liberalisation, the argument goes, a global pool of capital is created which is allocated efficiently to the most productive investment offering better opportunities for investors and lower costs of capital for borrowers so that there is more long-term investment and growth (Friedman 1953c; Bayoumi 1995).

However, in his *General Theory of Employment, Interest and Money* Keynes argued that market views are not formed according to the efficient market hypothesis but by a process that is similar to the beauty contest competitions that were conducted by some British tabloid papers at the time. To win, rather than forming and expressing their own view about women's pictures, each competing reader had to guess "what average opinion expects average opinion to be" (Keynes 1936: 156). Similarly, speculative financial flows in the global market are directed by what average opinion of investors expects average opinion about monetary policies to be and so an enormous premium is placed on signals about market reactions to specific events without the need of sophisticated interpretations of economic data (Eatwell 1996). Simplistic slogans that larger fiscal deficits lead to higher interest rates, that increased money supply leads to inflation or that public spending is bad and private spending is good, tend to dominate investment decisions despite the contrary findings of empirical research (*ibid*). Even worse, where investment decisions are formed in this fashion, investors have the tendency to move as a herd to the same direction irrespective of the economic fundamentals so that waves of excessive optimism are followed by excessive pessimism and vice versa (Scharfstein and Stein 1990; Froot, Scharfstein and Stein 1992).

Consequently, as the long series of financial crises since the liberalisation of capital controls demonstrates, markets are unable to provide the healthy discipline
that the efficient market hypothesis asserts.\textsuperscript{152} Since the liberalisation of capital controls, such crises have not only become very common but also highly contagious so that the default of even one emerging economy can quickly spread across the globe due to extensive financial exposures of global investors.

The growth of institutional investors represents a critical element in the transformation of global financial markets. While this phenomenon is often attributed to demographic changes, one cannot ignore the fact that the pressure on governments to reduce their spending combined with high unemployment or under-employment have been major contributing factors to the retreat of the state from pension provisions and the shift from pay-as-you-go to defined-contribution systems. Thus, as mentioned above, on a collective basis institutional investors have emerged as the largest managers of liquid financial assets and therefore as the main generators of global financial flows. Logically, this has led analysts to hold them responsible for triggering destabilising shocks to financial markets (Blommenstein 1997: 37). Due to their ability to pool financial assets on a global scale, institutional investors’ financial decisions not only increase dramatically the speed of financial movements, but also amplify their speculative effects on markets. Herd behaviour and the “beauty contest” decision-making of fund managers are further exacerbated by the fact that their performance is evaluated according that of their peers (Annaert 1999: 58).

For all the reasons mentioned so far, it is not surprising that the focus of national macroeconomic policies is now on market credibility instead of full

employment and demand management. While such macropolicy-making may indeed help preventing capital flight at least in the short term, it surely does not lead to higher economic growth rates. On the contrary, what global financial markets tend to perceive as sound policies has led to the dramatic increase of real interest rates with significant negative effects. While during the "golden age" interest rates were deliberately kept low to promote growth, since the liberalisation of capital controls in the late 1970s real interest rates have constantly exceeded real GDP growth even in the most powerful countries (see Figures 2.6 and 2.7). As a result there has been a reduction in national investment rates, which have slowed down growth and have suppressed effective demand. Moreover, public spending cuts have been imposed and the public sector is now seen as a burden rather than a tool for sustaining high levels of demand (Simmons 1999: 64). So the current global financial environment tends to punish expansionary policies and reward contractionary ones based on prolonged austerity programmes. The effects of such deflationary pressures are even more severe in crisis-struck countries which are left unable to adopt those policies that would reflate their economies with analogous consequences for global effective demand.

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153 See for example the British Labour Party's dropping of Clause 4 of the party manifesto combined with the emphasis by Chancellor Gordon Brown on financial "prudence".

154 See also Stephens, Huber and Ray (1999) reporting decreases in welfare state spending since the mid 1970s.
Figure 2.6. Real long-term rates in G3 countries

Source: OECD/Christiansen and Pigott (1997), Figure 1.

Figure 2.7. Real Growth and Real Interest Rates in the US 1960-1997

Source: OECD/Block (1998), Graph 2.
In addition to the negative impact of high real interest rates and deflationary policies, since the collapse of the Bretton Woods exchange rate system, both financial and non-financial corporations have had to commit portions of their cash flows or borrowed money to derivatives and other instruments in order to hedge against financial risk. This means that an enormous amount of finance is now capitalised on pure finance rather than real asset creation through production. This has further increased the cost of capital for financing investment in the real economy with equivalent consequences for growth and welfare. Moreover, trading risk-hedging instruments is itself an extremely complex and unpredictable activity that entails the possibility of heavy losses if something goes wrong. The examples of Orange County, Barings Bank, Daiwa Bank, Metallgesellschaft, LTCM and Enron indicate the reality and extent of the risks involved in derivative trading.¹⁵⁵

While all this has been a major factor contributing to the global economic slowdown by dampening effective demand, the simultaneous liberalisation of trade has exacerbated the problem. Where governments are unable to stimulate domestic effective demand an obvious solution to domestic industries is to resort to export-led growth often with the assistance of governments. But where there is no coordination of international trade, such policies can lead to situations where exporting nations with low domestic demand grow at the expense of importing ones with higher demand, so that in the end there is no growth in overall global output (Toner 1999: 142). In fact, it is this very effect, widely known as the "balance-of-payments constraint" (Thirwall and Hussain 1982), which led to the decline of the US economy in the late 1960s and its inability to support the Bretton Woods system (Marglin 1990: 24). As Myrdal (1957: ch.11) and Kaldor (1991: 607) have argued in their influential

works, unless there is a system of planned trade, nations with a competitive advantage tend to undermine the position of less advantaged ones with significant consequences for the global economy. Alternatively, as Keynes himself states in his *General Theory*, if appropriate demand management policies are adopted globally, such international trade conflicts should not arise:

if nations can learn to provide themselves with full employment by their domestic policy...there need be no important economic forces calculated to set the interest of one country against that of its neighbours. ...International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage. (Keynes 1936: 382-383)

However, for the reasons given above, expansionary, full-employment policies are no longer viable. Thus, due to the combination of global financial market orthodoxy, which tends to "punish" demand-driven government planning, with the current international trade regime, which is built upon uncoordinated liberalisation, balance-of-payments problems are very common. Where trade deficits are generated, e.g. due to competitiveness problems, they result to current account deficits and simultaneous increases in foreign borrowing in order to finance them. In turn, increasing levels of debt as a proportion of GDP exert downward pressure on exchange rates and raise the risk of speculative financial outflows. As the normal reaction of national monetary authorities to such currency dynamics is to defend the exchange rate by increasing interest rates, investment decreases and growth slows down. But even trade surplus countries do not remain unaffected in the long run, since the effects of balance-of-payments imbalances tend to spread. As effective demand slows down in deficit countries, there is a resulting negative effect on surplus
countries’ exports with analogous consequences for their domestic profitability. investment and growth. Thus, international trade acts as a transmission mechanism of recessions and leads to a worldwide economic slowdown.

In sum, the combination of global finance with uncoordinated international trade liberalisation has a negative overall effect, as it leads to a "vicious circle" of slowing global market capacity and output growth, lower profits and investment and further decreases in effective demand. Where there is a demand slowdown the general dilemma for firms wishing to maintain profitability is between cost-cutting and reducing output. While in a closed economy this dilemma is inescapable, the advent of economic globalisation may have created some alternatives. So, among other things, the following section will examine in more detail firms’ responses to the challenges that this new global economic environment creates and their macro- and microeconomic effects.

2.3.2. The Globalisation of Production, the New International Division of Labour and the Global Market for Corporate Control: Causes and Effects

The recorded data on trade and FDI presented in section 2.2 above are evidence of the dramatic changes that have been taking place in the world economy regarding production patterns. This subsection will now turn to examine in more detail the causes, nature and economic significance of the increasing activity of TNCs. It will be argued that economic globalisation combined with slowing demand

\[156\] For a theoretical examination of this dilemma see Fazzari, Ferri and Greenberg (1998).
have been a cause as well as a result of a dramatic reorganisation of production on a global scale with further consequences for firms' strategic choices.

Certainly, the dramatic reduction of trade barriers after a series of GATT negotiations during the second half of the 20th century has enabled firms to gradually view the world, rather than each particular country, as a single product market. The large ratios of international trade to world output (see Tables 2.1 and 2.2 above) signify this trend. However, if that is so, then what explanation can be given to the fact that in recent years foreign direct investment has surpassed international trade? Why do firms increasingly invest in facilities abroad to service the world markets for products instead of doing so from their home countries as exporters? Indeed, this contradicts standard neoclassical theory of foreign investment which tends to regard trade and FDI as substitutes so that “an increase in trade impediments stimulates factor movements and...an increase in impediments to factor movements stimulates trade” (Mundell 1957: 321).

Resolving this issue is crucial for understanding firms’ responses to economic globalisation and their effects. Since the 1960s, when FDI rates began to grow, several alternative but not mutually exclusive theories have been developed to explain this seemingly puzzling relationship between trade liberalisation and the factor movements. While none of them appears able to fully explain the causes and illuminate all the aspects of FDI and the globalisation of production, each theory has some useful insights to provide. It is for this reason that they should be regarded as complementary rather than as alternatives. Generally, these theoretical approaches tend to focus either on the microeconomic or the macroeconomic factors that determine firms’ strategic choices.
The pioneer of the microeconomic approach is Hymer (1960) whose path-breaking work provided the basis for modern theory of FDI and multinational production. His main insight was that FDI, as a form of foreign factor ownership, encompasses the element of control by the investor over products and processes and this helps offset the investment risks involved when markets are imperfect. Thus, where an investment entails significant risks arising from information asymmetries between the investing firm and local competitors in the host country, from volatile exchange rates or from unfavourable host government interference with trade or production, FDI can provide sufficient control over the venture and thus reduce the overall costs. Moreover, according to Hymer, since in imperfect markets not all firms have the same capabilities, FDI may constitute a means of exploiting a particular oligopolistic advantage over specific processes such as production or distribution which foreign rivals lack.\(^{157}\)

Hymer’s notion of control through factor ownership as an explanation of reducing risks bears a close resemblance to Coase’s and Williamson’s theory of the firm. In fact, Hymer has himself recognised a relation between the Coasean transaction cost theory in his own work (Hymer 1968). Indeed, this common ground between the two theories has led subsequent authors to develop the point further into a theory of FDI based on the internalisation of transaction costs. The main proponents of this approach are Buckley and Casson (1976), Teece (1977, 1982) and Rugman (1986) who regard the TNC as an organisational structure which has emerged to resolve international product market imperfections by bringing them within the firm, i.e. by internalising them. The main claim of the internalisation school is that alternatives to FDI, such as subcontracting or licensing of intangible

\(^{157}\) For similar theses see Caves (1982) and Kindleberger (1984).
assets—managerial skills, technological know-how, etc.—involve significant transaction costs, because such assets are easily appropriable. Therefore, the nature of FDI as direct factor ownership abroad is a transaction cost economising mechanism which ensures that assets remain under the control of the firm (Hennart 1991). This approach, however, tends to regard the TNC as a more efficient alternative to international product market contracting (exports) and thus overlooks the fact that resource allocation by command is not always efficient. This is something Hymer was aware of as he recognised that FDI and the emergence of the TNC constitutes both a response to and a cause of market imperfections (Ietto-Gillies 1992: 118). As it will be shown below, what is regarded as efficient from the firm’s perspective is not always efficient in terms of general economic welfare.

Moreover, both Hymer’s ownership theory and the internalisation thesis suffer from a further deficiency. While they explain why FDI is preferred over other types of investment, such as non-controlling portfolio investment or licensing, they do not provide sufficient reasons for the multinationalisation of investment. In order to deal with such theoretical deficiencies, Dunning (1977) developed his “eclectic” approach to TNC activity which is more elaborate as it attempts to combine the two theories above with considerations of locational factors. The most important aspect of this approach is that internalisation will occur only if certain locational advantages that are specific to the host country’s economy are sufficient to attract the particular investment. So, according to Dunning’s “OLI” theory, for FDI to take place there must be a consummation of the ownership (O) of advantages enjoyed by the firm with locational (L) comparative advantages that the host economy has developed and it must be profitable for the firm to internalise (I) those advantages it owns rather than...
merely sell them on foreign markets (Dunning 1980: 275). To use Dunning’s own words:

Foreign production then, implies that location-specific endowments favour a foreign country, but ownership endowments favour the home country’s firms. (Dunning 1977: 399).

Firms’ “ownership endowments” can include size and established position, product and process diversification, the ability to take advantage of division of labour, production technologies and managerial know-how, access to inputs (capital, labour, raw materials), market access, government protection and the ability to exploit differences between national and international/global markets. Countries’ locational advantages, on the other hand, include natural and manmade resources, low taxes, low labour costs, high labor productivity, or state-supported monopolies and stable political environment, as well as favourable trade and financial regulations (Dunning 1981: 80-81).

While Dunning’s OLI approach can be considered as an attempt to integrate micro- and macroeconomic elements into a theory of FDI and multinational production, other theories tend to give more emphasis to the latter elements. Vernon’s product life cycle approach is such a theory, as it regards the demand for a particular product as a central factor in a firm’s decision to produce abroad (Vernon 1966). More specifically, Vernon divides a product’s life cycle into three phases. The initial phase constitutes the introduction of the product to the market. At this stage, production takes place in the home market where the relevant technology and ideas originate. The product is still not standardised and there is an increased need for flexibility and adaptability to customer preferences, which makes spatial proximity to the market necessary. In addition, as product development is still a crucial element of
the firm's activities, highly skilled labour is a necessary input. In the following phase, as demand expands the product becomes increasingly standardised and its mass production becomes possible. Growing sales build up the product's reputation not only in the home market but also abroad so that in this second phase, to the extent that trade barriers permit, export markets begin to absorb an increasing portion of sales. Simultaneously, as product standardisation progresses the need for skilled labour declines and the ability of rivals to copy the product in question increases. Price competition gradually tends to prevail over innovation and there is an increasing requirement for low-cost unskilled labour so that labour cost differentials between countries become increasingly relevant. Thus, Vernon argues, provided low-cost labour is available abroad, FDI becomes an inevitable cost-cutting strategy for firms with mature products who want to remain competitive. Similarly, the presence of tariffs and other trade measures affecting the product's price will also create an incentive for allocating production within foreign markets to capture demand therein.

However, as Vernon (1979) himself and others\textsuperscript{158} have acknowledged, in the new macroeconomic environment of increasing product market globalisation the life cycle theory has lost some of its explanatory power. Due to the dramatic reduction of tariffs, products can now be introduced in different national markets simultaneously irrespectively of their life cycle stage. Moreover, the technological gap and income disparities between developed countries have declined considerably since the 1960's when Vernon developed his theory, so that product life cycles not only have become significantly shorter but also they cannot explain high FDI levels between high per-capita income countries. Nonetheless, this approach can provide important explanations for the allocation of production facilities to developing countries, where

labour is less skilled but abundant and cheap. It is an attempt to combine the demand variable with the firms’ cost-cutting strategies.

However, as Pitelis (1998: 198) observes, Vernon’s theory focuses on the demand for individual products and not on aggregate demand. He has therefore proposed an alternative approach to explaining the multinationalisation of production which is based on aggregate effective demand conditions and which should be seen as complementary to other theories focusing on microeconomic factors. In this way, Pitelis seeks to fill the gaps in the theories outlined so far by providing explanations for the cross-border element of FDI of all firms and irrespectively of their products’ life cycle phases.

Pitelis’ main premise is quite simply that the multinationalisation of production can be attributed to deficient effective demand. As that deteriorates, say within one country, all firms therein, albeit in different degrees, will see the demand for their own products decline too with corresponding negative effects on rates of return on capital. That being so, firms will then have to face the dilemma mentioned earlier: they can either reduce prices to boost sales or cut production. In imperfect (oligopolistic) markets the former option may not be particularly attractive as it can lead to catastrophic price wars. If, on the other hand, the latter option is followed, the effect in the medium and long term will be to further depress demand due to lower investment rates. What Pitelis’ model then suggests is that the way out of this “no win” situation is for firms to exploit effective demand outside their national economic boundaries. In other words, where domestic demand is deficient, foreign markets can create the economies of scale and scope that domestic markets cannot and thus reduce the cost of internalisation of foreign activities through outward investment. Of course, this model is not intended to and does not predict what form of foreign investment
will be chosen by the demand constrained firm; its purpose is to illuminate the
“foreignness” of investment. As Pitelis puts it,

It provides a partial answer to the question ‘Why internationalisation?’ but has
little to say on ‘Why TNCs?’ as opposed to exporting, licensing and/or
subcontracting. To answer these questions, it is necessary to go back to the
[microeconomic] theories. ...In this sense, a synthesis of supply-side micro
reasons...and demand side reasons represents a reasonably powerful ex ante

In the light of the findings in section 2.3.1 about global demand conditions, this
approach acquires particular value as it can explain the explosion of FDI flows since
the 1980s, especially between developed countries. The demand slowdown since the
liberalisation of financial controls and international trade regulations has led demand-
constrained firms to expand their operations abroad in order to exploit opportunities
arising in global product markets. Pitelis’ empirical analysis of FDI data between
developed economies since the Great Depression confirms his premise that flows tend
to follow favourable demand conditions (ibid.).

Moreover, as Pitelis suggests, only a synthesis of the available theoretical
approaches can help the observer form a fully informed interpretation of the data
presented in section 2.2 above. As already stated, the vast majority of FDI flows tend
to be of two types, those from developed countries to developing ones and those
between developed countries themselves. In the light of the above theoretical analysis
these two types of FDI flows reveal three main corresponding trends/strategies of
TNCs regarding their organisation of production in response to the challenges of
globalisation. The first is cost-driven, the second is demand-driven, and the third is
technology-driven.

Cost-driven FDI flows are almost exclusively directed from the developed
world to countries where inputs, mainly unskilled labour, are available at a low
comparative cost. This is part of firms' efforts to exploit input price differentials between different countries. Thus, for production processes that require low-skilled labour, less developed countries with low labour costs in terms of wages and employment protection enjoy significant locational advantages over those countries where wages are high and redundancies are costly. Provided those low cost countries do not restrict trade, firms seeking to remain globally competitive will have an incentive to transfer their low-skill operations there. This explains the large flows of FDI from developed countries with high labour costs to less developed ones. Moreover, the closer those low labour cost countries are to the main "demand markets", the better their locational advantage will be. It is not surprising, therefore, that Eastern European, Latin American and South East Asian countries have been significant hosts of cost-driven FDI. Their proximity to the "Triad", i.e. the EU, North America and Japan, makes them particularly competitive as they can easily serve the major product markets. Of course, whether FDI actually takes place or another method of shifting production, such as licensing or sub-contracting, is preferred also depends on the internalisation incentives of the firm. It is reasonable to expect that such incentives will be higher, and thus FDI more likely, where the technological or managerial know-how involved in the production process is firm-specific and/or where high quality standards are required.

Demand-driven FDI, on the other hand, tends to flow mainly between developed countries. The higher the per-capita income and the larger the population, the more attractive a market is. In the current macroeconomic environment aggregate demand has become a locational advantage which can attract FDI from firms that face constraints in their home markets and who compete in the global marketplace. As Ohmae (1985) argues, firms have to establish themselves in all Triad countries
constituting the major consumption powerhouses in order to become and remain competitive. Presence in these vast product markets carries significant internalisation advantages, because it enables TNCs to adapt their products to local tastes and needs as well as to exploit local distributional channels. Trade barriers, where present may also be a significant reason for a local presence to avoid their penal effect. Simultaneously, another important factor affecting a country's locational advantage as a host of FDI is the growth potential of its economy. China is a clear case of a host country of this kind due to its vast population and consistently high growth rates in recent years. It is then no surprise that TNCs from most Triad countries have been so keen to invest in Chinese industrial plants making China the largest developing country recipient of FDI (see Table 2.8 above).

Finally, technology-driven FDI flows can be more mixed. Technology, of course, should be given a broad meaning so as to include not only scientific knowledge but also organisational and other capabilities. Given that patent or copyright laws can bar access to scientific knowledge and that know-how and capabilities tend to be highly firm-specific, the direct investment option contains significant internalisation incentives. Obviously, developed countries score better in the area of technologies and therefore enjoy a clear locational advantage which makes them the largest hosts of this type of FDI. On the other hand, investment flows can originate from both developed and developing countries, since firms on either side have the incentives to acquire the highest technology available. However, subject to few exceptional cases, firms from developing countries usually do not have the necessary resources to make such investment. This is shown by the low levels of FDI originating from such firms. So, just as in the case of demand-driven FDI, technology-driven investment flows mainly between developed countries.
Although these three types of FDI can be considered as separate strategies, often they are interrelated and are pursued simultaneously by firms that compete in global product markets. This is because, faced with saturated markets, firms need to both tap as much of global effective demand as possible and reduce their costs to the minimum in order to remain price-competitive. At the same time, firms’ struggle for global competitiveness may also require that they ensure their access to the latest technological capabilities (Howells 1993). The globalisation of competition in product markets since the liberalisation of world trade and finance has been exerting pressures not only towards the multinationalisation of production but also towards the adoption of such integrated approaches in order to fully exploit OLI advantages.

Regarding the nature of global competition and firms’ strategic reactions to it in oligopolistic markets, Knickerbocker (1973) has offered some very useful insights by distinguishing between “aggressive” and “defensive” investments, the former being the establishment of a subsidiary in a particular country and industry by a firm as a first mover, while the latter being the responsive establishment of a subsidiary by a rival firm in order to offset its competitor’s initial advantage. Knickerbocker, therefore, argues that the strategic behaviour of firms operating in global oligopolistic markets tends to follow a pattern of action and reaction so that an aggressive FDI move by one firm can spark a defensive reaction by its competitors who seek to minimise the risk of being out-competed. In this way, a “bandwagon effect” is created and FDI tends to “bunch up” so that a move by one firm has the tendency to become amplified as rivals choose to mimic it.

As a result of all these dynamics the global economic landscape is being transformed into one dominated by TNCs, industrial as well as financial, usually operating in oligopolistic markets that transcend national boundaries. Enabled or
forced by the new economic order, such corporations have been reorganising their activities so as to reap diverse OLI advantages in multiple countries across the globe. As Gilpin (2000: 165-166) observes, while in the early post-war era multinationals pursued “horizontal investment” strategies by establishing self-sufficient subsidiaries in foreign (developed) countries, since the 1980s they have moved to a “vertical investment” tactic where different production facilities are scattered around the world as interdependent units heavily reliant on outsourcing in an integrated manner. Goods can now be produced all around the world and ultimately be exported back to the country where the TNCs’ head offices are based.

Of utmost importance is that with the shift of assembly and other low-skill activities to low labour cost locations the old international division of labour, by which the role of underdeveloped countries in the world economy was to supply unprocessed raw materials to industrialized countries, has now largely come to an end. As Fröbel et al. (1978, 1980) argue, a single world market for labour and industrial sites has emerged, encompassing all nations irrespective of their development stage. Thus, for the first time in history, production of both semi-processed and processed goods is being located in underdeveloped countries according to the demands of global competitive forces. As a result, a trend for a “new international division of labour” has emerged by which TNCs from leading countries relocate their production sites in favour of less developed countries. An unprecedented situation has arisen where such countries now export manufactured goods to the industrial world at competitive prices mainly due to low labour costs.

In sum, international trade liberalisation and the revolutionisation of transport and communication technologies have made such strategies possible and have given rise to what Flamm and Grunwald (1985) call the “global factory”. In oligopolistic
markets, this "global switching" (Howells 1993: 223) is not seen merely as a matter of choice but as a necessity for survival. Just like financial capital, industrial capital is also becoming increasingly global, i.e. beyond the control of individual governments and national regulatory frameworks; the latter not only can now be by-passed through FDI, but have also become more interdependent.159

So far this discussion has concentrated on the impact of economic globalisation on firms' strategies. However, it is particularly important for the purposes of this thesis to also examine the effect of these strategies, i.e. the global reorganisation of production, on the economic environment itself. While the theoretical approaches to FDI and the globalisation of production discussed above aim at explaining firms' adaptive reactions to their environment, they fall short of exploring the ability of firms operating in imperfectly competitive markets to influence prices and their environment according to their own needs. The importance of this power of firms over macro- and microeconomic pricing is even greater once the vast size of TNCs and their dominant role in product markets are accounted for.

Accordingly, a comprehensive effort to study the power of TNCs over the markets in which they operate has been made by Cowling and Sugden (1994) who found that the globalisation of production often gives rise to more imperfections than it resolves. TNCs, they argue, have the ability to subvert international trade, to "divide and rule" governments and labour, and as a consequence to create significant stagnationist pressures. These points are very important for understanding the nature and effects of TNC activity and therefore deserve a closer look.

The first issue, the ability of TNCs to subvert international trade, is a direct outcome of the globalisation of production as described above. The very essence of

159 For the nature and significance of this interdependence see section 2.4 below.
this strategy is that numerous companies scattered around the world, affiliated and organised under the umbrella of a single TNC parent firm are able to exchange goods and services with each other for the purposes of completing the production and distribution of the final product. In other words, trade takes place across national borders but within the boundaries of one single firm in the sense that these exchanges do not constitute market transactions but are internally managed according to the needs of the TNC. While it is difficult to be accounted for due to the lack of data, with the intensification of the globalisation of production, this type of *intra-firm trade* has undoubtedly become a significant portion of total international trade especially in manufactured goods accounting for 40 percent of world trade (European Commission 1995: 2). More specifically, Dicken (1992: 49) has placed the figures for the US and Japan to over 50 percent and to as much as 80 percent for the UK. The high levels of intra-firm trade mean that TNCs place international trade under their control. Consequently, Cowling and Sugden (1994: 69) argue, increasing portions of trade flows are being managed in the interests of those firms and not of nation states so that “a system of free international trade is in fact one of TNCs’ subverted trade.” As a result, increasing intra-firm trade can impose considerable constraints on government trade policies. In particular, the wide scope for the manipulation of transfer prices – i.e. the invoicing of internal transfers at non-market prices- by TNCs can affect governments’ tax revenues, their ability to impose exchange controls and to regulate the balance of payments and exchange rates, so that Keynesian demand management policies can become ineffective (Ietto-Gillies 1992: 36, 169 and 181).

Regarding the “divide and rule” strategies towards governments, Cowling and Sudgen claim that the ability of TNCs to organise production on a global scale according to OLI advantages means that industrial capital can migrate towards
countries with the best combination of locational advantages. In this way, national economic systems are placed in competition with each other in their efforts to attract FDI in manufacturing plants. This has increased TNCs’ bargaining power vis-à-vis governments so that taxation, employment, education and infrastructure policies are often formed according to what the former regard as efficient.\footnote{See Frenkel, Razin and Sadka (1991); Gordon and MacKie-Mason (1995: 29-37); Kurzer (1993).} Thus, a situation has arisen where “TNCs call the tune and governments dance; TNCs dictate strategy and governments respond” (Cowling and Sudgen 1994: 76). According to Cowling and Sugden, similar “divide and rule” strategies are also pursued towards labour which, just like national governments, is rather immobile. Factor mobility, therefore, gives the bargaining power to TNCs to dictate the terms of employment as they think fit. More specifically, the availability of low labour cost production locations creates a downward pressure on employment protection and wages for less skilled labour in industrial countries (Albo and Roberts 1998). Non-conformity can result in the relocation of production from high-cost to low-cost countries and thus create unemployment problems in the former. Conformity, on the other hand, leads to increasing wage disparities and the polarisation of income distribution. Moreover, as the new international division of labour progresses, the global dispersion of a TNC’s workforce limits the possibility for concerted action on behalf of the latter that would level the bargaining position of employer and employee (Fröbel et al. 1980: 40).

The macroeconomic effect of all this is not negligible. As Cowling and Sudgen (1994: 99) assert, the imbalance of power between capital and labour holds down national income with analogous repercussions for effective demand. Considering that developed economies are the powerhouses of the world economy in terms of aggregate demand, the negative effect of TNC activity on wages or
employment in those countries can lead to persistent, demand-driven stagnationist pressures on a global scale. This induces further reorganisation of production based on cost-cutting so that a new vicious circle of stagnation begins with corrective government intervention being virtually impossible due to the policy constraints imposed by the global economic system.

The repercussions of the ensuing global demand slowdown, whether as a result of financial globalisation or of TNCs’ activities or both, go beyond the drive for increased FDI and global reorganisation of production as strategic choices. Low aggregate demand also affects the form of such investments. Accordingly, Pitelis (1991) associates such macroeconomic conditions with the tendency of FDI to take the form of cross-border mergers and acquisitions (M&A) rather than “greenfield” investments. Empirical data confirms this contention. The number and value of cross-border mergers and acquisitions has been on the rise since the mid 1980s and have reached unprecedented levels in recent years accounting for most of FDI. In 1998, for instance, over 85 per cent of the value of all FDI flows in OECD countries was made up of cross-border M&A exceeding $984 billion (see Table 2.11). The number of transactions has also been on the rise. As UNCTAD (1999: 95) reports, in 1998 there were 89 “mega” cross-border deals of over $1 billion value each compared to just 35 in 1995, 45 in 1996, and 58 in 1997.

All this indicates that the intensification of economic globalisation since the mid 1980s is gradually giving rise to a particularly active global market for corporate control. Current and potential leading firms across the world strive to maintain or acquire those ownership advantages that will help them remain globally competitive and survive as independent firms. The pursuit of scale economies and technological
Table 2.11. International M&A Deals in OECD Countries (Billion US Dollars)

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<tr>
<td>United States</td>
<td>70.6</td>
<td>64.3</td>
<td>190.8</td>
<td>293</td>
<td>65.5</td>
<td>80.8</td>
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<td>145.7</td>
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<td>55.4</td>
<td>85.6</td>
<td>123</td>
<td>34.8</td>
<td>32.6</td>
<td>117.1</td>
<td>246.2</td>
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<td>3.8</td>
<td>6.1</td>
<td>59.7</td>
<td>1.5</td>
<td>6.3</td>
<td>14.0</td>
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<tr>
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<td>6.7</td>
<td>19.3</td>
<td>37.9</td>
<td>42.4</td>
<td>27.4</td>
<td>15.7</td>
<td>60.4</td>
<td>93</td>
</tr>
<tr>
<td>France</td>
<td>11.4</td>
<td>13.7</td>
<td>24.3</td>
<td>35.6</td>
<td>11.5</td>
<td>21.6</td>
<td>36.5</td>
<td>83</td>
</tr>
<tr>
<td>Canada</td>
<td>10.4</td>
<td>12</td>
<td>15.4</td>
<td>29</td>
<td>22.1</td>
<td>24.7</td>
<td>42.3</td>
<td>16.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3.6</td>
<td>8.8</td>
<td>18.4</td>
<td>26.9</td>
<td>20</td>
<td>20.7</td>
<td>39.1</td>
<td>52.1</td>
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<tr>
<td>Belgium</td>
<td>2.0</td>
<td>6.4</td>
<td>21.7</td>
<td>16.4</td>
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<td>1.9</td>
<td>2.1</td>
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<tr>
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<td>4.8</td>
<td>1.1</td>
<td>13.8</td>
<td>15.8</td>
<td>12.5</td>
<td>11.7</td>
<td>7.5</td>
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<td>Italy</td>
<td>5.2</td>
<td>9.2</td>
<td>5.6</td>
<td>11.4</td>
<td>3</td>
<td>4</td>
<td>15.6</td>
<td>14.4</td>
</tr>
<tr>
<td>Korea</td>
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<tr>
<td>Total</td>
<td>186.6</td>
<td>243.2</td>
<td>469.4</td>
<td>717.8</td>
<td>240.9</td>
<td>301.6</td>
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know-how that are not domestically available can be significant motives for foreign acquisitions. Nonetheless, the significance of M&A activity is that concluded deals constitute investments in existing factors rather in the creation of new ones so that, although they can lead to an increase in the acquitting firms’ capacity, they do not represent an equivalent net increase in the overall capacity of the world economy.

Chaisnais describes this as follows:
The type of corporate behaviour which may prevail when there is room in the market for many rivals to develop is likely to change as soon as slow or very slow growth sets in. This of course is what has occurred since the 1980s. Corporate growth and multinational expansion must now take place at the expense of other firms and thus FDIs occur principally in the form of mergers and acquisitions. (Chaisnais 1993: 17; emphasis added)

Most importantly, recent theoretical and empirical studies have shown that, just like in other forms of FDI, M&A activity has an inherent propensity to create herding effects, so that efficiency enhancement can become an objective of secondary importance. In an argument that bears similarities with Knickerbocker’s “bandwagon effect” in FDI, Gorton, Kahl and Rosen (2000) distinguish between aggressive and defensive acquisitions to show that firms may engage themselves in M&A as part of a strategy of discouraging other firms from launching hostile bids for them. This objective of clear managerial origin, they argue, eventually leads to merger waves where efficiency is often sacrificed in the name firm independence, so that M&A activity becomes itself an end rather than a means to exploiting OLI advantages. This, of course does not undermine the importance of the latter as causes of increased M&A in recent years. In fact, one could combine the argument of Gorton et al. with OLI motives to argue that firms often pursue defensive M&As in order to create and maintain “strategic comfort” (Schenk 1999). The outcome, however, is similar; one deal leads to another as a response. It is, therefore, not surprising that Black (2000) finds that the current cross-border M&A boom amounts to “the first international merger wave.” Certainly, the direction and extent of this wave can depend on whether hostile takeovers are realistically possible in the context of institutional sets such as those described in section 1.4 above. However, there is no doubt that the evidence on M&A activity presented above suggests that such a wave has indeed been underway since the mid 1990s or so.
The effects of the emerging global market for corporate control are anything but negligible. On top of the general effects of cost-driven FDIs on employment mentioned above, M&A transactions in most cases lead to workforce reductions in merged entities and, unless other jobs are available elsewhere, they result to intense downward pressures on employment and/or wage levels. In a restrictive environment where full employment policies are hard to pursue due to all the factors analysed earlier it is clear that merger waves should translate into increased unemployment or lower wages or, in the worst cases, both. Skilled and semi-skilled middle management employees are the most likely victims of staff redundancies, due to organisational overlaps between the merging firms. While some may find jobs elsewhere, it is likely that even then, due to increased labour supply, their salaries will be lower than in their previous posts and they should therefore be added to the low-skilled labour affected by FDI flows to less developed countries. This results to decreasing income levels and thus perpetuates the aggregate demand problem by completing the vicious circle of economic slowdown. The extent of these negative effects on labour should not be underestimated because of the relatively small number of deals that occur annually in comparison to the hundreds of thousands of firms that do not participate in the global market for corporate control. This is because, those who are directly involved are giant firms that not only employ millions of people on a collective basis but also constitute major economic units wherever they operate. One only has to consider that among the corporations that were parties to M&A transactions in 1998 were BP, Daimler-Benz, Alcatel, Total, Akzo Nobel, Coca-Cola, General Electric, Cable and Wireless, BT, Monsanto, Bayer, Nestlé, to name but a few.
Moreover, there are additional effects deriving from emerging global market
for corporate control which are specific to corporate finance and which signify how
financial globalisation can interact with the globalisation of production and with
M&A activity in particular. On the one hand, such transactions, especially when large
corporations are involved, require enormous amounts of money which often exceed
not only the funds available internally but also the capacity of national financial
markets. For large TNCs, however, this is not a significant constraint because they
have the capacity to tap global capital markets in order to obtain the funds they may
need. Not only do they often enjoy credit ratings that are better than those of many
governments, they also possess the necessary expertise to take advantage of global
financial markets and thus bypass domestic banks as providers of external finance.
This would not have been possible without the liberalisation of controls on financial
flows and the emergence of global finance. Where capital controls are present, funds
raised in the parent firm’s country become capital exports when used to finance
subsidiaries’ operations abroad and therefore subject to regulatory measures. In a
liberalised financial environment, on the other hand, money can be raised wherever it
is most cost effective and it can be used to finance investments anywhere in the
world. Thus, TNC activity goes hand in hand with financial liberalisation in a
mutually reinforcing manner.

Supranational markets such as Eurobond markets have been a source of trade
and FDI finance for TNCs since the 1960s due to tax advantages and the lack of
regulatory interference (Mellors 1974: 235). With the liberalisation of capital controls
during the 1980s, however, TNCs’ financial options have increased dramatically. The
growth of Eurobond markets during the past two decades has already been
mentioned. Although the globalisation of equity markets is still in its infancy, TNCs
have already begun to finance their activities through multiple equity offerings tapping most major stock markets simultaneously. In this way, firms overcome the severe cost and volume restrictions imposed by the thinness of domestic markets on their ability to raise the capital required; this is especially so in large M&A transactions. On the other hand, several deals are completed by a share swap between the merging firms and thus do not require new external capital. But even in these cases the integration of equity markets is not irrelevant because by listing their shares on each other's stock markets the two firms can establish a market for the swap and thus facilitate the transaction (Mittoo 1992: 43).161

Finally, irrespectively of what FDI strategies are followed financial globalisation and the gradual opening of formerly strictly national equity markets represents a whole set of new opportunities for those firms that can participate in them. In fact, the securing of access to the world's most liquid markets through foreign listings of stock has emerged as a significant competitive advantage for firms operating in world markets. The benefits are numerous and may differ for each individual company. Apart from the need to raise capital that domestic markets are unable to provide, some of the general advantages are the lowering of the cost of capital, the increase of stock liquidity, higher profile and visibility of the firm abroad (Pagano, Röel and Zechn 1999). It has been documented that companies pursuing expansionary strategies and which rely on export markets are the major users of the cross-listing vehicle (ibid). Despite all these benefits accruing, as section 2.4.2 below will show, the globalisation of corporate finance also entails costs, mainly in the form of securities regulation, with important corporate governance implications.

161 On the increased use of ADRs listed on the NYSE as “currency” for takeovers of US firms see Euromoney Magazine (1999: 80-82).
2.3.3. **International Organisations as Agents of Global Corporate Governance**

**Isomorphism**

While globalisation in its current form seems to have a negative impact on the workability of managerial systems through competition in world markets, some international organisations have also formulated strategies for the promotion of the shareholder supremacy principle and therefore deserve a brief mention.

The most important effort has been initiated by the Organisation for Economic Cooperation and Development (OECD) with the formulation of its Corporate Governance Principles. These were the outcome of an Advisory Group set up in 1996 with the mandate of the OECD Ministers to review international corporate governance matters and propose minimum standards that should be followed in Member Countries. The Advisory Group reported in April 1998 and the following year a Task Force was set up to develop the final set of principles which were eventually adopted by the OECD Ministers in June 1999.

Both the Advisory Group’s Report (OECD 1998) and the Principles that sprung from it follow an approach that limits the meaning of corporate governance to the alignment of managerial decision-making to shareholder interests (Dignam and Galanis 1999). Although the Principles recognise the importance of other stakeholders’ rights, by advocating for managerial accountability *solely* to current shareholders both directly and through the market for corporate control, they adopt the Jensenian model of the firm.

Certainly, the OECD Principles do not constitute either a legally enforceable instrument or even a code of best practice adopted by corporations across the world. However, since their formulation they have been gaining acceptance, not least due to...
their promotion by the OECD itself and other organisations such as the World Bank, the European Bank for Reconstruction and Development, the International Organisation of Securities Commissions and the IMF. Characteristically, the OECD Secretary General and the World Bank’s President have signed a Memorandum of Understanding aiming for the “improvement” of global corporate governance standards on the basis of the Principles. As part of this joint initiative, a Global Corporate Governance Forum and several Regional Policy Dialogue Roundtables have been formed to promote the acceptance of the Principles. In other words there are systematic efforts by international organisations for the institutionalisation of shareholder supremacy as a globally accepted corporate governance norm.

Simultaneously, further pressures in the same direction arise from the role of the IMF and the World Bank as lenders due to the “conditionality” that accompanies their loans to member countries. Generally, these conditions constitute pressures on borrowers for institutional reforms that seek to enhance the role of markets, domestic and global, based on the assumption that their discipline on government policy making is the best solution to economic crises and their prevention (Pauly 1994; Pieper and Taylor 1998). Prolonged austerity programmes, current and capital account liberalisation, capital market reregulation enhancing outsider investor protection, not only impair the sustainability of (insider-)managerial systems but also promote shareholder supremacy through the mechanisms identified in this thesis. Such policies of Bretton Woods organisations, which contradict the latter’s original remits, should also therefore be regarded as important drivers of globalisation and should be added to the forces of global isomorphism.
2.3.4. Significance

As the brief historical overview in section 1.2 above demonstrated, the influence of market conditions on the organisation of production is immense. Chandler’s account of the evolution of the capitalist firm shows how the expansion of markets and demand from the late 19th century onwards led to the gradual replacement of the entrepreneurial firm by the large managerial corporation with the separation of ownership and control. The economic developments presented above, i.e. the increasing integration of national economies with the advent of globalisation, certainly constitute a dramatic transformation of market conditions. Following, the Chandlerian thesis one possibility is that the spatial enlargement of product markets in the current globalisation wave should create vast opportunities for growth in scale and scope and thus lead to the promotion and entrenchment managerial capitalism. Indeed, Hymer (1972) has noted that the multidivisional form of the managerial firm gave it the appropriate administrative structure for its multinationalisation.

However, a closer look at the emerging global economic order as described above reveals that the current environment is not conducive to the necessary macroeconomic preconditions that could sustain a growth trajectory based on the managerial firm. On the contrary, significant pressures in the opposite direction seem to have arisen due to the recent slowdown of global effective demand and the ensuing needs for firms to reorganise their production processes. In such a macro-environment, managerial growth-oriented microeconomic models, such as those outlined in the previous chapter, cannot be easily sustainable. On the one hand, as the Kaldorian growth model of the golden age fades due to economic globalisation, production systems that used to rely on high output growth and financial stability face
increasing pressure to reorganise in order to deal with slower demand and the increased frequency and persistence of financial crises. On the other, this reorganisation leads to the re-evaluation of established relationships between the firm and its main resource providers, i.e. financial capital providers and employees. Regarding the former, the opening of new financial opportunities in global financial markets combined with the increased financial needs constitute direct challenges to the sustainability of long-term financial relationships. Similarly, the new international division of labour and the global market for corporate control impose significant obstacles to the creation and the maintenance of committed employment contacts, for skilled, semi-skilled and unskilled labour. Moreover, the dominant role of institutional investors in world financial markets and their tendency to maximise short-term returns on their investments in corporate securities creates additional pressures on managers to rethink long-term commitments. Recently, these pressures have taken a more “institutionalised” form since they have become part of international organisations’ agenda. Given these pressures from the emerging global economic (dis)order the following section will now turn to examine the ways in which corporate governance systems can respond on the basis of their internal institutional dynamics.

2.4. GLOBALISATION AND DYNAMIC RESPONSES OF NATIONAL CORPORATE GOVERNANCE SYSTEMS

In chapter 1 above, corporate governance systems were examined as static constellations of institutional subsystems. Stability is, of course, a fundamental
characteristic of institutional configurations. It is the stability of institutions that resolves transactional problems by introducing elements of certainty and predictability in markets that are full of unknown contingencies and informational asymmetries. Due to the existence of institutions, economic agents' behavioural patterns become more predictable, so institutional stability is 'a necessary condition for complex human interaction' (North 1990: 84). This is because, by improving the predictability of available choices, established institutions facilitate the supply of information to economic actors and thus reduce the transaction costs even of highly complex transactions (Hodgson 1993: 132-133). For example, as mentioned earlier, financial disclosure rules for companies are designed to reduce uncertainties for investors.

However, in the presence of resource scarcity and, therefore, of competition institutional sets are also characterised by continuous transformations. The causes of institutional transformations are changes in the opportunities perceived by economic agents. These are the result of external changes in the economic environment – e.g. changes in preferences and factor prices – or of the acquisition of skills and technological knowhow by agents (North 1990).

The developments in the global economy described above constitute a dramatic environmental change for firms and the national systems within which they operate. As the previous section shows, the opportunities and challenges stemming from economic globalisation have significantly altered the nature of basic input costs and of competition\(^{162}\) resulting to a shift in the preferences of corporations who want to adapt to the challenges of the emerging economic order and exploit the opportunities within it. Financial and industrial capital mobility have altered the role

\(^{162}\) See Baldwin and Martin (1999: 38-41).
of nationally bound resources, such as unskilled labour and domestic savings, as well as of national institutional structures which are now subjected to competitive forces through the firms that are active in global markets.

As the globalisation of economic activity intensifies, corporate governance isomorphism is being transformed from one that is nationally embedded to a new type that is increasingly determined by global market forces and institutional arrangements that are not bounded within one nation. The opening of economic borders allows firms' operations to transcend national institutional systems and thus facilitates the interaction between national systems themselves and between national systems and the global economy. So, it is argued here that, due to the existence of a direct interaction between firms' activity and the institutional infrastructure within which that takes place, the potential consequences for nationally determined corporate governance systems could be enormous. Therefore, a systematic theoretical examination of institutional responses to economic globalisation is essential.

As already mentioned in chapter section 1.4, the traditional neoclassical methodology à la Walras excludes institutions altogether from its analysis. However, as the microeconomic nexus-of-contracts model of Jensen and Meckling shows, attempts have been made to incorporate institutional analysis into the neoclassical theoretical framework though in such a way that it does not conflict with general equilibrium theory. In a similar fashion, others have attempted to stretch the neoclassical methodology beyond its static equilibrium limitations so as include a macro-dynamic institutional analysis.163 Institutionalists proper, however, have attacked such attempts as futile from a normative perspective, because the teleological postulates of neoclassical tradition are retained as their general theoretical

163 For instance, the "property rights" literature analyses the implications of institutions for performance. See Alchian (1965); Demsetz (1967, 1964); Furubotn and Pejovich (1972).
basis (Dulbecco and Dutraive 2001: 59; Myrdal 1957: 10). These two approaches and their normative implications for the evolution of corporate governance institutions in the context of a globalising economy will be discussed next.

It will be shown that, despite some claims of neoclassical origin that globalisation can give rise to optimal governance arrangements, in a world of imperfect markets the institutional responses of corporate governance systems are not easily predictable due to each national system's internal dynamics. However, in the light of the previous section's analysis, this thesis argues that, even in the presence of diversity in systemic responses, current developments in the global economy not only have destabilising effects on governance models based on the managerial-stakeholder consensus, but also exert increasing pressures towards a shareholder-oriented trajectory without, however, resolving the problems stemming from the fact that real markets do not function as the efficient market hypothesis assumes. Therefore, where convergence of corporate governance models occurs at all it is towards a sub-optimal system.

2.4.1. Neoclassical Theories of Institutional Change: The Convergence to Optimality Claims and Their Validity

As already noted, in a market where competition is perfect, prices are formed automatically by the market as firms are too small to influence them. Profit-maximising choices are then made according to those given prices so that a Pareto-

164 Accordingly, North (1994) states: 'the neo-classical paradigm is devoid of institutions and Pareto efficiency is meaningless when it comes to exploring different institutional structures and their implications for economic performance through time'. Similarly, Nabli and Nugent (1989b: 9) state that "the explicit or implicit assumption of given institutions is, of course, especially unrealistic and limiting in the context of economic development."
optimal equilibrium is achieved. When a price changes, e.g. due to an alteration in the availability of an input factor, an optimal adaptation of output occurs to accommodate the new equilibrium price. Similarly, if a new technology becomes available all firms will adopt it provided that is the profit-maximising course of action. This optimisation process is traditionally based on the axiom that firms as entrepreneurs are fully informed and rational agents. How does institutional change fit into this paradigm?

The precise answer to this question is that it does not. The reason for this is that neoclassical theory assumes that where markets are perfectly competitive rational economic agents design perfect institutions which lead to optimality. This is the claim encapsulated in the Coase theorem according to which when transaction costs are zero, that is when there are no informational asymmetries and, therefore, no risk of unilateral opportunism, institutions do not matter (Coase 1960). So, when rational and well-informed agents perceive a new opportunity they immediately choose to take it without being constrained by past institutional choices. In order for such a Coasean market to exist competition has to be perfect so that price arbitrage and informational feedback can eliminate informational asymmetries thus enabling all agents to make optimal choices (North 1990: 51).

In this neoclassical line of thought the possibility of mutual interaction between agents and institutions is completely excluded as it is only the former that shape the latter. So, given a change in the resources available or in market conditions, if any incumbent institutional constraints stand in the way of this process, they will be consciously abolished and replaced by others that are optimal so that a new optimal equilibrium is reached. In this sense, institutions are not seen as constraints but

165 For this condition to be satisfied it is assumed that intellectual property rights are imperfect and cannot prevent agents from ultimately having access to new technology.
simply as efficient transaction cost minimising mechanisms which eliminate market failure before it even arises. These constitute integral elements of efficient markets by facilitating information flows between economic actors, and thus support the role of the market as a resource allocation mechanism. So, in this optimisation process agents are the masters of institutions, since they are able to determine them according to their rational choices and expectations which in turn are independent of any institutional influence. To use Langlois' terminology, neoclassicists regard institutions as instances of market contracting between agents rather than as alternatives to market coordination (Langlois 1986: 16). Since institutions have no independent role or existence above and beyond the individual or the firm, they can be treated as irrelevant to the analysis of economic change. As Skott and Auerbach put it:

If institutional structures represented an optimal choice of instruments for the matching of exogenously given preferences and opportunities, then institutional change would have no more significance than, say, changes in consumption bundles as incomes increase; institutional change would be reduced to the status of epiphenomena. (Skott and Auerbach 1994: 14)

Similarly, all those factors that constitute sources of economic change are regarded as exogenous or given to the economic system so that ultimately economic analysis is limited only to resource allocation and exchange matters. Thus, just as the rationality premise excludes any discussion of agents' preferences, the availability of production resources is simply determined by non-economic factors – e.g. natural disasters, demographic changes, etc. – that are beyond the scope of economic science. Production-related technology, i.e. scientific and organisational know-how, is also an

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166 This was indeed Coase's claim in his seminal work when he claimed that the firm and the market are complementary resource allocation mechanisms.

167 Since the neoclassical 'economic man' can only be a rational utility-maximiser, the possibility of changing preferences as a result of institutional or other factors is by definition expelled from economic analysis. See Knight (1942).
exogenous non-economic variable, since it is assumed to be created outside the economic system and then uniformly disseminated across the market as a public good rather than being a private asset (Hall 1994: 12-15). Any change in those exogenous factors, that is any external shock to the economic system, causes an automatic and optimally adaptive reaction within the system as agents pursue their ends in a competitive marketplace. As Hayek writes, “a spontaneous order results from the individual elements adapting themselves to circumstances” (Hayek 1982: 36).

Admittedly, when compared to the Walrasian static equilibrium, Hayek’s thesis is indeed revolutionary, because it introduces a dynamic approach to institutional evolution that appears to break away from the strictly static tradition of general equilibrium theory. His model is one where an equilibrium occurs after self-interested agents form plans and strategies which eventually come into mutual consistency after an adaptive process of learning within a changing environment. However, his insistence, though indirect, on the ability of agents to eventually make rational decisions and form correct expectations excludes any constraining influence of institutions on individual choices and thus defeats the whole purpose of institutional analysis. So, in essence Hayek’s concept of ‘spontaneous order’ is not much different from Adam Smith’s ‘invisible hand’.

That conscious rational optimisation constitutes a rather unrealistic postulate is not disputed even by some of the most faithful adherents to the neoclassical

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168 Certainly, technological progress has been incorporated in some neoclassical models as the product of research and development or the by-product of “learning by doing”; see Arrow (1962); Levhari (1966). However, it is again assumed that even if a new technology is created endogenously it automatically becomes a public good so that all firms or nations can benefit from it irrespective of their own technology investment policies. In this way, increasing returns to scale in physical inputs become externalized so that, provided markets are competitive, equilibrium can occur (Shaw 1992).

169 See Hayek (1948: ch.2). Indeed the neoclassical evolutionary model presented herein is founded upon this revolutionary attempt to expand general equilibrium theory.
methodology. The requirement of conscious rational choices and expectations is too stringent to have a real application. So, as noted in the section 1.3.2 above, Alchian’s competitive selection argument has often been used to support the neoclassical ‘black box” analysis of the firm (Alchian 1950). However, Alchian’s theory is equally relevant to the macroeconomic analysis of institutional change and, therefore, neoclassical scholars, often identified with the Chicago School (Bratton and McCahery 1999: 243), have embraced it wholeheartedly to defend the orthodox view that a free market economy is able to develop institutions that are efficient without non-market intervention. Accordingly, in his classic essay on methodology Friedman (1953b) claimed that, although conscious optimisation may be impossible in an uncertain and complex world, the maximisation postulate could still hold because competitive selection forces agents to act as if their rationality was not bounded and therefore optimal institutional arrangements are established.170

The argument is that, just as firms who fail to maximise profit are selected out by the system, institutions that prevent firms from making rational profit-maximising choices are outcompeted and eventually weeded out. In other words, those institutions that fail to deal effectively with transaction costs are eliminated and only optimal ones survive competition. Ultimately, institutional change as a result of exogenous shocks takes the form of a continuous evolution from one efficient institutional outcome to the next. The adverse selection process is usually indirect in the sense that it is agents that compete against each other rather than institutions.171 So efficient

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170 Nonetheless, Alchian himself was more hesitant in assimilating competitive selection with rational optimisation: “The economist may be pushing his luck too far in arguing that actions in response to changes in environment and changes in satisfaction with the existing state of affairs will converge as a result of adaptation or adoption toward the optimum action that should have been selected, if foresight had been perfect” Alchian (1950: 220).

171 As Matthews (1984: 92) observes, “[o]ptimization is direct choice by the economic agent, competitive selection is indirect social choice through changes in the relative weight of different decision-makers, brought about through the working of the system.”
institutional outcomes emerge because some firms are rational profit-maximisers *ex ante* and those firms who are not and are associated with inefficient institutions fail or *copy* the former by altering their institutional preferences.

Matthews (1984: 92) identifies two possible ways in which competitive selection can operate. The first is one where uniformly defective knowledge prevails among economic agents so that conscious optimisation is not possible. In this case, some firms, or groups of them, achieve optimal institutional results only because they happen to make the right choices by chance. Competition, then, ensures that all other institutional choices are abandoned by those agents who chose them or are replaced by optimal ones. The second neoclassical version of competitive selection is one where there is differentially defective knowledge, i.e. informational asymmetries, among agents so that some can consciously make optimal institutional choices while others cannot. Thus, while there is a difference in the cognitive features of agents in these two versions of competitive selection, the final institutional outcome in both is an efficient one.

So, if a general neoclassical approach can be constructed to deal with the process of institutional change, it would be founded upon a combination of optimisation, conscious or fortuitous, and competitive selection. It must be emphasised that the most crucial element in this process is the intensity of competition. Unless the market is perfectly competitive so that individual agents cannot influence prices, an efficient institutional system will not emerge. The general neoclassical belief is that markets that operate freely are sufficiently competitive. What restricts competition is non-market interventions in the form of government regulation that constrain individual choices and destroy the equilibrium of the market. In Hayek’s view, a “spontaneous order” cannot come about when governments
impose price regulations, trade barriers, quality standards and so on, because markets are so complex that no central authority can acquire the necessary information and knowledge to make efficient institutional choices; decentralised decision making by individual agents is thus more efficient than government planning (Hayek 1945: 524).

The faith in market forces is epitomised by Lachmann as follows:

It would be wrong to think that a market economy, when faced with the problems just outlined, could, or in the ordinary course of events would, find no answer to them. History shows that whenever left sufficiently free from political interference to evolve its response to such challenges, the market economy has 'grown' the institutions necessary to deal with them. (Lachmann 1978: 67)

This neoclassical evolutionary model has some very important implications for the direction of institutional change. Firstly, if agents within a single economic system face common problems and opportunities, the institutional adaptation process will result to one optimal structural solution that is common to all. Competitive selection will ensure that institutional choices which diverge from that new model will disappear, either due to the failure of those who chose them or because less successful agents imitate those whose performance is superior. That is, competition ensures that superior institutional technologies are disseminated evenly across the market so that a universal 'best practice' prevails (Boyer 1996: 46). This has given rise to the popular neoclassical theory of institutional convergence which claims that, through the process just described, competition leads initially diverse institutional structures to converge towards a unique superior outcome that is adopted or supported by all (surviving) agents in a single market.172 Ultimately, optimal institutional

172 Originally the optimal convergence thesis was limited to economic growth rates; e.g. see Sala-i-Martin (1996). However, once institutions are considered as relevant for economic performance, convergence of growth rates should also imply institutional convergence; this is a point not expressly made by neoclassical economists since they do not regard institutions as economic factors. An exception to this is North’s early work on institutional evolution from which he retreated later in his
convergence will lead to the disappearance of economic performance disparities within each particular marketplace.

The optimal convergence thesis is founded upon a further sub-argument which springs from the neoclassical model of economic change outlined earlier; namely, the premise of institutional reversibility. This notion implies that markets can not only move freely from one institutional equilibrium to another but also they can as easily return to previous equilibria if that is an optimal choice. To illustrate this David (1997: 13) has borrowed from physics the concept of "ergodic systems", i.e. systems that are connected in such manner that "it is possible to transit directly or indirectly between any arbitrarily chosen pair of states, and hence, eventually, to reach all the states from any one of them." It was shown earlier that, since in the neoclassical framework institutions do not constitute constraints to agents' maximising strategies, past institutional choices do not exhibit a controlling influence in present or future strategic decisions unless agents themselves so desire. In this fashion, institutional equilibria at any given moment are ergodic and can move both backwards and forward so that eventually concepts such as the past or the future become meaningless and history is irrelevant. So, perhaps not surprisingly, in the neoclassical approach to institutional change the dimension of time is ultimately as irrelevant as it is in the static general equilibrium theory of Walras; they both belong to the same tradition that David (1997, 2001) would call "ahistorical economics".

The implications of the neoclassical theory of institutional change for corporate governance are quite obvious. The starting point is that performance is directly linked to the efficiency of corporate governance techniques. Due to the determinant influence of institutions the efficiency of these techniques depends on the

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career; see North and Davis (1971) and North and Thomas (1973). For applications of the optimal convergence thesis on corporate law and governance see infra n.175 and text.
effectiveness of related institutional arrangements in dealing with transactional and allocational issues and in enabling firms to fully exploit profit opportunities that may arise. On the basis of this link between performance and corporate governance, competitive selection as described above ensures that from those institutions that determine firm behaviour only optimal ones survive. Furthermore, as the convergence thesis asserts, in a single perfectly competitive market one unique and efficient corporate governance model emerges as all other inferior models are selected out and fade. Of course, free-market competition is the driving force towards optimality; therefore, any non-market intervention constitutes a distortion of the competitive selection mechanism and should be avoided. Thus, mandatory government regulation of corporate governance is inherently inefficient because it constitutes a constraint to rational individual choice and should, therefore, be avoided. Similarly, institutions that restrict competition by imposing direct and indirect barriers on economic activity are artificial imperfections imposed by governments. It is these non-market institutions that segregate national markets and distort competition between corporate governance systems at the expense of efficiency.

Thus, with the advent of globalisation as an integration process of formerly segregated national markets into a global marketplace, the emergence and universal adoption of a new and efficient model of corporate governance is inevitable. The argument is that, as the deregulation in financial, factor and product markets progresses and national economic borders erode, global competition will eventually drive costs and prices towards unique equilibrium levels. Thus, firms will not only

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173 On the influence of institutional structures on economic performance see Myrdal (1957). Accordingly, Boyer (1996: 41) states: “Complex interactions between economic convergence and institutional diversity and, conversely, an inadequate institutional harmonisation may all induce economic divergence.”

174 E.g. Easterbrook (1997) argues that free-market competition between corporate law and governance systems leads to a unique efficient outcome.
compete on an equal footing but they will also face the same challenges and opportunities. Consequently, in order to survive they will have to develop and adopt the same optimal corporate governance solutions. Best practices will either be adopted as rational optimal choices of efficient firms or they will be "imposed" by the market as inefficient corporate governance institutions and those firms associated with them are driven out by global competition. To the extent that rational firms' optimising choices are constrained by inefficient national institutions that impose unnecessary costs, globalisation has opened up the exit option so firms can choose the national systems they regard as more facilitative for capitalising on their OLI advantages. As Bratton observes:

We come to a moment –whether in the immediate past, the present, or in the near future- at which intensifying competition in international product markets for the first time turns endowments derived from national governance systems into factors relevant to firms' competitive survival. (Bratton and McCAhery 1999: 240)

Eventually, with the emergence of a global marketplace, competition is between different national institutional sets within which firms operate as promoters of change. As firms become increasingly mobile, regulatory arbitrage – e.g. through foreign listings, shifts of production operations or even re-incorporations in what firms regard as the best jurisdictions – results to an institutional “race to the top”.175

Once globalisation is complete – i.e. when a perfectly competitive global market is established – a process combining rational optimisation and competitive selection between national systems will give rise to a unique, universal and optimal equilibrium

175 For classic expositions of the “race to the top” argument in the context of US state competition for corporate regulation see Romano (1993, 1998) and Winter (1989). It is important to note, however, that this literature on corporate governance systems’ competition takes as given the superiority of the shareholder model. In the absence of this assumption this interpretation of corporate governance developments can become much more complex and inconclusive. For instance, if one took the view that the managerial model were superior, the race to the top argument would then have to be reversed.
model of corporate governance formed by the market forces. According to Matthews, there will be:

Imitation of the advancing country’s institutions or its other modes of economic behaviour; adaptation by means of optimisation to changes in comparative advantage brought about by events in the advancing country; adaptation by means of competitive selection to those changes in comparative advantage; and achieved by emigration of entrepreneurship and management from the advancing country. (Matthews 1984: 114)

Following an essentially neoclassical methodology many observers have been suggesting that a process of global corporate governance convergence towards one “best-practice” model is already underway. 176 Thus, Hansmann and Kraakman (2001) follow the example of Fukuyama’s “end of history” claim 177 to categorically argue for the coming of the end of history in the sphere of corporate law and governance with the universal acceptance of the shareholder-oriented model’s superiority over other models. 178 They contend that “experimental” regulatory interventions by governments during the 1950s and 1960s reinforced managerial discretion and curtailed shareholder power in a way that hampered the efficient operation of product and capital markets. 179 Thus, the failure of managerial and stakeholder models in the 1970s and 1980s was not only inevitable, but also proved the superiority of shareholder supremacy as a guiding principle of corporate governance. 180 Therefore, Hansmann and Kraakman claim that, with the intensification of global competition, institutional systems supporting managerialism, being the outcomes of government intervention rather than market forces, are being selected out by investors and TNCs

176 For an early exposition of this argument see Karmel (1991: 90).
177 See Fukuyama (1989) arguing for the final triumph of western free-market capitalism and its universal acceptance.
178 Interestingly, Hansmann and Kraakman acknowledge that national differences may in fact persist but they do not explain how this is reconciled with their end of history claim.
179 On the idea that government controls constitute barriers to convergence see also Ramseyer (1998: 544) and Berger (1996: 1).
180 For a forceful presentation of this “superiority” claim see Macey (1998).
as locations for their investments and production activities due to their inefficiency as they contradict the market value maximisation objective. Thus, institutional systems which ensure that the principle of shareholder supremacy is observed enjoy a locational advantage. They provide firms with a more efficient organisational structure which ensures easier access to global capital markets and therefore give them a significant competitive advantage in the global marketplace. As a result of competitive pressures, all jurisdictions should be expected to develop similar locational advantages by converging towards what Hansmann and Kraakman call “the standard model of the corporation”, that is the model put forward by Jensen and Meckling in which the only corporate objective is to pursue the interests of current shareholders as residual claimants and managers’ principals. With the removal of government-imposed “distortions”, such as capital controls, markets will succeed in enhancing mechanisms of shareholder monitoring over managers, either directly or indirectly through the market for corporate control, global and national. Efficient corporate governance institutions will emerge through private market-contracting rather than mandatory regulation of corporate activity.181

Certainly this would not be a problem if the outside-shareholder model could generate a high growth trajectory. Indeed, if one accepts the neoclassical postulations that markets are able to eliminate agency and other transaction costs, then all profitable opportunities can be exploited without firms having to internalise financial or production investment decisions, except when markets believe it is efficient to do so and provide the necessary incentives to corporate decision makers. In such a theoretical construct, global capital markets should be able to allocate finance efficiently so that firms across the world have unrestricted access to the funds they

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181 Goddard (1996) identifies an ongoing global trend towards this direction.
need as long as they have profitable growth opportunities to pursue. Simultaneously, by relocating their activities to what they regard as the most advantageous locations, profit-maximising TNCs and other firms will reward efficient systems and punish inefficient ones giving them the incentives to adopt the global model. The objectives and form of financial, employment, macroeconomic and other policies must then be determined by free market forces without “distorting” interference by governments.

If that is so, Hansmann and Kraakman’s claim that the “experimental” government interventionism, which created and sustained the managerial microeconomic governance model in a Kaldorian macroeconomic environment, was a recipe for economic failure is indeed valid. Just as Friedman and other Chicago School free-marketeers have been arguing all along, government controls over financial flows, international trade and labour markets during the “golden age” were inefficient, because they constrained good firms’ access to financial capital and their ability to adopt the right organisational structure for doing so. Thus, the coming of globalisation and the “end of history” with the adoption of shareholder-oriented corporate governance as the standard global and uniquely superior model will apparently bring the final efficient resolution to a long-standing debate.

**Implausibility of the optimal convergence thesis**

The optimal convergence thesis is difficult to defend if the neoclassical laboratory conditions do not apply. Given the record of financial markets as inherently inefficient and unstable due to “beauty contest” speculation and investors’ herding strategies described earlier, the idea that the shareholder model is optimal
automatically loses its validity. It has already been shown that where markets are imperfect and the efficient market hypothesis does not apply, running the firm solely in the interests of shareholders could be damaging, as the extraction of cash flows, e.g. in the form of dividends, will constrain the firm’s ability to invest and capture profitable growth opportunities. So, if one recognises that financial markets are not efficient enough to create strong complementarities between financial assets and growth opportunities, the shareholder model ceases to be superior to the managerial one in both allocative and macroeconomic growth terms. This means that, where the neoclassical “laboratory” preconditions do not apply, i.e. in reality, adaptation towards the outside-shareholder model constitutes part of a vicious circle leading to a process of cumulative instability, low investment and slow growth.

Similarly, as already argued above, the globalisation of production capital creates inefficiencies that markets are unable to resolve without outside intervention. Even if firms pursue what they honestly regard as profit maximisation strategies, the negative externalities can be severe. Consequently, competition for FDI cannot provide a healthy discipline for government policies. As many authors have acknowledged, where markets are imperfect free competition between states and jurisdictional arbitrage can lead to a regulatory race to the bottom rather than to the top. That being so, non-market interventions, such as demand management macro-policies, capital controls, employment protection or other regulations to reverse this circle, become necessary and not “experimental” or “inefficient”.

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182 For a collection of essays on the topic see Bratton, Mc Cahery, Picciotto and Scott (1996) and especially ch.9 therein. For an early exposition of the “race to the bottom” argument in the sphere of corporate regulation see Cary (1974) and Bebchuk and Cohen (2001). However, the same caveat in respect of the shareholder model’s superiority assumption also applies to the “race to the bottom” argument; see supra, note 175.
In the light of the analysis so far it is perhaps surprising that not all advocates of the optimal convergence thesis seem to agree on the shareholder model's superiority claim. Kester (1996) for instance, argues that while competitive selection can lead to corporate governance convergence to best practice, the new global model will be neither the managerial nor the shareholder model. Instead, a hybrid model will emerge which will combine the best elements of each system. Before the advent of global competition, national systems of corporate governance could maintain their diversity in the ways they dealt with the transaction costs of production processes. This diversity, Kester argues, does not mean that one model is necessarily superior to the other. On the contrary, he claims that both the shareholder model and the managerial model, though not optimal, have offsetting strengths and weaknesses that make them equally fit (ibid.: 127). If the shareholder model is more efficient in minimising agency costs in the shareholder-manager relationship but less so in dealing with transaction costs in the production process, the managerial model has exactly the opposite qualitative characteristics. Thus, as globalisation progresses and competition between systems intensifies, the two corporate governance systems will gradually merge by adopting institutional arrangements that combine both production efficiency and agency cost minimisation. Certainly, if the two corporate governance models are different but equal in terms of efficiency, then their respective systemic costs and benefits should work out roughly the same so that systemic differences do not affect bottom line results (Bratton and McIahery 1999: 242). Thus Kester's convergence thesis is based on the competitive selection scenario where agents have
uniformly defective knowledge, so that, if convergence to optimality occurs, it will be because optimal institutional choices are made within each system by chance.

In fact, by accepting the equal fitness argument what Kester does is to misconstrue the concepts of workability and complementarity, part of which, of course, are the macroeconomic growth considerations mentioned above. Indeed, he does identify the complementary relationship between macroeconomic factors and corporate governance; he correctly recognises the superiority of the managerial model in the context of high rates of growth and its inferiority in a slow growth environment (Kester: 127). However, by subsequently putting forward his equal fitness claim, he is led to contradict himself; one can either accept the efficient markets hypothesis or reject it, but cannot do both. Either self-regulated markets are able to create the necessary macroeconomic conditions and organisational structures that will enable firms to maximise profit or they are not so that non-market intervention is necessary in order to correct market failures. If complementarity and workability are to be understood in their complete form as described in this study, it is difficult to explain how the managerial and the shareholder model can be equal from an efficiency perspective within the same global macroeconomic context. If markets are efficient, as Kester appears to assume, shareholder supremacy should be the only principle underlying corporate decision-making.

Eventually, this contradiction in Kester’s model arising from its failure to incorporate complementarities between the macro-environment and corporate governance leads to the outright rejection of the concepts of complementarity and workability. That is so because his convergence scenario is based on what Bratton and MacCahery (1999) call cross-reference, that is the exercise of selecting the best institutions from each model in order to combine them and construct a third model.
that is superior to the two original ones. But, as the analysis in the previous chapter has shown, due to the implications stemming from the notion of institutional complementarity and its relation to systemic workability, convergence by institutional cross-reference is *ab initio* inefficient. So, even if the optimal convergence thesis is valid, its final outcome will have to be a "spontaneous order" that is workable. For these reasons, Kester’s optimal convergence hypothesis based on institutional cross-reference must be rejected as theoretically inconsistent. Thus, one can partly concur with Schmidt and Spindler’s (2000) and Bratton and MacCahery’s (1999) claims that, unless global competition led to the emergence of a system along the lines of *either* the shareholder model *or* the managerial model, convergence would be towards an unworkable outcome. Still, in a context of imperfect markets, even these claims are incomplete and muddled because they are based on the equal fitness misnomer. In doing so, they exclude the macroeconomic considerations analysed above and, thus, impose an unnecessary and distorting limitation on the concept of complementarity.

In sum, given the current nature of globalisation, if the global corporate governance convergence thesis is well-founded, only two corporate governance outcomes are possible depending on the theoretical postulations used. If one adheres to the neoclassical paradigm of efficient markets and zero transaction costs, an outsider-shareholder system should emerge which will not only be suitable to global economic trends, but will also create the necessary complementarities between global financial assets and investment opportunities so as to promote sustainable economic growth and prosperity. Free from government interventions, global markets and firms operating in them will by themselves create a “spontaneous order” establishing all institutions necessary for aligning the interests of managers with those of
shareholders, just as Jensen and Meckling assumed in their seminal work. Indeed, in accordance with the neoclassical theory's predictions, national corporate governance systems would converge to optimality.

On the other hand, outside the neoclassical lab, where markets are not assumed to be perfect or able to construct efficient spontaneous orders of the Hayekian type, a completely different picture emerges. As it was argued above, to the extent that competitive markets can impose their wishes on institutional structures, convergence towards the shareholder model would constitute an adaptation to a systemic trajectory characterised by inefficiency and slow growth. Even then, once transaction costs are introduced into market contracting even this second version of the convergence thesis cannot hold in its absolute form. As the following analysis will show, outside the neoclassical laboratory conditions optimal corporate governance convergence or any other type of convergence is anything but inevitable. This is because while competitive forces may push towards systemic convergence of some kind, a whole set of other institutional forces may simultaneously pull corporate governance systems towards their original position so that predicting where the resultant force will lead becomes an impossible empirical exercise.

2.4.2. Institutional Complementarity, Path Dependence and the Possibility of Convergence in Imperfect Markets

Viewed through the prism of institutional economic theory, corporate governance developments can be interpreted in a way that is very different from the convergence claims discussed above. As already mentioned, institutionalist criticism
of the neoclassical assumptions as unrealistic has gained momentum over the years. As stated in chapter 1, the focus, or rather the beginning, of the institutionalist critique is the zero transaction cost-perfect market assumption of conventional economics. By recognising the existence of positive transaction costs in market contracting, institutionalists have sought to introduce realism into economic theorising in order to explain real phenomena, such as persistent underdevelopment and performance differentials, that cannot exist in the utopian world envisaged by Coase. Thus, they have reversed the Coase theorem to claim that, because in the real world transaction costs are significant, institutions do matter as endogenous constraints on agents' behaviour and therefore their independent role in economic activity cannot be ignored.

Once the theoretical analysis of institutional change is modified to include market imperfections and deviations from the global rationality postulate, its predictions are significantly different from those of the approach outlined above. While neoclassicists regard institutional change as a process that is driven by exogenous environmental factors that temporarily push the economic system out of equilibrium until a new optimal equilibrium is found, institutionalists acknowledge that institutional systems may not always evolve efficiently. As Hodgson observes:

Economic evolution does not always proceed slowly and smoothly in Darwinian terms so that a permanent equilibrium is maintained. It can also proceed by succession of periods of stability and crisis, i.e. of apparent equilibrium and cumulative instability. (Hodgson 1988: 144)

This is because, where transaction costs are positive neither rational optimisation nor competitive selection are capable of producing optimal outcomes. As regards the former, it is obvious that agents' bounded rationality prevents them from consciously designing optimal institutional sets. This is not denied even by neoclassicists who, as
mentioned above, resort to competitive selection as a “corrective” mechanism with results equivalent to those of rational optimisation. But even this position is difficult to defend.

To begin with, there is a fundamental difference between the two processes; while in rational optimisation the choice of efficient institutions is made ex ante, competitive selection operates ex post. This means that the former, as a process of continuous and conscious optimal change, by definition excludes institutional imperfections. The retrospective nature of competitive selection, on the other hand, implies that there has to be a reversal or modification of past institutional choices which have become inefficient as a result of changes in prices and agents’ preferences. For Friedman’s claim that competitive selection can be regarded as equivalent to rational optimisation in terms of efficiency to be valid, the costs generated during such institutional reversals or modifications must be zero. According to Matthews (1984: 103-106), this can be the case only if institutional adaptation is instantaneous, so that there is no loss of output during the change, and if institution-specific assets can be fully redeployed within the new optimal institutional framework. While the former condition is as arbitrary as the process of tatonement in Walrasian equilibrium economics, the latter is simply paradoxical. Consequently, institutional reversals or modifications may involve significant costs due to potential loss during the adjustment period and to “ex post non-malleability”, i.e. the dumping of past investments that were specific to the old institutions (ibid.: 104). This means that the process of competitive selection is itself subject to significant transaction costs, which can be called adaptation costs, and it therefore cannot be regarded as equivalent to rational optimisation.

183 Tatonement is the process of price adjustments following a change in demand, during which it is assumed that no exchange takes place until equilibrium prices have been established by the operation of the law of supply and demand.
The significance of adaptation costs in institutional change is not exhausted with the observation that competitive selection can lead to sub-optimal but still good results. On the contrary, their most important consequence is that where they are above a certain level that agents are willing to bear, change may be delayed or not pursued at all so that a situation of temporary or permanent institutional inertia can arise. In this case, the very nature of institutional evolution is altered, for it has to also encompass the scenario of a systemic failure to adapt to changing circumstances. The implication is that institutional change can become locked in an evolutionary path that not only diverges from optimal adaptation but from wealth-enhancing efficiency altogether (Eggertsson 1996: 12). In other words, the presence of adaptation costs makes possible the perpetuation of institutions that were built to serve needs of the past and which through their stability determine the path of systemic change. Thus, as stagnant and new institutions are randomly mixed together, institutional choices of the past can have a direct impact on the form institutional change takes in the present and thus create historically rooted trajectories of evolution (Zysman 1994). This process, described by the concept of path dependence, provides the theoretical basis for explaining the persistent diversity in form and performance between institutional systems (Boyer 1996; Boyer 2000; Boyer and Hollingsworth 1997: 51; North 1990: 7; Soskice 1999; Whitley 1999) as well as for rejecting the notions of ergodicity and systemic reversibility due to the introduction of historical influences in institutional change (David 2001).

Thus, in a world of imperfect markets, where institutions can have a significant and independent role above the individual economic agent, the mechanics of change are fundamentally different from those in the neoclassical paradigm. Firstly, institutionalists reject the deterministic nature of neoclassical theory where
agents' choices, actions and preferences are reduced to mere mechanistic reactions to external changes imposed by market forces. As already mentioned, since institutional sets are not perfect, they never totally determine agents' economic behaviour. Instead, the significance of institutions lies in their role in shaping economic choice by simply defining its boundaries, which then allows sufficient freedom for real deliberative action (Lewis 1978: 142). Thus, while institutions introduce a certain degree of predictability in the system, much of economic activity remains outside the *ex ante* determinant influence of institutions and therefore is indeterminate and unforeseeable (Hodgson 1988: 12).

It is the interaction between the existing set of constraints and agents' purposeful activity, i.e. their effort to exploit the opportunities that arise and they perceive, that drives institutional change. More specifically, while incumbent institutions will often permit and help the exploitation of available opportunities, there will also be instances where there are mismatches between agents' capacities, as shaped by institutional constraints, and tasks (Zysman 1994: 259). To put it differently, by operating as constraints on agents' choices of action, institutions simply determine which opportunities or preferences are "exploitable" or legitimate and which are not. This means that some opportunities and preferences will be within the limits imposed by the existing institutional set and others will not, irrespective of whether this is efficient or not. It is when this situation arises that institutional adaptation may become necessary in order to expand or alter agents' capacities so as to match the new tasks. So, as North (1990: 79) argues, dissatisfied agents will have

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184 See above section 1.3.2. notes 23-24 and accompanying text.
185 Unlike neoclassical theory, which ultimately treats these opportunities as the by-product of exogenous changes (see *supra*. notes 167-169 and text), institutionalists claim that they can also be endogenously derived.
an incentive to devote resources to changing the restrictive institutions.\footnote{Certainly, agents might as well pursue their objectives without prior alterations in their institutionally determined capacities, e.g. by violating a law or a convention. In this case the agents would have to balance the costs of punishment, if any, with the benefits of the violation. Such cases are not uncommon. However, they constitute exceptions rather than the rule and so do not deserve a more extensive analysis for the purposes of this study.} Whether they eventually pursue this course of action or simply abandon the extra-institutional opportunities will depend on their subjective perception of the costs and benefits.

However, this is not a straightforward process. The presence of externalities\footnote{The economic definition of \textit{externalities} is that people involved in actions do not bear the full cost or receive the full benefit of their actions.} gives rise to a conflict between the interests of those agents who would benefit from alterations in the institutional framework and of all others who have made institution-specific investments and who as a result would have to bear the adaptation costs if change occurred. Thus, where transaction costs are positive, institutional change inevitably creates winners as well as losers. The efficiency of change, that is its wealth-enhancing effect, is then just a matter of how many winners as opposed to losers are created both in numerical and in value terms. Since informational asymmetries between agents as a typical characteristic of imperfect markets translate into power differentials, institutional change becomes dependent on the relative bargaining power of those seeking it and not on neoclassical rationality. As such institutional change may not proceed to serve general social needs but what Veblen (1924: ch.8) calls "vested interests" of the "conservative class", that is the group of agents interested in maintaining the status quo and who then become the "carriers" of inertia and path dependence. Accordingly, van Tulder and Ruigrok (1997: 131) argue that "core firms" in a particular economy have the ability to occupy a central position in the supply, distribution, financial and political networks and, thus, have a significant influence in the design of institutional frameworks.
Furthermore, institutional change may not occur even when all leading agents share a common perception that existing institutions are disadvantageous and that their change would be beneficial. The root cause of this type of inertia is the classic collective action problem as originally analysed by Olson (1965, 1982) and Hardin (1968) and then further enriched by Hirschman (1970) with the introduction of the "exit" and "voice" concepts. Thus, in order to surmount inertia, a "critical mass" of interested parties must be formed who are willing to engage themselves in voicing their dissatisfaction with the status quo and actively seek to change it (Granovetter 1978). The formation of stable constellations, such as lobby groups, trade unions and political alliances, may be necessary in order to overcome the free-rider problem which may frustrate the process (North 1990: 87). Alternatively, change may also come indirectly as agents may exercise the exit option, provided institutional factors and relocation costs allow this, by leaving a system they regard as inefficient for another one and thus potentially cause the decline of the former. Ultimately, systemic decline may raise the costs accruing from inertia relative to adaptation costs and therefore result to institutional change.

Furthermore, while, as mentioned above, institutional complementarity does not deserve specific analysis in a neoclassical context, where the independent role of institutional constraints is recognised the notion becomes extremely important. The horizontal and vertical interactions between institutional forces that complementarity implies are crucial for the process of institutional change because they can affect both its direction and its speed. Generally, institutional complementarity can be regarded as having a dual role as a transmission mechanism of adaptation costs as well as of systemic change.

188 Obviously, the availability of alternative and competing institutional systems is a precondition for this.
189 See section 1.4 above.
Firstly, institutional interactions may constitute obstacles to adaptation by introducing rigidities into the system. For instance, even where a group of agents have the ability and incentives to design a new fully adapted institution to replace an old one, before its implementation the new institution will have to be modified so as to fit complementary institutions. Modification may be direct and prospective during the formation process or indirect and retrospective through enforcement after the institution’s adoption. Ultimately, institutional change takes the form of a compromise between adaptation to environmental factors and suitability to existing institutional configurations. The significance of this is that, even if information were sufficient for an efficient adaptation to changed circumstances, new institutions as single units can eventually lose at least some of their optimal attributes. It is for this reason that the function and performance of one particular institution often vary considerably within different institutional contexts (Amable 1999). In a more extreme but not uncommon case, a desired institution may be totally unfit for the existing framework and as a result be abandoned altogether either before its implementation or after it by becoming unenforceable and obsolete. In fact, these complementarities create a significant rigidity bias in institutional change by establishing a link between the adaptation costs of institutions that change and of institutions that remain in force. This accumulation of adaptation costs creates important obstacles to institutional adaptation, hence the role of institutional complementarity as a factor of systemic stability and therefore of path dependence. As Dulbecco and Dutraive (2001: 58) affirm, once institutional complementarity is taken into consideration, the claims of efficient adaptation and “spontaneous order” cannot hold.

On the other hand, the other side of the compromise between institutional adaptation and suitability that complementarity implies is that the successful
implementation of a change will have an effect on the function of existing complementary institutions. This is because the resulting functional change of an existing institution will almost inevitably affect its overall adaptation costs either directly or indirectly through an alteration in the relative bargaining power of agents who are interested in the stability of that institution. It is reasonable to assume that when the implementation of a new institution is successful, the tendency will be towards a net reduction of at least some complementary institutions’ adaptation costs. Thus, during a process of this kind, institutional complementarity has the potential to become the vehicle of change and cause a domino effect of alterations in the system. This is what more than a century ago Veblen (1898; 1924: 201 and 208) described as an ongoing process of cumulative causation. Of course, the final outcome of a change shall depend on the interaction between adaptation costs that are specific to existing institutions and the forces of change. In practice, these are normally very difficult to calculate in advance, so that predicting the speed and the direction of this cumulative process is hardly a simple task. Accordingly, Myrdal has outlined his cumulative causation model as follows:

The point is not simply that ‘many forces are working in the same direction’. They are, in fact, not doing so. In general there are periods when opposing forces balance one another so that the system remains in rest until a push or a pull is applied at one point or another. When the whole system starts moving after such a shock, the changes in the forces work in the same direction, which is something different. (Myrdal 1957: 17)

In the light of the discussion above one can read into Myrdal’s statement the dual role of institutional complementarity as a factor of stability and change. Amable (1999) takes the argument further by drawing a distinction between “destabilisation” and “change”. The former amounts to a breakdown in the pattern of a complementary system, whereas the latter describes institutional alterations that do not affect the
general logic of relations within that system. In this fashion, what Myrdal, perhaps somewhat metaphorically, regards as a “balance” is Amable’s “change”, i.e. a normal process of systemic evolution along a pre-selected path. Destabilisation, on the other hand, is the result of a “shock” which triggers a process of cumulative change and which pulls or pushes the system away from its initial path.

In order to elaborate on this distinction it is necessary to introduce into the equation the concept of workability as defined in chapter I above. Where the destabilisation of a workable system occurs, there are two possible outcomes. The first is one where cumulative causation progresses until a new workable equilibrium is found. In this case there is full adaptation to the shock and destabilisation is only temporary. The second possibility, however, is one where the initial shock is not radical enough so as to produce a complete overhaul of the system. This is where the concepts of path dependence, complementarity and workability come to meet. Change may progress so as to affect only a few less path dependent institutions or sub-systems and leave all other more path dependent ones unaffected. Due to strong complementarities that exist between institutions and sub-systems the result will then be a system that is unworkable. In this case, full adaptation fails to take place and destabilisation becomes a more permanent condition with significant negative effects on the system’s performance.

Finally, another important link can be made between path dependence and the concept of workability due to the effect the latter has on a system’s adaptation costs. To a great extent adaptation costs arise as a result of the uncertainty about what effects the new regime will have. Shelpse (1986: 51-81) argues that this uncertainty

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190 In a similar fashion, Hollingsworth (1997: 267-8) claims that “[i]nstitutional arrangements are always changing, but with a logic that is system specific[…] Being path dependent, a social system of production continues along a particular logic until or unless or until a fundamental societal crisis intervenes.”
about the impact of structural change on economic outcomes is enough to stabilise a system. Of course, the more successful a system, the more preventive the effect of this uncertainty will be. Hence, due to the link between performance and workability established earlier,¹⁹¹ the more workable a system is, the greater its path dependence and *vice versa*. In fact, this is simply another formulation of the argument that, subject to the path dependence issues described so far, good performers have a lesser incentive to change than bad performers do.

All these insights of institutional theory about the workings of institutional change in imperfect markets have led to the imposition of important limitations on the claim of efficient convergence of corporate governance systems as a result of globalisation. Once it is accepted that institutions have a significant role in economic development as shown above, even quasi-efficient adaptation of all systems to exogenous changes is anything but certain. Whether it eventually occurs will depend on the nature and significance of overall adaptation costs. Of crucial importance will be the ability of systems to resolve collective action problems and to create mechanisms for compensating those parties who have to bear the costs of adaptation. North (1990: 80-3) defines this quality of institutional systems as “*adaptive efficiency*” which he distinguishes from allocative efficiency. Accordingly, he states:

> [Institutions] will not only determine the kinds of economic activity that will be profitable and viable, but also shape the adaptive efficiency of the internal structure of firms and other organizations by, for example, regulating entry, governance structures, and the flexibility of organisations. ...It is essential to have rules that eliminate not only failed economic organization but failed political organization as well. ...Moreover, the very nature of the political process encourages the growth of constraints that favor today's influential bargaining groups. But adaptively efficient institutional frameworks have existed and do exist, just as adaptively inefficient frameworks have existed and do exist. (ibid.: 81-2).

¹⁹¹ See section 1.4.3 above.
In sum, once the teleological assumptions of neoclassical theory are relaxed so that institutions are not neutral, the theory of convergence towards a unique optimum model is not inevitable even in an increasingly global economy. There are two reasons for this.

Firstly, the fact that national systems adapt to the forces of globalisation does not mean the resulting convergence will inevitably lead to real productive and allocative efficiency. As already argued above, the globalisation of economic activity has created more inefficiencies than it has been able to resolve so that global competition is unable to eliminate national market imperfections. It simply *elevates* them to the global level by creating pressures on national systems to converge towards an inferior model. Thus, convergence would be undesirable since it would not constitute a race to the top as neoclassical theorists claim.

Secondly, at least in the foreseeable future it is unreasonable to expect that the boundaries defining national economies as distinct institutional systems will be totally eliminated. In the absence of a fully integrated global marketplace the focus remains on the reactions of national systems to global forces of change. As the institutionalist analysis of change shows, even in the global presence of such pressures, depending on their internal dynamics institutional systems may not adapt fully and uniformly. Of course, the possibility of convergence as a process cannot be completely excluded; but, before a truly global marketplace is established, if it occurs it is more likely that it will be incomplete and within the margins set by different institutional systems. As already explained, these margins can be very different depending on the institutional complementarities and adaptation costs involved. As Boyer (1996: 55) observed, "a unique equilibrium is not warranted: the multiplicity of equilibria in an institutionally
rich economy is the rule not the exception."192 After the initiation of a convergence process, depending on the institutional dynamics within each system change may be slow or fast, complete or incomplete, and thus the final institutional outcomes can be workable or unworkable. Therefore, differences in the nature, extent and transmission mechanisms of adaptation costs within particular systems do not allow for general predictions of convergence or non-convergence without specific analyses of particular systems' internal dynamics.

There have been several recent attempts to introduce these general insights of institutional theory to the analysis of corporate governance. The pioneering attempt to introduce market imperfections as sources of systemic inertia and path dependence was made by Milhaupt (1998) who argued that, contrary to the belief of optimal convergence advocates, the evolution of corporate governance institutions is all but straightforward due to the persistence of inefficient institutions. This claim has been taken further by Bebchuck and Roe (1999) who have predicted that path dependence as a force of diversity will probably prevail over the pressures of global competition for convergence at least in the short and medium-term. Building upon earlier work by Roe193 arguing that corporate governance institutions are formed by historical and political factors that are country-specific, they come to the conclusion that rationality and optimality considerations may have less influence in the institutional choices of firms and states. Instead, historically and politically rooted institutions in national financial, labour and product markets constrain institutional choices of the present and, thus, prevent the "efficient" adaptation of corporate governance to modern challenges. This is because past institutional choices have created powerful interest groups of stakeholders, such as managers, workers, creditors and various types of

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192 See also Zysman (1994: 268).
blockholders who have an overriding interest in entrenching themselves by preserving
the status quo and who are, therefore, determined to prevent the divergence of
corporate governance evolution from the pre-selected path. The reason for those
stakeholders’ resistance to change is that under the current regime they enjoy
privileges, mainly in the form of private rents, and make firm-specific investments
that would be lost or devalued if radical institutional changes were implemented.

Due to these internal workings of institutional structures, Bebchuk and Roe
are of the view that an external shock, such as globalisation, would not lead to an
immediate “destabilisation” and reorientation of a national corporate governance
system. The pervasiveness of rent extraction by those dominant stakeholder groups
translates into high adaptation costs that eventually impede reform unless its aim is to
“strengthen” existing rules and thus perpetuate the existing system. On the other
hand, less entrenched stakeholders lack the resources and the necessary bargaining
power in a polity to push through their reforms against the will of dominant parties.

Moreover, Bebchuk and Roe argue, even if some path dependent corporate
governance institutions were in fact replaced by non-path dependent ones,
convergence would still not be inevitable, because rules that remained unchanged
could ensure that established practices are perpetuated. This is, in fact, the
institutional complementarity argument reiterated. On the one hand, if firms decide to
evade what they consider inefficient legal rules by using private contracts, they may
find their plans being frustrated by courts’ and other organisational structures’
unwillingness to uphold them in order to maintain what they would consider as
“public good”. Since private contracts are less formal institutions than legal rules, this
is a clear example of vertical complementarities’ effect on systemic change. On the
other hand, even if some “non-private” institutions were altered, Bebchuk and Roe
claim, other legal rules could still neutralise the impact of these changes; horizontal complementarities between equal institutions would maintain the system's stability.

If these arguments are accepted, then obviously the convergence thesis about corporate law and governance is indeed implausible. However, by overemphasising the stabilising effect of institutional complementarity what Bebchuk and Roe fail to recognise is its dual role as a mechanism transmitting both adaptation costs and systemic change. It is with this theoretical one-sidedness that Schmidt and Spindler (2000) took issue to argue that, although the persistent diversity scenario is plausible, it is equally possible that corporate governance systems could converge to an inferior outcome. The theoretical basis of this claim is provided by the close relationship between (horizontal) institutional complementarity and the concept of workability as a superior characteristic of a system. As already mentioned this link between the two concepts is the reason for rejecting institutional cross-reference as inefficient. Nonetheless, Schmidt and Spindler admit that despite its negative impact, cross-reference is a real possibility, mainly because in the presence of adaptation costs a leap from one workable system to another is highly unlikely – for this to happen all component sub-systems would have to be reformed simultaneously in an ergodic manner.

Thus, competitive pressures may indeed lead to the alteration of a less path dependent institution or subsystem – something that Bebchuk and Roe also accept – which would then make the system as a whole unworkable and therefore potentially inferior to the original. It is the unworkability of the new system that makes it unstable and thus reduces the adaptation costs of further changes.194 Further change, Schmidt and Spindler argue, could take two directions: a reversal to the initial

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194 See supra. note 191 and text.
workable equilibrium as advocated by Bebchuk and Roe or further away from it towards a totally different workable system. However, nothing could possibly guarantee that the outcome of the latter scenario, which resembles the cumulative causation process outlined above, will be the most efficient solution. This is because systemic instability creates an emergency situation which demands "some kind of order immediately" rather than "the best order later". In other words, Schmidt and Spindler assert that in the presence of horizontal complementarities the efficiency of convergence depends on how easy or difficult it is to establish the potentially superior system.

Despite Bebchuk and Roe's path dependence contention mentioned above, attempts have also been made to demonstrate the potential of vertical complementarities to promote corporate governance change and convergence. The pioneer of this argument is Gilson (2000) who has distinguished between what he calls "convergence of form" and "convergence of function".195 Although he does not specifically define the terms "form" and "function", one can deduct from his analysis that the former comprises formal legal rules while the latter describes private inter- and intra-firm contracting within the general legal framework. The starting point of Gilson's argument is that corporate governance systems may allow sufficient margins for firms to adapt their behaviour and function in accordance to changing circumstances without alterations in formal institutional structures. This type of adaptation, which resembles Amable's "institutional change", will not be sufficient to push a system away from its path (ibid.: 12).196 Where competition is imperfect, different systems can develop diverse but equally effective institutional solutions to

195 For the sake of accuracy, it should be noted that Gilson regards convergence based on contractual agreements as a third type of institutional change. However, the nature and effect of this third type and of functional convergence as described in his paper allow for their treatment as equivalent.

196 See also Gilson (1996: 334).
common problems without their destabilisation or their convergence. However, contrary to Bebchuk and Roe’s view, Gilson accepts that functional convergence may also “disarm” path dependent institutions and their supporting stakeholder coalitions even if no change in formal rules is effected. Once a formal institution is rendered obsolete, its adaptation costs are dramatically reduced so that convergence of function can eventually facilitate convergence of form.

This link between vertical institutional complementarities and corporate governance convergence towards a global model has been further explored by Coffee (1999). In a three-stage argument, which follows a similar line to that of Gilson, Coffee argues that forces of path dependence in formal corporate governance institutional arrangements can be neutralised and eventually overcome by the pace of functional convergence which should eventually “dominate formal convergence”. The main vehicle for this process, the argument goes, will be the increasing pressures on and incentives of large firms to list their stock on those stock exchanges that are most developed in terms of liquidity and investor participation. As securities transactions become more spatially concentrated to those countries which enjoy better locational advantages as hosts, a few major stock markets emerge as dominant in the trading of international stocks. Effectively, cross-border corporate securities’ listings should be seen as a type of regulatory arbitrage between national financial systems and those dominant stock markets. If capital markets in one system are not suitable to a firm’s needs, financial globalisation has now opened the possibility of partial or

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197 However, this proposition can be problematic, since to some extent it seems to coincide with the equal competitiveness hypothesis which, as already mentioned, is difficult to support. More specifically, Gilson (2000) uses Kaplan’s (1994) empirical findings on the relation between managerial turnover and firm performance to argue that different systems can provide equally effective managerial accountability measures. In a more recent study than Kaplan’s, however, Abe (1997) found that variations in measuring firm performance affect CEO turnover differently, since some systems place more emphasis on sales and employment growth –two measures that are related more to managerial rather than shareholder objectives- than others.

198 Note that Gilson (2000) incorporates Coffee’s conclusions on convergence.
total exit based on a balancing between the costs and benefits that such a move entails.

While, as already mentioned, there are significant micro-economic benefits from this type of corporate migration to foreign stock markets, for the convergence argument the costs' side is more important. This is because, the listing of a firm’s securities on a foreign market constitutes the subjection of that firm to different securities regulations, including financial disclosure and even corporate governance standards that apply therein. It is reasonable to expect that the orientation of such regulations in developed capital markets is towards enhancing transparency from the outside investor’s perspective. The institutional analysis in the previous chapter has already provided some explanations for this. Thus, Coffee’s first claim is that firms seeking to remain competitive in global markets are increasingly adopting more outside shareholder-oriented governance policies without the need of formal institutional changes in their home systems. Indeed, cross-listings of securities are a good example of functional convergence pursued by firms seeking to remain competitive by exploiting OLI advantages in the sphere of corporate finance.

However, contrary to Coffee’s and to a lesser extent Gilson’s contentions that functional convergence precedes and dominates formal convergence, foreign securities’ listings, would not have been possible without prior changes of laws governing international capital movements and foreign exchange rules, to name but a few, which have opened the door to regulatory arbitrage. Moreover, without the growth of Euromarkets – themselves a creation of government policy decisions not to regulate international capital markets unilaterally when it was still possible – as sources of corporate finance, firms would not have had the bargaining power to push forward the abolition of financial regulations that restricted global securities
investments. Therefore, convergence of function and form should be seen as two interdependent aspects of one process, i.e. of institutional convergence, rather than two separate ones.

In any case, as regulatory arbitrage by firms seeking to optimise their financial structure gains momentum, competition between national securities markets across the world for international securities’ offerings intensifies. Therefore, Coffee’s second argument is that the globalisation of corporate finance creates pressures for securities regulation and disclosure standards’ convergence with dominant stock exchanges providing the benchmarks. Thus, the deregulation of global corporate finance is an illustration of how institutional changes on one side of the financial system (cross-border capital movements) alters firms’ opportunity sets and preferences so as to trigger further institutional changes on another side (securities regulation). Arguably, the change of securities regulation rules should entail relatively low adaptation costs for two main reasons. Firstly, as an increasing number of large and, therefore, “core” firms are becoming subjected to higher investor protection standards, it should be reasonable to expect that they will be less inclined to oppose change and they may even use their bargaining power to promote it. Secondly, as Coffee (1999: 670) claims, securities regulation convergence should be less politically sensitive and, therefore, less path dependent, because it comprises rules that are largely “neutral and technocratic that does not, on its face, challenge long-established social policies.”

The third stage of Coffee’s argument is that progress in the sphere of corporate securities regulation and financial disclosure will eventually lead to corporate governance convergence without the implementation of changes in national company laws. To reach this conclusion, Coffee concurs to some extent with the view
presented in 1.4.1 above on the neutrality of company law as a determinant of corporate governance. Recalling similar experiences with the interactions between state corporate laws and federal securities regulation in the US, he concludes that the harmonisation of national securities laws will be the driving force behind global corporate governance convergence, even if diverse national corporate laws persist.

Even if one accepts the first stage of Coffee's convergence argument, the second and third stages are not satisfactory for two reasons. Firstly, regarding the third argument, Coffee overemphasises the determinant role of securities regulation alone. Even though it is an important set of institutional constraints on corporate governance, without "supporting" developments in financial markets, as well as in other sub-systems, the impact of securities regulation convergence alone may prove to be insufficient to push managerial models towards a shareholder-oriented one. As stated in the previous chapter, disclosure rules and investor protection regulations are mechanisms for reducing transaction costs for outside shareholders. More specifically, they aim at reducing the ability of insiders to extract private rents to the detriment of outsiders. If insiders lost the private benefits associated with their incentive to make firm-specific investments, their incentive to diversify would increase causing the externalisation of financial relationships. Hence, convergence to higher market transparency standards in securities markets constitutes a re-orientation of one set of financial rules towards the outsider corporate governance model. As already shown in 1.4.2 above, share-ownership dispersion in imperfect markets may not be able to constrain managerial discretion if shareholders are individual investors. In that case, if anything, securities rules' convergence may simply lead to a shift from one type of managerialism based on insider control to another through the de-concentration of insiders' shareholdings, i.e. global corporate governance.
convergence would be towards an outsider managerial model. Thus, for a more radical shift away from managerialism towards a shareholder model further institutional changes would be needed, such as the growth in the percentage of corporate securities held by institutional investors and the increased bargaining power of the latter that results from this. Indeed, as the discussion in the preceding sections shows, pressures for such changes already exist as a result of financial and production globalisation, but these are not part of Coffee’s argument.

Secondly, in respect of the second stage, even if financial re-regulation along the lines described above commences, adaptation outside the financial system may not progress enough to bring about a workable shareholder oriented system. The reason for this is that, although securities regulation is more “technocratic”, institutional complementarities with other institutional sub-systems may eventually make the impact of regulatory changes in securities markets more obvious to adaptation cost-bearing stakeholders. If complementarity is a carrier of change, it is also a carrier of path dependence, and this is something Coffee fails to recognize. Therefore, path dependence in one sub-system can also prevent the complete re-orientation of another. This is a recipe for unworkability not only within a system as a whole but also within its particular sub-systems. Certainly, one possibility is that the “technocratic” changes that do get implemented are eventually reversed so that the system as a whole reverts to its original position. However, such a reversal to the old regime can be difficult, as new vested interests may have emerged supporting the new regulations. Therefore, when the complexity of dynamic institutional interactions is taken into account, unworkability becomes a very real scenario once systemic change begins. In sum, Coffee’s three-stage convergence argument has to be qualified and

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199 On the definition of the term “workability” in this thesis see section 1.4.3 above.
200 Recent experiences in Germany show exactly this; see chapter 3 below.
significantly altered by the fact that adaptation depends on how institutional complementarities resolve themselves, either as carriers of change or of path dependence. When forces of change prevail systemic adaptation progresses, but when they are overcome by path dependence forces adaptation stops until the dynamics of change re-emerge.

2.5. SUMMARY AND CONCLUSIONS

The current wave of economic globalisation has created forces that challenge the viability of corporate governance models based on managerial discretion. It calls for a redefinition of basic institutional arrangements in financial and industrial relations systems which have in the past made the managerial firm the most successful and dominant business form since the turn of the last century.

The negative impact of aggregate demand problems on the sustainability of managerial models that rely on high output have already been discussed. If manager-controlled firms, whether dominated by insiders or outsiders, do not find the necessary markets for their output, overcapacity or price-based competition can constrain their ability to bear the costs of internalising labour and capital markets and, thus, lead to the deconstruction of the main sources of their competitive strength. In this sense, managerial capitalism is too inflexible for a macroeconomic environment that is stagnant or grows relatively slowly.

Simultaneously, the continuing growth of institutional investors as the largest managers of financial assets is becoming a global phenomenon. The combination of the institutionalisation of securities trading with the potential dispersion of
shareholdings is perhaps the most crucial factor affecting global corporate governance. If institutional investors emerge as the dominant type of shareholders who have the necessary sophistication to influence managerial decisions, the globalisation of equity markets can become the vehicle for convergence towards an outsider shareholder model. Institutional investor growth being a phenomenon closely connected to the intensification of economic globalisation, both as a cause and an effect, and the fierce competition among fund managers creates increasing pressures on corporate managers to focus on generating value for current shareholders. Moreover, the emergence of the global market for corporate control provides the forum in which institutional investor influence can also be exerted in an indirect manner. As globalisation progresses in its current form, with the continuing integration of securities markets and globalisation of shareholdings, these pressures should be expected to escalate.

Further pressures on managerial models also derive from the globalisation of production and the new international division of labour. As already explained, the persistent slowdown of growth since the 1980s has been forcing managers to reconsider, water-down or completely abandon their role of balancing different stakeholder priorities in order to promote their companies' overriding interests. Cost-cuttings and production efficiency enhancement are now objectives that are often being pursued against the interests of the current workforce so that the old manager-stakeholder consensus is being severely undermined. The intensification of domestic and global M&A as a result of macroeconomic conditions further exacerbates the problem. While employment relationships become more adversarial, the global reorganisation of production is also eroding labour's bargaining power inside and outside the firm. Consequently, the influence of labour in corporate-decision making
diminishes at the same time as (institutional) shareholder power increases. Simultaneously, as micro-management tends to reflect stakeholder power differentials, governments' ability to re-establish a balance via the implementation of macro-management measures aiming at full employment and unemployment compensation is significantly curtailed. In an interplay between functional and formal changes direct pressures from global portfolio investors or from core employers and their associations who can easily use the "exit" option as a tool for influencing government decisions do not allow policy-makers much discretion if they wish to re-establish a balance between various interest groups.

As the analysis so far has shown, these developments in financial, industrial relations and macroeconomic structures are closely linked with each other through causal relationships. This means that their overall effect as well as their cause is the emergence of a global trajectory away from managerial corporate governance and towards an outside shareholder-oriented model. The latter is not only dependent upon the increased ability of firms to redesign their internal governance arrangements and contracts in a flexible manner, but is also better equipped to deal with radical demand fluctuations. Ironically, the shareholder model seems to be the only workable corporate governance solution to the challenges that the current wave of globalisation creates.

In 1.4.3 above the workability element of corporate governance systems was related to the concept of efficiency. It was argued therein that, while workable systems are superior to unworkable ones, it would be meaningless to proclaim the shareholder and the managerial model as equally fit. More elaborate explanations for this were given above, when it was argued that in imperfect markets an outside-shareholder model is unable to sustain high levels of growth and prosperity. On the
contrary, theoretical as well as empirical evidence was presented showing that, provided the necessary government regulations are in place, the managerial corporate governance model, as the microeconomic component of a Kaldorian virtuous circle, can and has achieved much superior growth levels with analogous benefits in terms of economic welfare. Therefore, the better ability of the outside-shareholder model compared to the managerial one to cope with the current economic globalisation processes is not an indication that it is the superior optimum, unless of course one regards slow growth better than high growth. Consequently, if the current wave of liberal globalisation leads national corporate governance systems to converge to some degree, it will be towards an inferior but still workable outcome. It seems that convergence to an inferior system is easier than the coordinated reorganisation of the world economic structure.

Of course, the institutional dynamics within diverse systems can vary considerably so that national corporate governance models should be expected to react differently to the common stimulants of globalisation. The intensity, extent and final outcome of any process of institutional change and thus the degree of global convergence towards an outside-shareholder model will ultimately depend on the nature and strength of complementarities that are particular to each national system.

Given all the above insights the following chapter will seek to provide evidence of the impact of globalisation on managerial systems through the investigation and interpretation of recent institutional developments in German corporate governance.
CHAPTER 3
THE IMPACT OF GLOBALISATION ON AN INSIDER MANAGERIAL MODEL: THE CASE OF GERMANY

3.1. INTRODUCTION

Having identified the dynamics of isomorphism in world markets during the current globalisation wave this thesis will now proceed to a case study investigation of their impact so far on managerial governance with the main focus being on Germany’s insider managerialism.

After providing an analytical overview of the main institutions of German managerialism in sections 3.3 and 3.4, the main aim of this chapter is to assess how these are affected by globalisation as defined and analysed in the preceding chapters. It will be argued that in recent years the systemic stability and workability of the German model of insider-managerialism have been under threat by the new economic environment. Firstly, section 3.5 will follow the developments in industrial relations to argue that functional changes have been destabilising the traditional micro- and macro-level consensus between capital and labour, and that the perseverance of some formal labour market institutions in a slow growth macroeconomic environment has been contributing to high levels of unemployment. Secondly, section 3.6 will show that financial market globalisation has also been affecting traditional financial relations and has been leading to a gradual reorientation of the German financial system towards a more market based one. Section 3.7 will then argue that this reorientation of the financial system is associated with a series of legal changes which are closely related to corporate governance and which have the effect of promoting the principle of shareholder supremacy in Germany by redefining some of the basic
legal arrangements that used to support managerial discretion. Section 3.8 will then assess the impact of these legal reforms on relationships between traditional stakeholders and follow simultaneous changes in non-legal institutional arrangements in which corporate governance is also embedded. It will be argued that a redefinition of intra- and inter-firm relations is already underway which is leading to the curtailment of managerial discretion. Finally, evidence will be presented that the concept of shareholder value with its implication of shareholder supremacy is already taking root in German corporate decision-making as a benchmark of performance.

However, before embarking on the analysis of developments within the German system of institutions determining corporate governance, this chapter will begin with a brief analysis of corporate governance change in the two most influential outsider-managerial models of the US and the UK, where, for several reasons that will be identified, adaptation to globalisation with the establishment of shareholder supremacy as a guiding governance principle has already occurred. This exercise is essential for understanding the developments in German insider-managerialism because of significant interactions between the two systems as globalisation progresses. For instance, Anglo-American institutional investors have not only emerged as dominant players in global financial markets but also as champions of shareholder supremacy, either directly or through the market for corporate control. Moreover, securities markets in these jurisdictions are by far the largest in terms of liquidity and therefore constitute major sources of corporate finance for corporations seeking to establish a global presence. German firms that take advantage of Anglo-American securities markets unavoidably subject themselves to institutional constraints that are not compatible with the equivalent at home.
3.2. ECONOMIC GLOBALISATION AND OUTSIDER MANAGERIAL MODELS: THE ESTABLISHMENT OF SHAREHOLDER SUPREMACY IN THE US AND THE UK

For almost a century, beginning with the late 19th century managerial revolution in the US, corporate practice and theory had set the shareholder supremacy principle aside either as irrelevant or as unfounded and undesirable. The economic success of managerialism legitimated managerial theory and vice versa to such an extent that a virtual consensus had emerged against shareholder supremacy (see sections 1.2 and 1.3 above). Managers were left unchallenged to pursue their growth objectives and continually develop their corporations' organisational capabilities by retaining excess cash flow rather than distributing it to shareholders. Corporate expansion ensured the balanced and sustainable distribution of corporate income to the main resource providers, including financiers and labour, with managers of large corporations seeking to balance diverse interests and to promote cooperative intra-firm relationships (Brody 1980). Although this privately established consensus broke down during the Great Depression, the subsequent coming of unionisation, government welfare programmes such as the New Deal, and renewed prosperity after the 1940s fostered a fairly balanced relationship between employers and employees.

On the other hand, capitalism in the UK did not follow the same pattern as in the US. Characteristically, the country's largest firms were still controlled by founding families until well into the 1960s (Chandler 1990: 235-294). Therefore, the managerial corporation did not play a major role in the British economy during most of the 20th century, which is perhaps reflected by the constantly mediocre economic performance of the country even during the post-war era in comparison to other major
economies. The separation of share ownership from control came relatively late with an impressive merger boom during the second half of the 1960s as a response to changes in competition regulation and an obvious need for reorganisation to compete against foreign rivals who had gained access to UK markets (Channon 1973: 35). Thus, the capitalist consensus mentioned in sections 1.3.3 and 2.3.1 (esp. p.146) above seems to have never had the opportunity to arise in British firms as the golden age of capitalism was already in its last years when the managerial firm begun to emerge in the UK.

As a result of the events described in section 2.2 above, i.e. the global economic slowdown, and with the oil crises further deteriorating economic conditions, by the end of the 1970s expansion strategies had reached their limits. Rising unemployment and severe industrial disputes, such as those during the 1979 “Winter of Discontent” in the UK, meant that change was necessary to reverse the US decline and the UK underperformance. This economic environment, as discussed earlier, proved fertile ground for the anti-managerial arguments based on neoclassicism and advocated by prominent American economists such as Milton Friedman. Thus, by the late 1970s Keynesianism had already fallen out of fashion. In such an environment only one option was available, and that was not the reestablishment of the post-war international macroeconomic order with the imposition of capital controls. Instead, a different path was chosen which aimed for the creation of a model based on the economic discipline imposed by free market forces. The election of Margaret Thatcher in the UK and Ronald Reagan in the US signified the turning point for both countries.

As full employment policies became unsustainable they were quickly abandoned. Deregulation and privatisation programmes were widely pursued in order
to balance government budgets and promote competition for the re-establishment of “efficient” market discipline. Certainly, due to some differences in political institutional structures, reforms were more drastic in the UK than in the US, but nonetheless the former had a longer road to walk towards liberalisation than the latter. In sum, there was a shift of government policy from Keynesian objectives to the promotion of national firms’ competitiveness as well as of locational advantages that would attract FDI and prevent capital flight even if those policies involved significant social costs. An important element of this shift was the reorientation of labour market regulation. Job-protection and union power were no longer regarded as efficient because they kept labour costs high in times of slowing demand and limited the ability of employers to adopt flexible industrial relations arrangements. As a result of this direct attack on institutions affecting labour power within and without the firm employees’ bargaining power vis-à-vis their employers was significantly curtailed.

At the same time as the reduction of labour’s power was pursued, dramatic changes also occurred in financial markets, which completed the transformation of the corporate landscape with the entrenchment of shareholder supremacy as the dominant principle of corporate governance practice in both the UK and the US. At the centre of this change has been the combination of two related events. Firstly, there was a dramatic growth of institutional investors as owners of listed shares, and secondly, there was a hostile takeover boom that peaked in the mid 1980s.

Since the emergence of the managerial firm with dispersed share ownership, individuals have been the dominant type of shareholder in both the US and the UK. However, during the 1970s and 1980s the assets controlled by institutional investors such as mutual funds, pension funds, and life insurance companies saw a dramatic

201 The federal structure of the US government constitutes a constraint on federal authorities’ policy implementation. See King and Wood (1999).
increase. Significant steps towards the privatisation of retirement funding were made in order to deal with the funding problems created by the type of fiscal constraints and demographic changes mentioned in section 2.3.1 above. Characteristically, in both the UK and the US generous tax incentives were provided for collective savings and pension funds in particular. \(^{202}\) Furthermore, regulatory restrictions that existed during the 1960s preventing pension funds and life insurance firms from investing in equities were significantly relaxed. \(^{203}\)

At the same time, high inflation, mainly as a result of the two consecutive oil crises, meant that fixed income securities like bonds provided mediocre yields that could not cover the needs of the institutional investors' beneficiaries. This induced institutions to seek higher returns in riskier assets. With the steady growth of stock markets the obvious solution was investment in equities and other high-risk securities. Most importantly, institutions invested in low-value bonds ("junk-bonds") which are risky but high-yield securities issued by companies lacking an established or sound earnings history. Moreover, with the growth of institutional assets the abolition of fixed commissions for securities transactions which held up trading volume became inevitable. The elimination of fixed commissions first in the US \(^{204}\) and later in the UK \(^{205}\) dramatically increased trading volume and unleashed unprecedented amounts of capital into equity markets. \(^{206}\) As a result, institutional investors became the largest


\(^{203}\) In the UK there were no restrictions on the formation of institutions' investment portfolios. In the US, ERISA was amended in 1978 to permit the investment of substantial proportions of pension funds' and insurance companies' assets in stocks and other high-risk securities.

\(^{204}\) The Securities and Exchange Commission prohibited fixed commissions on May 1, 1975. This decision was enacted a month later by the Securities Acts Amendments 1975.

\(^{205}\) The prohibition of fixed commissions by the London Stock Exchange officially came in October 1986 as part of the financial "Big Bang". However, LSE brokers had been giving discounts to institutional investors since 1983 (Poser 1991: 25).

\(^{206}\) For instance, the UK equity turnover in the London Stock Exchange jumped from about 160.8 million pounds in 1986, the year fixed commissions were abolished, to 520.9 million in 1987 and has grown steadily since then to reach almost 2 billion in 2000. (Data: London Stock Exchange, Historical
owners of stock especially in large listed corporations with pension funds acquiring
the lion’s share. For instance, in 2000 almost half of all listed equities in the US were
held by domestic institutions (see Table 3.1). In the UK institutional holdings peaked
during the mid 1990s when they exceeded 61 percent in 1994 (Table 3.2.). Since then
there was a considerable drop in domestic institutional ownership which, however,
can only be attributed to the increase of foreign, mainly American, institutional
holdings.

Table 3.1. Equities Held by Domestic Institutional Investors in the US

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<thead>
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</thead>
<tbody>
<tr>
<td>Private pension funds</td>
<td>0.8</td>
<td>8.0</td>
<td>16.8</td>
<td>15.2</td>
<td>11.0</td>
<td>11.4</td>
</tr>
<tr>
<td>State &amp; local pension funds</td>
<td>0.0</td>
<td>1.2</td>
<td>7.6</td>
<td>8.0</td>
<td>6.9</td>
<td>7.6</td>
</tr>
<tr>
<td>Life insurance companies</td>
<td>1.5</td>
<td>1.7</td>
<td>2.2</td>
<td>3.7</td>
<td>4.9</td>
<td>5.4</td>
</tr>
<tr>
<td>Other insurance companies</td>
<td>1.8</td>
<td>1.6</td>
<td>2.3</td>
<td>1.6</td>
<td>1.1</td>
<td>1.1</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>2.0</td>
<td>4.7</td>
<td>6.6</td>
<td>12.1</td>
<td>17.4</td>
<td>18.5</td>
</tr>
<tr>
<td>Closed-end funds</td>
<td>1.1</td>
<td>0.5</td>
<td>0.5</td>
<td>0.4</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Bank personal trusts</td>
<td>0.0</td>
<td>10.4</td>
<td>5.4</td>
<td>2.6</td>
<td>1.7</td>
<td>1.6</td>
</tr>
<tr>
<td>Total</td>
<td>7.2</td>
<td>28.2</td>
<td>41.4</td>
<td>43.6</td>
<td>43.2</td>
<td>45.8</td>
</tr>
</tbody>
</table>


Table 3.2. Equities Held by Domestic Institutional Investors in the UK (Percent of Total)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance</td>
<td>10.0</td>
<td>12.2</td>
<td>15.9</td>
<td>20.5</td>
<td>18.6</td>
<td>21.9</td>
<td>23.5</td>
<td>21.0</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>16.4</td>
<td>9.1</td>
<td>16.8</td>
<td>26.7</td>
<td>30.6</td>
<td>27.8</td>
<td>22.1</td>
<td>17.7</td>
</tr>
<tr>
<td>Unit Trust</td>
<td>1.3</td>
<td>2.9</td>
<td>4.1</td>
<td>3.6</td>
<td>5.9</td>
<td>6.8</td>
<td>6.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Investment Trusts &amp; Other Financial</td>
<td></td>
<td></td>
<td></td>
<td>1.6</td>
<td>2.0</td>
<td>1.9</td>
<td>1.9</td>
<td></td>
</tr>
<tr>
<td>Institutions Excl. Banks</td>
<td>11.3</td>
<td>10.1</td>
<td>10.5</td>
<td>6.8</td>
<td>2.7</td>
<td>3.3</td>
<td>3.9</td>
<td>6.7</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>34.3</td>
<td>47.3</td>
<td>57.6</td>
<td>59.4</td>
<td>61.8</td>
<td>58.1</td>
<td>48.7</td>
</tr>
</tbody>
</table>


These developments have had a remarkable impact on capital markets with equally important spillover effects on corporate governance in both the US and the UK. Firstly, as stocks and bonds were placed in direct competition with each other in terms of yields they could offer, a general preference for higher short-term returns on equity was created which in turn pushed for higher dividend distributions by listed corporations (Lazonick and O'Sullivan 1996: 22). As real interest rates constantly exceeded real growth rates (see Figure 2.7 above) shareholders had no interest in cash retention by firms and preferred the distribution of cash-flows and their reinvestment in high-yield securities (Block 1998). The pressure for higher returns on equity has intensified because, in contrast to individual investors who are relatively slow in restructuring their limited portfolios and generally follow a “buy-and-hold” pattern, institutional investors generate most of their income from fees and capital gains through trading. As a result, the institutionalisation of corporate stocks combined with the macroeconomic conditions led to the erosion of financial commitment (Lazonick 1992: 456).

The second effect has been even more dramatic. As collective investment instruments gave higher yields than deposits in savings banks, unprecedented financial market deregulation programmes were initiated in order to create a level playing field in the financial sector. Fierce competition within deregulated financial markets made investments in high-risk securities a very attractive activity for banks as well as for other institutional investors. Thus, by the 1980s both the demand and

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207 Indeed, recent empirical evidence reveals a link between institutional ownership and dividend payout increases; see Short, Zhang and Keasey (2002).

208 Apart from the abolition of fixed commissions on securities transactions, deregulation programmes included the liberalisation of interest rates and the lifting of restrictions on the types of assets in which financial institutions could invest. For instance, the Garn-St.Germain Act 1982 permitted US banks to hold junk-bonds. More recently, the final enactment of the Gramm-Leach-Bliley Act of 1999 effectively repealed the Glass-Steagal Act of 1933 and the Holding Company Act of 1956 which segregated commercial banking from the securities sector has epitomised financial market reform in the US.
the supply were present for the establishment of a large market for equities and junk-bonds. It was this market that by the early 1980s created the conditions for an unparalleled wave of hostile takeovers in both the UK and the US with financial institutions being the main participants (Henwood 1997).\footnote{A major turning point, at least in the US, was the successful takeover of Electric Storage Battery by International Nickel Company of Canada financed by Morgan Stanley in 1974. Allegedly this changed the attitudes of investment bankers who until then regarded hostile takeovers as "dirty business" (Lipton and Panner 1993: 117). For similar attitudes that persisted in Germany until well into the 1990s see chapter 3 below.} In particular, the high demand for junk-bonds facilitated the financing of hostile takeover bids (leveraged buyouts) for even the largest corporations\footnote{According to an SEC study junk bonds accounted for 33% of the financing in the largest tender offers in the US (Coffee 1986: n.111). See also Yago (1990) and Taggards (1988).} so that in effect, what had emerged was a direct application of Jensen and Meckling’s model. A very active market for corporate control had been established where firms with excess cash flows became targets and where acquirer firms ended up with massive amounts of debt to pay off after the transaction’s completion. This created enormous pressures on managers to boost the market value of their companies by implementing downsizing or labour reduction strategies or a combination of both to pay off the amassed debts (Lazonick and O’Sullivan 2000: 18). In other words, as a result of the financial policies of the 1970s and 1980s, at least two of the Jensenian management constraints were enacted: there was a increase in corporate debt which implies a reduction of discretionary cash flow and a higher risk of bankruptcy, and there was an increase in hostile takeovers.

Consequently, the rise of the institutional investor and of the market for corporate control in the US and the UK has led to a drastic re-orientation in managerial motivation towards creating value for the shareholders by maximising current profitability even if that entails disposing of company assets. Moreover, where market discipline is unable to enforce outside shareholders’ priorities, managerial compensation packages based on stock-options and other similar methods of incentive payment have become common. In this way, the pressure of the market for corporate control has acted as a constraint on managerial discretion and led to the implementation of strategies that maximise the market value of the firm.
instruments have fostered a coalition between institutional investors and managers. Thus, during the past two decades the principle of shareholder supremacy has been encapsulated into the concept of "shareholder value", first introduced by American business consultants in the 1980s,\(^{211}\) which provided the justification of corporate restructuring strategies based on downsizing and spin-offs. An indication of how significant this change in managerial motivation has been is the fact that equity finance eventually became negative in both the US and the UK\(^{212}\) mainly as a result of extensive cash redistributions to shareholders in the form of share repurchases (Corbett and Jenkinson 1996). In addition, dividend payouts rose to unprecedented levels despite the decline in profits (Lazonic and O'Sullivan 2000: 22-23). These developments often led to allegations that the system forced managers to pursue short-term profit to the detriment of long-term performance (Cosh, Hughes and Singh 1990) - a clear example of shareholder opportunism against the corporate interest as a balanced promotion of all stakeholder interests collectively.

Of course such concerns about systemic short-termism would have no validity if the neoclassical assumptions mentioned in 1.3.2 above applied. However, as Coffee (1986: 104) observes, in the real world outside neoclassical models of perfect or efficient markets "shareholder wealth and social wealth are not synonymous." Thus, the takeover boom of the 1980s led to excesses, high speculation and eventually to the "Black Wednesday" stock markets' crash in October 1987. Ironically, in 1990 Drexel Burnham Lambert, the Wall Street investment bank that pioneered junk bonds, went bankrupt symbolising the end of an era. Moreover, the large increase in

\(^{211}\) See Rappaport (1986). Major consultancy firms gradually developed their own metrics for shareholder value, such as Economic Value Added (EVA\(^{TM}\)), Market Value Added (MVA), Cash Flow Return on Investment (CFROI), Total Shareholder Return (TSR), and so on. For a comparative overview of such metrics see Froud et al. (2000).

\(^{212}\) This is also shown by the fact that while the aggregate value of shares repurchased by NYSE listed corporations was $1.1 billion in 1975 and $6.3 billion in 1982, by 1985 it had reached $37.1 billion (Brudney and Chirelstein 1987: 541).
job-losses following takeovers, which in the UK was combined with redundancies due to privatisations, meant that a large share of the risk of doing business was transferred from shareholders to employees. Meanwhile, higher rank managers who were supposed to be the most disadvantaged party in an active takeover market were protecting themselves with the introduction of high contract termination payments ("golden parachutes"). Such payments increased not only the costs of takeover bids but also social costs due to rising unemployment or under-employment; the manager-labour consensus had already broken down.

Interestingly, these excesses combined with persistent underperformance in comparison to foreign competitors during the 1980s and early 1990s strengthened pro-managerial arguments and eventually led to the deflation of the takeover boom. In the US the decision of the Federal government to delegate the responsibility for takeover regulation to individual states allowed the enactment of "Corporate Constituencies Statutes" allowing incumbent company directors to balance the interests of shareholders with a large number of non-shareholder interests including those of employees, customers, suppliers and the community.\(^\text{213}\) Moreover, the widespread adoption of takeover defences such as poison pills, super-majority vote requirements, dual-class shares, and "greenmail" by several companies often impeded the operation of the market for corporate control. Of course the collapse of the junk-bond markets in 1992 had already made the financing of takeovers more difficult.

In the UK, although there were no such legislative responses, the concerns about systemic short-termism were taken seriously as they were expressed by several influential voices with institutional investor backing, such as the National Association of Pension Funds (NAPF 1990) and the Institutional Fund Managers’ Association

These events, combined with collapses of notorious private and privatised corporations created a pervasive general and academic interest in corporate governance (Dignam 2000). However, the widespread feeling was that the main problem with corporate governance had been that managers still enjoyed too much discretion. Excessive compensation packages, including stock options, awarded to executives of even underperforming companies fortified anti-managerial attitudes. Thus, the quest was for increased managerial accountability to shareholders as a panacea to corporate governance problems, a view that goes back to the Industrial Reorganisation Corporation of the 1970s. The most important attempt to provide some answers came with the report of the Cadbury Committee (1992) which was set up with the general support of the business community. Among the Committee’s many and important recommendations were the appointment of independent non-executive directors, the establishment of audit and director nomination and remuneration committees, the re-election of directors every three years, better financial reporting directly to shareholders and the enhancement of the audit function by ensuring external auditors’ independence from management. This initiative continued with the report of the Greenbury Committee (1995) on directors’ remuneration until the final consolidation by the Hampel Committee (1998) of all recommendations into what is now the Combined Code which is appended to the listing requirements of the London Stock Exchange.

However, none of these regulatory efforts have the force of law. Rather, they are based on a long British tradition of self-regulation (Holland 1996; Dignam 1998:

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214 The IRC was indeed keen to promote institutional investor activism to “revitalise flagging managements”. See Industrial Reorganisation Corporation (1970: 6), cited in Channon (1973: 37).

215 Dignam (1998) explains the business community’s participation in this and other initiatives as an effort to prevent mandatory corporate governance regulation. For an earlier committee on corporate governance in the US see Riley (1994).
Thus, as all these Committees stress in their reports, a lot depends on the support by all interested parties and most importantly institutional investors. This is not surprising due to the size of their shareholdings and their relative sophistication and larger resources in comparison to individual shareholders. In fact, many of the Committees’ recommendations had been on the agenda of institutional investors and the financial community in general since the early 1980s. For example in 1980 the Bank of England with the support of City institutions set up PRO NED, a body dedicated to the promotion of the wider use of non-executive directors. Moreover, institutions have been campaigning for minority shareholder rights’ protection by opposing the abolition of pre-emption rights or the issuing of non-voting shares (Rabinowitz 1989: paras. 3-805), something that also appears in the Institutional Shareholder Committee’s (ISC) 1991 code of practice together with other recommendations that resemble those of the Cadbury Committee (ISC 1991). Institutions have also been supporting the City Code on Takeovers and Mergers which prohibits the implementation by management of any post-bid defensive measures.

This involvement of UK institutional investors in corporate governance not only persisted in the 1990s but has also intensified and become more direct through face-to-face meetings with managers in their portfolio companies in order to ensure that current shareholder value maximisation is pursued. This direct monitoring has been combined with the implementation of incentive compensation schemes for managers, such as stock-options, which are designed to align managerial motivation with the maximisation of the firm’s market value.

216 This regulatory method is a prime example of how formal institutions based on contract are supported by social norms and peer group pressure to ensure compliance.

Thus, the growth of institutional investor activism has been a catalyst in the re-orientation of corporate governance during the 1990s. By pooling their shareholdings and forming control coalitions institutions have been able to exercise direct control over managers and thus challenge directly the Berle and Means thesis of managerial unaccountability. \(^{218}\) Trade associations such as the Association of British Insurers, the NAPF, IFMA, umbrella organisations such as the ISC to which institutions belong, as well as specialised consultants like the Pensions and Investments Research Consultants (PIRC) have facilitated concerted action. According to Black and Coffee (1994) on at least three occasions between 1991 and 1993 such a coalition undertook to remove a board of directors. In a more recent example, institutions exerted pressure upon the management of NatWest Bank to restructure the company's entire strategy to haul itself free of takeover speculation due to major concerns about the incumbent management's performance (Finch 1997). However, institutional monitoring action is not always observable since UK institutions prefer to exert their influence behind closed doors saving adversarial methods such as proxy contests and ultimately hostile-takeovers as a last resort after all other efforts have failed (Holland 1996: 133 \textit{et sec}).

US institutional investors have also been very active monitors of managerial conduct. However, their methods of corporate governance activism are generally more adversarial as they often resort to proxy fights and create target lists comprised of underperforming companies. Thus, in 1990 there were more than 120 proxy resolution proposals by institutions, up from 70 in 1989 and just 28 in 1988 (Taylor 1990: 74). Regarding the outcome of such initiatives a report by Analysis Group, a proxy research and advisory firm, has shown that the vast majority of dissident

\(^{218}\) Such claims have been put forward even before the current level of financial assets' institutionalisation. See Florence (1953).
institutions' proposals get passed (ibid.). This type of institutional activism has been assisted by the fact that, apart from takeover regulation, all other important aspects of securities' regulation remains the responsibility of the powerful Securities and Exchange Commission (SEC) which has actively pursued the involvement of institutions in corporate governance. For instance, in 1992 the SEC amended its proxy rules, which had previously significantly increased the costs of co-ordinated activism, by abolishing reporting requirements formerly imposed on institutions for discussions with other shareholders on voting issues. Thus, consultancies and institutional investors' organisations such as the Investor Responsibility Research Center (IRRC) and the Investor Rights' Association of America (IRAA) now facilitate co-ordination and often issue specific guidelines on proxy voting. Another significant incentive for pension fund activism was provided in a ruling by the Department of Labor – known as the “Avon Letter” - according to which under ERISA the pension plan managers' fiduciary duty to the beneficiaries also applied to the decision to exercise the right to vote at General Meetings (US Department of Labor 1988). Thus, despite the retreat of the hostile-takeover as a disciplinary mechanism for managers and the enactment of constituency statutes, the pressure for current shareholder value maximisation is now more direct as a result of institutional investor activism. Furthermore, devices similar to those put forward by the various corporate governance Committees in the UK, such as independent board members and committees, are also present in the US either because of institutional pressure or because they are demanded by regulators such as the SEC.

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219 SEC rules 14-a-1 and 14-3(a).
220 For instance, the SEC has made the establishment of audit committees comprised only of independent directors for listed companies mandatory. See also IRC's corporate governance requirements (code of practice).
The rise of the institutional investor as a corporate monitor in the UK and the US has transformed corporate governance in these two countries and has signified the re-establishment of shareholder supremacy. It has done so not just indirectly through the market for corporate control, but also directly by means of the traditional channels of shareholder control. The pressure on managers to pursue profit maximisation and to redistribute excess cash flows, the main source of discretionary spending, is so intense that an Anglo-American model of shareholder capitalism has now emerged after almost a century of managerialism. However, this is not the full story as not all types of institutional investors have the incentives to exercise direct control. In fact, with the exception of some public pension funds, such as CalPERS, TIAA-CREF in the US and Hermes in the UK, most institutions are rather passive shareholders without a crisis to prompt them. Thus, the market for corporate control, even after the collapse of the takeover boom of the late 1980s, has not lost its importance as a managerial constraint completely. The hostile takeover is still around and many non-activist institutions are eager to participate in such transactions and often play the role of arbitrageurs speculating on the stock of potential targets. But even activist institutions - to some extent with the help of regulators - ensure that the takeover option is at all times open to them, as they are obviously eager to capture takeover premia. In sum, it seems that now the game is played according to the “restructure or be taken over” rule.

Thus, in effect most of the Jensenian constraints on managerial discretion as a tool for balancing stakeholder interests now appear to be operative in the UK and the US in a complementary manner. On the one hand, bonding devices, such as management stock-option plans or independent board committees, fulfil an *ex ante*  

\[221\] For analytical accounts of US and UK institutional investor activism see Brancato (1997); Useem (1996); Stapledon (1996).
monitoring purpose. On the other, the market for corporate control through the hostile-takeover endures as an *ex-post* disciplinary force for managers. Institutional investors, either as activists or as traders, constitute the backbone of this system of controls as they play a central role both in the implementation of *ex ante* governance devices and in the market for corporate control by opposing takeover defences as well as by organising or supporting hostile bids. These developments occurred in the UK and the US long before there were any significant signs of corporate governance change in other countries where the managerial firm has been dominant. For instance, as it will be shown below, German managerialism has persisted well into the 1990s. What then can explain the comparatively swift response of the UK and US corporate governance systems?

Several factors, particular to these two countries, can be identified which facilitated reform. Firstly, the passage from an outsider managerial model to an outside-shareholder one is simply one step shorter; in systems with insiders as important players an additional step is required in order to facilitate a dilution of those concentrated blocks of control. As already observed, powerful insiders may seek to frustrate institutional changes that can affect the structure of financial claims if they are unwilling to surrender their controlling interests and the private rents that accrue from them. Where such complications do not arise, as in the case of the US and the UK, the shift towards an outside-shareholder system where arm’s-length relationships are the rule involves fewer adaptation costs.

Secondly, for historical reasons in both the UK and the US securities markets have been important institutions through which public funds are channelled to the private sector (Coffee 2001; Cheffins 2001). Particularly in the US the banking sector has been highly fragmented as an effect of the Glass-Steagall Act. In contrast,
regulation in other countries, including Germany, hindered the development of such markets with the effect that for over a century big business’ external finance was almost exclusively provided by banks instead. Moreover, parallel to the early development of British and American stock markets was the formation of investor protection institutions that ensured the smooth functioning and reliability of those markets. Initially those institutions were of mere private character, mainly in the form of stock exchange self-regulation with the New York Stock Exchange and the London Stock Exchange being the pioneers. But gradually private sponsored regulation influenced the formulation of and was codified in government statutory rules designed to protect outside shareholders (Coffee 2001). Thus, by the 1970s British and American capital markets already had the liquidity, depth and institutional mechanisms necessary for providing the infrastructure for the market for corporate control as an indirect mechanism of shareholder control or for direct shareholder activism.

Thirdly, despite several government attempts, industrial co-operation and coordination never took root in either the British or the American economy as they did in other countries (King and Wood 1999: 377). As already discussed,222 in the US strict antitrust regulation since the early 1900s prevented any form of collusion between firms, either informal or formalised with exchanges of equity stakes. In Britain, competition rules became more restrictive only after the implementation of the Monopolies and Restrictive Practices Act of 1948, but even so cartelisation had never taken the form of extensive formal cooperation between firms crystallised with cross-shareholding arrangements. The rarity of inter-firm cooperation and cross-shareholdings is important because it means that industrial partners never became

222 Supra. section 1.2.
insiders through the acquisition of friendly and strategic equity stakes, so that inter-
firm relationships were largely arm’s length. Thus, any informal institutional
obstacles to a change of managers’ attitudes in relation to predatory action against
each other were rather weak and insufficient to prevent hostile takeover bidding.

Finally, persistent underperformance in comparison to other major economies
during the 1970s and 1980s reduced the uncertainty about what institutional change
would bring and therefore there were fewer adaptation costs. Certainly, already
disadvantaged groups had to bear most of those costs, mainly in the form of
unemployment, lower incomes and worse employment conditions. However, the very
fact that reform did take place is an indication that these groups did not have the
collective bargaining power to prevent it. On the contrary, financial institutions and
related interest groups were powerful enough to induce the deregulation of financial
markets which was key event in the transformation of corporate governance in the
UK and the US.

3.3. HISTORIC ROOTS OF GERMAN MANAGERIALISM

The German model of corporate governance is also a prime example of a
system where management has, at least until recently, been significantly alienated
from external financial forces. However, managerialism in Germany followed a
different path from that of the US and the UK mainly because German securities
markets did not develop as they did in the latter countries. Certainly, the lack of stock
securities markets meant that the market for corporate control could not constitute the
medium through which outside-shareholder objectives could be enforced through the
hostile takeover exit. Thus, in the absence of liquidity other more direct mechanisms of information flows evolved, mainly through concentrated ownership of financial claims and board representation.

Moreover, securities markets' underdevelopment was also the reason for German banks leading role in financial markets as the main institutions through which savings have been channelled through to industry. A well-developed universal banking system – i.e. a system with no legal separation of deposit-taking and lending activities from underwriting, holding and trading securities – initially gave German banks the incentives and ability to provide the industrial sector with the enormous funds required during the pre-war industrialisation era. This led to the formation of close relationships between non-financial firms and universal banks, particularly the Big Three, i.e. Deutsche Bank, Dresdner Bank and Commerzbank, who have also been able to acquire stock in some of their long-term corporate customers.

Due to the central role of universal banks in Germany's financial system many commentators have characterised the German model of corporate governance as bank-based – i.e. with banks being the main controlling and disciplinary force for managements. However, the following section will show that this mainstream view is not completely accurate. As firms grew and became more self-reliant during the early 1900s by generating their investment funds internally, their dependence on bank finance diminished considerably. The influence of banks in the formulation of corporate policies was also undermined by the high inflation crises during the inter-war and early post-war years, since extremely high interest rates rendered bank finance very unattractive compared to retained earnings (Chandler 1990: 419, 495, 512-513). Even after the post-war recovery, banks have not been able to re-establish themselves as major players in corporate decision-making, despite their improved
ability to provide investment finance, their continual involvement in the securities underwriting business and their remaining presence on company boards. According to Chandler (ibid), their role has diminished to one of facilitating co-operation among their corporate clients rather than controlling them.

Inter-firm co-operation dates back to the era of the second industrial revolution in the beginning of the 20th century. As the German business landscape was increasingly dominated by large oligopolistic firms that were no longer entrepreneurial or family-controlled but managerial, co-operation was more preferable to price competition that could threaten profitability. Inter-firm contractual agreements and cartels became common, since not only were they not illegal but they were also enforceable in German courts. However, as the threat of arbitrageurs circumventing those arrangements could never be totally eliminated, many firms begun to form profit pooling associations (Interessengemeinschafte or “IGs”) and corporate groupings (Konzerne) that were commonly accompanied by interchange of share blocks. During the economic downturn in the inter-war era such arrangements became even more common and to some extent substituted bank borrowing as a source of corporate finance (Chandler 1990: 512-513, 590-591). Thus, by 1930 representatives of affiliated industrial firms already outnumbered bankers on company boards.

These developments have contributed to the significant alienation of German managers from external financial pressures, and have, thus, allowed them broad discretion over corporate policy. Co-operation rather than rivalry among firms and the managerial insulation from external financial pressures and the market for corporate control, that could have placed the emphasis on dividend distribution as opposed to cash-flow retention, became the cornerstones of German managerialism. Retained
earnings provided most of the financial capital for the investments necessary for the continuous growth and competitiveness of German industry. Moreover, banks, who provided most of the external finance, have been committed financiers that preferred co-operative arrangements that ensured stability and long-term profitability to adversarial confrontation (Wengenorth 1999: 142). For most of the 20th century, managerial discretion has been the basis of German corporate governance as a stable and successful system that Chandler (1990) defines as "co-operative managerial capitalism". The German firm has not been regarded as solely the property of the shareholders, but as an organisation which exists in its own right.

An important building block of German managerialism has also been the co-operative nature of intra-firm relationships, especially between employers and employees (Wengenorth 1999: 172). German managers realised early the importance of long-term investment in human capital for the full exploitation of technological and organisational opportunities. They also understood that commitment to long-term growth and competitiveness requires commitment to cooperation with the labour force. Thus, they used their control over the allocation of funds in order to not only continually upgrade the quality and skills of the workforce but also to reward it with stability, good career prospects within the firm and satisfactory salaries. The basic element of and prerequisite for this co-operative arrangement has been the mutual commitment to it by employers and employees. This would have not materialised without the availability of "committed" capital, mainly retained earnings but also bank finance, and the insulation of management from the market for corporate control which could otherwise have focused managers' attention on current shareholder return maximisation.
Mandatory labour representation on company boards did not come until after the Second World War. However, the basis for this formal institutionalisation of balancing capital and labour interests was already there. The influence of the German *Soziale Marktwirtschaft*\(^{223}\) (Social Market Economy) model on managements' attitude and German corporate governance in general has been emphasised by a number of commentators. Streeck, for instance, in analysing the origins of the economic institutions in Germany, finds that they are the result of an historical compromise between liberal capitalism [...] and two different countervailing forces, Social Democracy and Christian Democracy – as well as between traditionalism and two alternative versions of modernism, liberalism and socialism, and of course between capital and labour. (Streeck 1995: 7-8)

Most authors trace the initial origins of this compromise even before the First World War to Bismark's social policies introduced in order to silence the most radical voices of socialists and trade unions (Gardner 1998: 320-321; Smith 1994: 3-5 and 19; Wood 1997). However, the most revolutionary industrial democracy measures, such as the compulsory inclusion of labour representatives on the boards of large German companies, were implemented during the reconstruction efforts initiated after the two World Wars and aimed at the mobilisation of the workforce.\(^{224}\) These policies played a crucial role in the balance of interests within and outside companies as well as in the evolution and success of the German post-War economic order. They formally introduced and maintained the "stakeholder" element in corporate decision-making that remained intact for almost half a century.

\(^{223}\) Some commentators have placed particular emphasis on the influence of the Hegelian vision of a socially responsible free market economy as well as the concepts developed by the renowned Freiburg School. See Hegel (1942); Emmons and Schmid (1998: 22-25); Smith (1994: 16-20).

\(^{224}\) It now seems ironic that board-level co-determination was envisaged and implemented for the first time by the British Administration in 1947, during the de-concentration and democratisation programme devised for Germany by the Allies. See Smith (1994: 300).
3.4. INSTITUTIONAL BUILDING BLOCKS OF THE GERMAN MANAGERIAL GOVERNANCE MODEL

Given the above-described socio-economic background it is not surprising that the German system of corporate governance has not evolved around the stock market. Moreover, shareholder interests have not enjoyed the supremacy they now do in countries like the US and the UK. Concepts such as shareholder value and return on equity have not been central benchmarks in corporate decision-making. On the contrary the German model has been build upon long-term relations both between employers and employees as well as between shareholders, creditors, industrial partners, and the company. The fact that all these interests are represented and amalgamated on a typical company board, supports the characterisation of German corporate law and governance as managerial rather than shareholder-oriented.

The discussion that follows will provide an analysis of German managerialism by assessing the nature and effect of the main institutional arrangements in which it is embedded and which determine corporate governance. After a brief description of the two-tier board, industrial relations, share-ownership and voting structure of the German public listed company and the macro-structure, it will be argued that for a number of reasons the market for corporate control has been historically inactive as a managerial discipline mechanism. It will then be examined whether this governance "gap" has been filled by the existence of holders of large voting blocks, such as banks or other non-financial corporations, who could have the potential to exert control over management. After showing that such blockholders do not actually have the incentives to undertake the type of monitoring role that is often attributed to them, it will be argued that the discretion German managers have enjoyed has been the
quintessence of an efficiently workable system of complementary institutions for almost a century. This discretion combined with a whole set of institutional constraints enabled corporate controllers to pursue the corporate interest by balancing different stakeholder objectives.

3.4.1. Board Structure and Composition

The board structure of German public companies is a two-tier one, comprised of a supervisory board (Aufsichtsrat) and a separate management board (Vorstand). This structure has its roots in the Verwaltungsrat, a body on which shareholders, bankers and other entrepreneurs were represented, and which was instituted for the first time in the 1870s by a mandatory requirement for a supervisory board separate from management with members appointed by the shareholders. The original reason behind the creation of such a body was not only to provide a mechanism for management control by the shareholders but also to protect the public interest because of fears of managerial corruption and exploitation of stakeholders. From its origins and design therefore one can easily understand that the German two-tier structure constitutes a “representational” model of corporate governance, where different interests are expected to be present on the Aufsichtsrat as a body assigned to counterbalance the Vorstand’s power.

225 This board structure came as a response to a severe market crash in 1873 which set the stage not only for the subsequent marginalisation of the stock market but also for the dominant role of banks who then took over the financing of early industrial development.
Aufsichtsrat

Under the German Aktiengesetz (Stock Corporation Act (“AktG”)) a stock corporation (AG) is obliged to have a supervisory board strictly separate from management. The Aufsichtsrat is responsible for the appointment and dismissal of the Vorstand members\(^{226}\) including the CEO as well as for their supervision\(^{227}\). However, there is a strict separation of two bodies’ functions since the day-to-day management of the company is exclusively the responsibility of the Vorstand.\(^{228}\) There are no specific statutory requirements as regards the length of tenures; however, they usually last for five years before a renewal is necessary. Aufsichtsrat members are not professional in the sense that they may accept mandates in several companies simultaneously. This operates in practice with relatively infrequent meetings, restricted time dedicated by the members, and limited flow of information between the two boards. As regards the latter, it is indicative that very often the auditor’s report is not presented to the board until the actual meeting. Accordingly, Baums and Frick (1996) comment that, except in times of financial distress, in practice the Aufsichtsrat acts more like an advisory rather than a monitoring body.\(^{229}\) Thus, it is no surprise that since 1976 the number of transactions requiring the supervisory board’s approval has been decreasing (Bemeier, Mülter and Schilling 1994: 57-60).

Generally, the board of all German companies is comprised of a minimum of three and a maximum of twenty-one members with an average between nine and thirteen members and with only 17.43% of all Aufsichtsräte reaching the maximum number (Prigge 1998: 955). Board size for large companies is legally prescribed.

\(^{226}\) Article 84 AktG.
\(^{227}\) Article 111 AktG.
\(^{228}\) Article 111(4)(1) AktG.
\(^{229}\) The depleted role of the Aufsichtsrat as a monitoring body has recently attracted criticism which eventually led to legislative intervention (see section 3.7.2 below).
Thus, in companies with a workforce between two and ten thousand the Aufsichtsrat has twelve members, in companies with a workforce between ten and twenty thousand the number raises to sixteen, and those companies with more than twenty thousand employees have twenty board members. A recent survey on the twenty-five largest companies in a number of European countries found that German Aufsichtsräte are by far the largest in Europe (Russell Raynolds Associates 1999). An explanation for this is that the board members’ background is not uniform and the interests they represent are diverse, i.e. not only shareholder interests. A major contributing factor is the labour co-determination regulation which requires that a number of employee representatives be appointed on the Aufsichtsrat of large corporations.\textsuperscript{230}

There are three board-level co-determination regimes in which the number of labour representatives varies according to the actual number of employees in the firm. The first is the full-parity regime. It concerns only the “Montan” coal and steel industries and was introduced for the first time in 1951 with the enactment of the Montanmitbestimmungsgesetz (“Montan Co-determination Act”) which provides for eleven Aufsichtsrat members five of which are labour representatives and the eleventh member is elected by a three-fifths majority of all members.\textsuperscript{231} The second is the one-third co-determination system which was created by the Betriebsverfassungsgesetz (“Company Constitution Act”) 1952 and applies to corporations with more that five hundred and under two thousand employees. It provides for one-third employee representation on the supervisory board. Finally, the

\textsuperscript{230} Recently, a size reduction of Aufsichtsräte as part of a draft law (see section 3.7.2 below) has been supported by academics as well as the non-employee members but it has been fiercely and successfully opposed by the trade unions. On other co-determination institutions see section 3.4.2 below.

\textsuperscript{231} It now seems ironic that this model of co-determination was envisaged and implemented for the first time by the British Administration in 1947, during the de-concentration and democratisation programme devised for Germany by the Allies (Smith 1994: 300).
third regime was created with the enactment of the Mitbestimmungsgesetz 1976 which extended full parity codetermination to all companies with two thousand employees or more. While there is not specific prescription regarding the size of the board under this Act labour representatives must comprise half of the Aufsichtsrat. Generally each board member irrespectively of his background has one vote. However, in case of a stalemate in a vote by the board, the chairman, who is not a labour representative but is nevertheless elected by a two-thirds majority of the board, has a casting vote. In all these co-determination regimes the majority of labour representatives are elected by employees and the rest are trade union delegates.

The rest of the Aufsichtsrat members are elected by the General Meeting and are shareholder representatives. In practice, however, it is not uncommon for these members to be selected by the management, especially in companies with dispersed ownership with no major shareholders (Hopt 1998: 250). Even though there is a legal requirement that the Aufsichtsrat be a body independent from management, independence under German law is not necessarily perceived in the same way as in the UK and the US. In Germany independence is merely understood as the prohibition for company managers to sit on the supervisory board. Thus, a recent study has shown that 43% of German supervisory boards include a former manager (Korn/Ferry International 1996). Moreover, independence may also be compromised by personal links that can arise from the possibility of a company’s managers and Aufsichtsrat members sitting together on boards of other companies, a common practice in Germany. Prigge (1998: 957-958) also notes that the connection between supervisory boards and management is often manifested by the influence of CEOs.

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232 See the discussion on non-executive directors’ independence in the Cadbury and Hampel Reports (Cadbury Committee 1992; Hampel Committee 1996).
and chairmen on the selection of Aufsichtsrat members and the frequency of cases where retiring CEOs become chairmen.

The relationship between management and Aufsichtsrat members compromises the motivation and ability of what would otherwise be shareholder representatives to supervise management in accordance with the interests of shareholders. Indeed, Hopt (1998: 233-235) finds that one of the main aspects of supervisory board representation, is the promotion of business networking; perhaps an indication of German managerialism’s cooperative character. He claims that often appointments on the Aufsichtsrat have a relationship dimension, in the sense that they constitute a formalisation of relations between the company and its business partners, resource providers, advisers or even former managers. A good indication of this is that in 1996 13% of Aufsichtsräte have at least one retired executive from another company, 70% a commercial banker, 13% a government official and 96% a worker representative (Korn/Ferry International 1996) – the latter being required due to mandatory co-determination provisions. Thus, one observation that can be made, bearing also in mind the preceding discussion on the origins of German corporate governance, is that the German model of corporate structure is not designed solely to protect the interests of shareholders as owners. Rather, through board representation, it provides the mechanisms for accommodating stakeholders’ diverse interests, including of course those of shareholders.

Vorstand

The Vorstand is responsible for the day-to-day management and represents the company in business and legal affairs. The appointment of its members is usually for
five-year terms and dismissals are allowed only when there is just cause. Managing directors' remuneration is set by the Aufsichtsrat, which is perhaps one of the reasons why management pay in Germany has not reached the extreme levels of the U.S. or the U.K. (Prigge 1998: 966-967).

Managing directors have a variety of duties to comply with, such as a duty of skill and care and a duty of loyalty. Of central importance as regards corporate governance is that managing directors owe their duties to the company itself. In marked contrast with UK law, the corporate entity's interests are not identified solely with those of the shareholders. Accordingly, the Aktiengesetz of 1937 provided that management was responsible for shareholder interests as well as for the workforce and the public good—a view of the corporation that closely resembled Dodd's stakeholder model. Even though its replacement of 1965 does not make such a specific reference to non-shareholder interests, Hopt and many other authors believe that this is because the inclusion of employee and social considerations are legally self-evident. Thus, the right to bring an action against the management rests with the Aufsichtsrat which represents the company and not the shareholders vis-à-vis the managers. The Aufsichtsrat, however, can be forced to commence an action against managers by a General Meeting resolution or by a minority holding at least 10% of the equity capital.

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233 Article 84 (3) AktG. Such a “just cause” may arise when there is a serious neglect of duty, withdrawal of confidence by the General Meeting on objective grounds, etc.
234 Another reason can be that until recently stock option awards to company managers were prohibited; see section 3.5.3 below.
235 For a general discussion of directors' duties in German company law see Baums (1998).
236 See section 1.4.1 above.
237 See Hopt (1998: 230-231, 237) and references provided therein. On employee interests see also the discussion on co-determination below.
238 See, for example, the recent decision of the Bundesgerichtshof (Federal Supreme Court) of April 21, 1997, Betriebsberater 1997, 1169.
239 The position of shareholders has now been strengthened; see section 3.5 below.
Nonetheless, the enforcement of director duties by the company's organs in the company's interests as well as the composition of the supervisory boards in co-determined companies, are clear reflections of corporate realism with additional elements from Dodd's stakeholder model since the position of shareholders vis-à-vis employees is balanced by board-level co-determination. In general, German company law allows management sufficient discretion and incentives to balance diverse stakeholder objectives while shareholder supremacy is not considered to be paramount in corporate decision-making. Accordingly, Raiser states:

Under German law, in the public company the power of the managing board is rather strong, because Article 76 rules directors to guide the company under their own responsibility, free from any binding instructions of either shareholders or supervisory board. Only fundamental changes require approval of the shareholder meeting, and the supervisory board may exercise a veto in certain cases where the by-laws provide such a veto. This widely discretionary power of the managing board favours a bias towards managerial "absolutism" which sometimes can hardly be stopped. (Raiser 1992: 37).

Thus, in contrast to the nominalist vision of the corporation where shareholders are the only constituency to which directors are accountable and therefore the company should be run in order to maximise current shareholder-value, German company law does not provide any such clear-cut managerial obligation. At least in law, German managers have the ability to channel company cash flow to projects and schemes that do not necessarily create value for current shareholders without running the risk of being removed or in breach of duty.
3.4.2. Works Councils, Collective Bargaining and Labour Market Internalisation

While board-level co-determination gives German company law a managerial orientation from the top down, other labour market institutions are designed to enhance labour "voice" within and without the corporate organisation.

Firstly, the Betriebsverfassungsgesetz (Company Constitution Act) of 1952 re-institutionalised the role of works councils, which were first introduced during the Weimar years in order to isolate the radical left in Germany’s labour movement but then abolished by the Nazis (Thelen 1991: 63-71). While the underlying intentions behind this were to fragment labour power by cutting the link between the shopfloor and unions, eventually the latter managed to dominate works councils and thus increase their influence inside German firms (Wood 1997).

Initially the powers of works councils were strictly defined, reflecting the aims of the 1952 Act. However, over the years the measure proved to be highly successful and accepted by employers who begun to recognise the value of consensus based employment relations. This was also confirmed by the Biedenkopf Kommission (1970) established in 1970 to assess the impact of codetermination in the Montan industries, which found that increased labour voice within the firm had resulted to a peaceful compromise between employers and employees without any negative effects on productivity and profitability. Cooperation between management and labour was important for the efficient setting of wage levels without conflict and the smooth implementation of new technologies, e.g. by facilitating the coordination of training and re-skilling programmes (Backes-Gellner, Frick and Sadowski 1997).
These findings were thus followed by the enactment of the *Betriebsverfassungsgesetz* of 1972 which expanded the role of works councils and removed any barriers between them and the unions. This law granted a right to the election of works councils in all plants with five permanent employees or more by a direct vote and for a maximum term of three years. Candidacies for Works Council membership have to be supported by at least 10 percent of the plant’s workforce. According to Wood (1997), this gives the German Trade Union Federation (Deutscher Gewerkschaftsbund, DGB) significant influence over the selection of candidates and therefore increases the leverage of unions within works councils. What is important is that, even though they represent a particular constituency within the firm, council members are legally bound to act for the promotion of the welfare of the corporation as a whole (Müller-Jentsch 1995). This can be explained by the broad spectrum of issues in which works councils are involved. More specifically, they have extensive *codetermination* rights over working hours, bonus rates, working conditions, employment transfers and dismissals, and *information* rights regarding personnel planning, financial matters and major strategic changes. Obviously, these legal rights provide an institutional framework for an enhanced micro-level governance role for employees.

Besides codetermination channels, labour voice is also influential at a macro-level due to the important role of unions in collective bargaining. Unionisation levels have traditionally been quite high in Germany and have averaged at about 40 percent of the total workforce during the post-war era while at the same time there is a virtual monopoly of interest representation due to the dominant position of DGB unions and the marginalisation of non-DGB ones. Collective agreements between unions and employers’ organisations, once concluded, are legally binding to all signatories and
usually cover matters that do not fall within the scope of works councils with the focus being wage determination. Generally, the law promotes the centralisation of industrial relations policy as its gives higher status to collective agreements than to codetermination arrangements unless the former expressly delegate matters to the latter (Hassel 1999: 486-487). However, there is no specific legislation governing collective bargaining which is simply guaranteed by the freedom of association provisions of the Grundgesetz (German Constitution) with courts having formulated a general code through their rulings.

In sum, firm-level codetermination through Aufsichtsrat representation and works councils and macro-level collective bargaining agreements between unions and employers' associations complement each other as channels of labour voice in industrial coordination. Moreover, the linkages between the two channels, e.g. due to the dominant role of DGB unions in works councils, have ensured the stability of the system. The complex web of German industrial relations institutions has been a significant force behind the incentives of managers to use their discretion in order to balance shareholder and employee interests. The most important consequence of this has been that, without the fear of opportunism, employers and employees have been willing to invest extensively in firm-specific training as a building block of German industrial competitiveness. Empirical evidence showing that human capital related investment has been significantly more than in most other developed countries with no codetermination demonstrates this (Smith 1991: 276). Moreover, such firm-specific investment has made labour market internalisation policies highly significant in Germany. Trainee apprenticeship schemes undertaken by German companies, for instance, have constituted one of the major institutions in German socio-economic life combining both formal vocational education and on-the-job training (Smith 1994:
Generally, long-term commitment in employment relationships has been the backbone of the German corporate organisation's success.

3.4.3. Ownership and Voting Structure

Given the above regarding the identity of the corporation, the inter-firm and employment relationships as well as the legal position of shareholders in German corporate governance, it would seem appropriate to examine the structure of shareholdings in German corporations due to the complementarities involved. This is not always an easy task, however, because there is a general lack of transparency (Becht and Boehmer (1999). Until 1995, equity stakes below 25% were not subject to mandatory disclosure. Recent legislation, however, implemented as part of the Wertpapierhandelsgesetz (Securities Trading Act 1994 ("WpHG"))\textsuperscript{240} has made it obligatory for listed AGs to disclose equity stakes of 5% and above of outstanding equity. Nevertheless, difficulties in determining the ownership structure of German firms still exist.

Several studies have recently emerged examining the structure and identity of German shareholdings. Generally, their results show that corporate ownership in Germany is highly concentrated and that the market for corporate control is dominated by large blockholders. A study conducted by Becht and Boehmer (1998) has shown that more than 50% of all listed firms have a single majority shareholder and that only 17.4% have no blockholder with a 25% stake or above. The same authors have also found that 85% of listed companies have at least one dominant

\textsuperscript{240} This piece of legislation is discussed more extensively in section 3.7.1 below.
blockholder (Becht and Boehmer 1999). Moreover, Franks and Mayer (1992) have discovered that concentration in the largest 200 German companies is even higher since such a blockholder is present in almost 90% of them. In addition, Goergen (1995) documents that ownership structure tends not to fluctuate significantly over time and that, even after German firms list on the stock exchange, their semi-private ownership structure is maintained due to the strong presence of large blockholders.

Particularly interesting is also the identity of shareholdings. Table 3.3 shows the identity of the largest blockholders in a sample of two hundred large firms in 1993. In almost half (96) of them the largest blockholder is another domestic non-financial corporation. The second largest group is that of families with 43 largest blocks, followed by foreign non-financial companies (21), banks (16) and the German government (11). These figures also reflect the size of shareholdings owned by each shareholder type (Table 3.4).

Table 3.3. Significance of Blockholders in German Firms

A. Largest Blockholders in a Sample of 200 Large German Firms in 1993

<table>
<thead>
<tr>
<th>Type of Largest Blockholder</th>
<th>Number of Blocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Non-financial firm</td>
<td>96</td>
</tr>
<tr>
<td>Foreign Non-financial firm</td>
<td>21</td>
</tr>
<tr>
<td>Families (incl. Trusts)</td>
<td>43</td>
</tr>
<tr>
<td>Domestic Banks</td>
<td>16</td>
</tr>
<tr>
<td>Domestic Government entities</td>
<td>11</td>
</tr>
<tr>
<td>Domestic Insurance Company</td>
<td>2</td>
</tr>
<tr>
<td>Foreign Government Entities</td>
<td>1</td>
</tr>
<tr>
<td>Non-profit Organisations</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>200*</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of Firms</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms without a Blockholder</td>
<td>9</td>
</tr>
<tr>
<td>Firms with a Blockholder</td>
<td>189</td>
</tr>
<tr>
<td>Total</td>
<td>198</td>
</tr>
</tbody>
</table>
B. Largest Blocks Held by Domestic Non-financial Firms (% of Total Voting Stock)

<table>
<thead>
<tr>
<th>Size</th>
<th>Number of Blocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-25%</td>
<td>4</td>
</tr>
<tr>
<td>25-50%</td>
<td>14</td>
</tr>
<tr>
<td>50-75%</td>
<td>32</td>
</tr>
<tr>
<td>75-100%</td>
<td>46</td>
</tr>
<tr>
<td>Total</td>
<td>96</td>
</tr>
</tbody>
</table>

* Two firms had blockholders of equal size


Table 3.4. Ownership Structure of Domestic Shares 1984-1996 (% of nominal value)

<table>
<thead>
<tr>
<th>Year</th>
<th>Banks</th>
<th>Insurance Companies</th>
<th>Investment Funds</th>
<th>Non-financial Companies</th>
<th>Households</th>
<th>Public Sector</th>
<th>Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>7.6</td>
<td>3.1</td>
<td>2.7</td>
<td>36.1</td>
<td>18.8</td>
<td>10.2</td>
<td>21.4</td>
</tr>
<tr>
<td>1990</td>
<td>9.4</td>
<td>3.2</td>
<td>3.3</td>
<td>41.4</td>
<td>18.3</td>
<td>6.0</td>
<td>18.6</td>
</tr>
<tr>
<td>1996</td>
<td>9.5</td>
<td>5.6</td>
<td>5.8</td>
<td>37.3</td>
<td>15.7</td>
<td>10.9</td>
<td>15.3</td>
</tr>
</tbody>
</table>

Source: Prigge (1998), Table 5.

As regards the high level of non-financial company ownership it is important to note that to a great extent it is explained by the high level of cross-shareholdings. Given the fact that the most common type of shares in Germany are bearer shares and taking also into account the possibilities of avoiding disclosure rules, revealing with accuracy the exact level and structure of cross-shareholdings in German firms is not an easy task. Nevertheless, the Deutsche Bundesbank (1997: 38) has estimated that cross-ownership among firms accounts for about three-quarters of all blockholdings controlled by the non-financial sector. Moreover, in their analysis of listed firms, Wegner and Kaserer (1997) found that the amount of cross-shareholdings is between 27% and 36% of gross market capitalisation. On the other hand, as Table 3.5 shows the degree of cross-ownership is even higher in the banking sector. Also important is the link between different segments of the financial sector. For instance, in 1996 the insurance conglomerate Allianz and certain banks, Bayerische Hypotheken- und
Wechselbank, Dresdner Bank\textsuperscript{241} and Münchener Rückversicherung, hold stakes in each other of between 28\% and 42 \% (Wegner 1996). Finally, the big banks appear to account for almost half of all bank holdings in all sectors (Deutsche Bundesbank 1987: 24-33), while in 1995 Allianz and Deutsche Bank controlled 4.87\% and 3.43\% respectively of the gross stock market capitalisation in Germany (Wenger 1996). Still, most of the equity owned by banks is not in non-financial firms but in other financial institutions.

Table 3.5. Share in Voting Rights of Five Largest Private Banks at Their Own General Meetings in 1992

\begin{tabular}{|c|c|c|c|c|c|c|}
\hline
 & Deutsche Bank & Dresdner Bank & Commerzbank & Beyr. Vereinsbank & Bayr. Hypo & Total \\
\hline
Deutsche Bank & 32.07\% & 14.14\% & 3.03\% & 2.75\% & 2.83\% & 54.82\% \\
Dresdner Bank & 4.75\% & 44.19\% & 4.75\% & 5.45\% & 5.04\% & 64.15\% \\
Commerzbank & 13.43\% & 16.35\% & 18.49\% & 3.78\% & 3.65\% & 55.70\% \\
Bay. Vereinsbank & 8.80\% & 10.28\% & 3.42\% & 32.19\% & 3.42\% & 58.11\% \\
Bayr. Hypo & 5.90\% & 10.19\% & 5.72\% & 23.87\% & 10.74\% & 56.42\% \\
\hline
\end{tabular}

Note: Percentage of present shares, including majority-controlled bank subsidiaries and investment companies.

Source: Prigge (1998), Table 18.

Perhaps even more significant is the structure of voting rights. There, despite their relatively small amounts of equity in non-financials, banks, particularly the \textit{Grossbanken}, are able to act as proxies and thus control voting majorities in many large firms. This is because under Article 135 AktG in order to have an exercisable voting right shareholders must either deposit their shares with the company or give a proxy to a credit institution, a professional shareholder agent or a shareholder association. For holders of bearer shares, who normally want to remain anonymous, bank proxy voting is most preferable. Table 3.6 shows the importance of proxy-

\textsuperscript{241} In April 2001 Dresdner Bank was taken over by the insurance conglomerate Alliaz AG.
voting rights held by the banks which on average constituted more than 80 per cent of
total votes present at the General Meetings of the one hundred largest firms in 1986,
with the Big Three accounting for more than half of them (45.44 percent of total votes
present). So it is obvious that these rights can be a very powerful corporate
governance tool. Certainly, share depositors have a right to instruct their bank on how
to vote in a general meeting, but in practice such instructions are rare and usually
banks vote as they think fit. This has led some observers to regard German corporate
governance as bank based, in that banks use their voting power to discipline
management. However, a close analysis of the banks' role shows this view is a
misinterpretation of German corporate governance system. This point along with the
other governance issues arising from the structure of share ownership and voting
rights in Germany are more extensively dealt with in sections 3.4.4 and 3.4.5 below.

Table 3.6. Voting Blocks of Banks at Shareholder Meetings of the Largest 100
Firms in 1986

<table>
<thead>
<tr>
<th>Company and Ranking</th>
<th>% of Shares Present at the AGM</th>
<th>% of Shares Voted by Deutsche Bank</th>
<th>% of Shares Voted by Dresdner Bank</th>
<th>% of Shares Voted by Commerzbank</th>
<th>% of Shares Voted by All Big Three</th>
<th>% of Shares Voted by All Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Siemens</td>
<td>60.64</td>
<td>17.84</td>
<td>10.74</td>
<td>4.14</td>
<td>32.52</td>
<td>79.83</td>
</tr>
<tr>
<td>2 Daimler-Benz Mercedes-Holding</td>
<td>81.02</td>
<td>41.80</td>
<td>18.78</td>
<td>1.07</td>
<td>61.66</td>
<td>69.34</td>
</tr>
<tr>
<td>3 Volkswagen</td>
<td>50.13</td>
<td>2.94</td>
<td>3.70</td>
<td>1.33</td>
<td>7.98</td>
<td>19.53</td>
</tr>
<tr>
<td>5 Bayer</td>
<td>53.18</td>
<td>30.82</td>
<td>16391</td>
<td>6.77</td>
<td>54.50</td>
<td>95.78</td>
</tr>
<tr>
<td>6 BASF</td>
<td>55.40</td>
<td>28.07</td>
<td>17.43</td>
<td>6.18</td>
<td>51.68</td>
<td>96.64</td>
</tr>
<tr>
<td>7 Hoechst</td>
<td>57.73</td>
<td>14.97</td>
<td>16.92</td>
<td>31.60</td>
<td>63.48</td>
<td>98.18</td>
</tr>
<tr>
<td>9 VEBA</td>
<td>50.24</td>
<td>19.99</td>
<td>23.08</td>
<td>5.85</td>
<td>47.92</td>
<td>98.18</td>
</tr>
<tr>
<td>11 Thyssen</td>
<td>68.48</td>
<td>9.24</td>
<td>11.45</td>
<td>11.93</td>
<td>32.62</td>
<td>53.11</td>
</tr>
<tr>
<td>12 Deutsche Bank</td>
<td>55.10</td>
<td>47.17</td>
<td>9.15</td>
<td>4.04</td>
<td>60.36</td>
<td>97.23</td>
</tr>
<tr>
<td>13 Mannesmann</td>
<td>50.63</td>
<td>20.49</td>
<td>20.33</td>
<td>9.71</td>
<td>50.53</td>
<td>95.40</td>
</tr>
<tr>
<td>18 MAN (GHH)</td>
<td>64.10</td>
<td>6.97</td>
<td>9.48</td>
<td>13.72</td>
<td>30.17</td>
<td>52.85</td>
</tr>
<tr>
<td>21 Dresdner Bank</td>
<td>56.79</td>
<td>13.39</td>
<td>47.08</td>
<td>3.57</td>
<td>64.04</td>
<td>98.16</td>
</tr>
<tr>
<td>27 Allianz-Holding</td>
<td>66.20</td>
<td>9.91</td>
<td>11.14</td>
<td>2.35</td>
<td>23.41</td>
<td>60.08</td>
</tr>
</tbody>
</table>
3.4.4. Role of Securities Markets in Corporate Control and Finance

The theoretical analysis in section 1.3.2. above reveals that the governance role of the market for corporate control, that is its ability to resolve “agency” problems between managers and shareholders, has come under detailed academic scrutiny over the years. The majority of studies, however, refer to the Berle and Means type of company where shareholders are widely dispersed and lack the incentives to monitor management. As already noted, in this case Jensen’s neoclassical agency theory argues that even where shareholders are not directly involved in management discipline through the General Meeting or through direct
contact with managers, shareholder supremacy can be enforced indirectly as shareholders show their discontent by selling their shares on the market. Eventually, a successful bid will inevitably lead to the replacement of the incumbent management by a more "efficient" one. However, this mechanism is subject to two conditions. First, the stock market must be relatively liquid because of the trade-off between liquidity and active shareholder monitoring (Coffee 1991). Second, it has to be efficient in producing the necessary information in order for shareholders to be in a good position to make their investment decisions.242

These conditions, however, do not seem to be fulfilled in the case of Germany. Practice supports this contention, since historically hostile-takeovers in Germany have been virtually non-existent, as opposed to the U.S. or the U.K. for instance.243 Two types of factors have been instrumental for the absence of hostile takeovers and the subsequent insignificant role of the market for corporate control as a mechanism of aligning German managers’ interests with those of current shareholders.

**Structural Factors – Takeover Barriers**

*Prima facie* it seems that, at least partially, the absence of hostile takeovers can be explained directly by ownership concentration. Edwards and Fischer (1994: 192) argue that the mere existence of a 25% blockholder can put off a potential hostile bidder from making an offer for the target company. This is because the

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242 Certainly, the desirability of the hostile-takeover mechanism in imperfect markets is questionable. See sections 1.4.2 and 3.2 above.

243 There have only been very few hostile takeover attempts in Post-War Germany. However, almost all of them were of minor significance apart from some recent attempts that took place within the past 10 years and may suggest a change in German corporate governance, an issue that will be discussed in more detail in sections 3.8.1 and 3.8.2 below.
acquisition of a stake below 75% by the bidder would not be enough to remove the incumbent supervisory board members and pass successfully resolutions regarding important matters such as mergers, acquisitions and changes in the Articles of Association. Moreover, buying a blocking minority stake may be rather costly because the blockholder would normally require a premium that would render the cost of the takeover too high, especially if the block in question is owned by a founding family.

An additional takeover barrier with relation to shareholder structure is the high level of cross-ownership between German companies. The inter-firm cooperative arrangements that often led to the exchange of stock were mentioned in section 3.3 above. Even if not all of those cross-shareholdings have been used for management entrenchment, a large number of them have indeed been created for this sole purpose. A characteristic example is that of Mercedes Automobil Holding which held a 25% stake in Daimler-Benz and was created by the latter with the help of some of Daimler's main shareholders, namely Deutsche Bank, Dresdner Bank, Commerzbank and Allianz Holding, for the sole purpose of preventing unwanted hostile-takeover attempts. Because of such management entrenchment effects, corporate cross-ownership has attracted some fierce criticism from a number of academics who adhere to the shareholder supremacy principle. Wenger and Kaserer, for example, claim that:

The most effective way for management to stave off capital market pressure is to build a network of mutual shareholdings financed with retained earnings or coordinated capital increases serving the sole purpose to exchange equity among colluding companies. (Wenger and Kaserer 1997: 21).

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244 Articles 103 and 179 AktG.
Consequently the possibilities of finding a potential takeover target in Germany have historically been limited. After a detailed examination of all German listed companies, Jenkinson and Ljungqvist (1997) found a maximum of only 77 firms out of all those listed on the stock exchange with a free float of 50% or more. This shows that the ownership structure of German firms constitutes a significant hurdle for the ability of the stock market to exert external pressure on management.

However, the minimal role of the German stock market and the hostile-takeover in corporate governance cannot be explained by the ownership structure alone. A number of other management entrenchment devices have been introduced over the years. For instance, voting caps have until recently\(^\text{246}\) been quite common particularly where founding families wanted to retain control or in firms that felt threatened by the increasing foreign ownership, mainly from oil producing countries, during the 1970s (Gordon and Schmid 1996: 9 and n.17).\(^\text{247}\) Furthermore, non-voting preference shares as well as shares with transferability restrictions (\textit{Vinkulierung})\(^\text{248}\) have also been common types of publicly traded stock. (Becht and Boehmer 1999). Multiple voting rights have generally been prohibited subject to the exception that state authorities could grant their approval for the use of this type of shares when deemed necessary to protect the overriding interest of the economy as a whole.\(^\text{249}\)

Another very significant takeover barrier with regard to voting arises from the ability of German banks to act as custodians of shares and proxy-holders. As already mentioned, the voting power of banks in General Meetings of large German firms is substantial. However, their attitude towards management has usually been supportive

\(^{246}\) New legislation has now abolished voting caps in German companies; see section 3.7.2 below.

\(^{247}\) See also Baums (1993: 156).

\(^{248}\) Some German companies have issued nominative shares that are registered in their stock ledger together with the name and details of their owners. Articles 67 para.1 and 68 para.2 AktG allow the insertion of a clause in the Articles of Association making the transfer of such shares subject to approval by the company in question.

\(^{249}\) Article 12 para.2 AktG ; see section 3.7.2 below.
so that not only would they not damage their reputation among their corporate clients, but also so that they would protect their investments as risk averse creditors. Indeed, the introduction of restrictions on voting rights has usually been supported by the banks, while hostile takeovers have been opposed.\(^{250}\) For instance, the involvement of Deutsche Bank was instrumental in the implementation of a 5% voting cap during two respective hostile takeover bids for Feldmühle Nobel AG by Veba AG and the Flick family in 1988 (Franks and Mayer 1998: 1389). Mercedes Automobil Holding is also an illustration of how banks have been helping corporate managers protect themselves from outside shareholder pressures. Thus, it is reasonable to assume that banks’ proxy-voting function has constituted a significant mechanism of managerial insulation from outside financial pressures over the years rather, than a disciplinary mechanism against managers.

Finally, another structural impediment to hostile takeovers arises from the corporate board structure itself. More specifically, the labour representatives on a co-determined \textit{Aufsichtsrat} will normally be fierce opponents to hostile bids because of the risks involved for the workforce in such transactions. Moreover, Roe (1999) argues that control of half \textit{Aufsichtsrat} seats by employees undermines diffused ownership because in such a case the bargaining position of shareholders’ vis-à-vis employees would be inferior.

According to Roe, a consequence of this capital-labour clash is that the 1976 extension of codetermination has led to the degeneration of the monitoring functions of the \textit{Aufsichtsrat}, mainly through reductions of information flows and of decisions requiring its approval. This board is a body whose quality and constructive influence is particularly valuable for dispersed owners of stock who do not have the necessary

\(^{250}\) See Goodhart (1988) on the policy of banks not to participate in hostile bids mainly due to reputation reasons among their large corporate customers. On the role of banks as blockholders of votes see section 3.4.5 below.
information to exercise control and thus entrust the Aufsichtsrat members with the function management discipline. Therefore, due to the lack of the necessary internal controls that a strong Aufsichtsrat could provide, shareholders in Germany need to acquire large and therefore costly equity stakes in order to ensure they have the necessary influence to protect their investment.

Deficient Outside Shareholder Protection

At this stage it is useful to distinguish between two types of shareholders. The first is the committed inside shareholder who makes a large and therefore firm-specific investment in the company and who has the incentive to engage in active monitoring of management, and the second is the shareholder who lacks monitoring incentives and prefers to remain an uncommitted "outsider". If one general observation can be made from what is described so far it is that the German system has evolved in such a way that it encourages the former type of shareholder and discourages the latter. This "systemic" bias against the latter type of shareholder is also manifested by and reflected on the deficient investor protection regime when it comes to minority shareholder rights and disclosure.

Firstly, a minority investor in a German company faces a real and significant risk of wealth appropriation by insider blockholders or banks who may use their proxy votes for this goal.251 Edwards and Weichenrieder (1999) provide empirical evidence for this appropriation of private benefits by the largest shareholders in German companies which nonetheless diminishes as the equity held by the second largest shareholder increases. However, the ability of large blockholders to acquire

251 For an analysis see Schmidt, Drukarczyk and Honold (1997: 77-93).
private benefits to the detriment of minority shareholders is more pronounced with regard to changes of control. This is particularly attributed to the lack of effective takeover regulation in Germany.\textsuperscript{252}

The traditional approach of takeover regulation in Germany follows the path of ex-post protection of minority shareholders, that is, \textit{within} the merged entity, rather than the \textit{ex-ante} protection, i.e. before the takeover transaction is complete.\textsuperscript{253} It is widely believed that this form of regulation does not provide a minority shareholder sufficient protection. Thus, the dilution of minority shareholdings by controlling majority shareholders has been both possible and common in German takeovers. This is because tender offers to minorities, when they occur, are usually at a discount. Wegner and Hecker (1995) have found that in 45 cases between 1983 and 1992 such offers were 27.1\% below the market price. Similarly, Jenkinson and Ljungqvist (1997) show that in three out of four cases in their sample discounts ranged from 15\% to 64\%.

In addition, the absence of effective insider trading regulation, at least until recently,\textsuperscript{254} has also acted as a deterrent for outside investors. Although in 1970 the Voluntary Insider Trading Guidelines were adopted, their voluntary character and the lack of specific criminal or even civil sanctions as well as of an effective enforcement mechanism rendered them ineffective and insider trading a common and even accepted practice. For instance, Standen (1995: 198) reports a case where in 1986 a member of the AEG AG \textit{Aufsichtsrat} purchased 700 shares in the company just before it was made publicly known that the company would be acquired by Daimler-

\textsuperscript{252} The "Guiding Principles" of 1979 merely constituted some non-binding recommendations. Regarding the recently introduced regulatory measures see section 3.7.4 below.
\textsuperscript{253} Article 311 ff. AktG. The most important rule of ex-ante protection is the requirement for a mandatory offer to all shareholders once certain thresholds (e.g. 30\% of share-capital) are met. See Baums (1996) and Schmidt \textit{et al.} (1997: 77-93).
\textsuperscript{254} It was as late as on July 8, 1994 that the passage of the Second Financial Markets Promotion Law (\textit{Finanzmarktförderungsgesetz}) rendered insider trading a criminal offence. See section 3.7.1 below.
Benz AG. After an investigation by the Frankfurt Stock Exchange, the board of inquiry characterised the event as a “minor infraction” and found that there was no infringement of the rules.

As regards disclosure, it was stated above that it is often difficult to identify the exact ownership structure in terms of ultimate control of German corporations. This means that an “outside” shareholder faces increased uncertainty and therefore higher risk due to the possibility that an ultimate controlling blockholder or coalition of blockholders can have the ability to extract private benefits. Thus, he will try to balance this risk by downgrading the shares’ target price and as a result increase the cost of equity finance for the company. Obviously, the higher the level of information provided in the market about ownership is, the lower the costs of raising equity and securitised finance in general.

In this respect, German accounting standards (German GAAP) have not been designed on the basis that they should provide the highest possible level of information and transparency that is required for outside-shareholder protection. On the contrary, they are thought to be manager- and creditor- rather than shareholder-oriented (Baetge and Thielete 1998; Schmidt 1998). This is because they allow extensive discretion to managers to undervalue company assets (usually land and shares) and overvalue liabilities and thus create significant hidden reserves which are often used to smooth earnings in less profitable years. The accumulation of hidden reserves is clearly not in the interests of outside investors as it distorts the accurate picture of investment risks for them. However, it suits creditor banks, because the existence of such funds minimises the risk of loan default. It also suits managers because the cushion of hidden reserves reduces the risk of bankruptcy. And, of

255 Nonetheless, it can also be in the shareholders’ interest to undervalue the company’s assets because of the so-called “conformity principle” which links statutory and tax accounting. See Schmidt (1998: 745-746).
course, it suits labour because hidden reserves can be used to avert redundancies and other wage-related cost-cuttings during adverse financial circumstances. In general, it would be fair to say that the German GAAP are less informative and less detailed than the International Accounting Standards (IAS) or the US GAAP and therefore of more limited value for the outside investor.

All the factors described here have reflected and contributed to the relatively low liquidity in the German stock market in comparison to the UK or the US. Almost all stock trades with immediate corporate control significance have been in the form of large blocks. For a large blockholder, the sale of its equity stake on the public market does not seem to be an attractive option, since it would normally be at a discount due to the actual size of the block; the sale of a large stake on the market is bound to create a downward pressure to the share price. Therefore, the choice of selling it as a whole in a “semi-private” manner though negotiations with potential buyers is more preferable. But, even when ownership is dispersed, banks can accumulate voting control through proxy voting and thus lead to the same result that concentrated share-ownership has.

An additional factor of great significance for the liquidity of German listed stocks has until recently been the high capital gains tax imposed on stock trades. A rate levied as high as 50% on capital gains resulting from trading acts as a significant hurdle to stock market liquidity. Many shareholders, even if they were prepared to divest their holdings in German corporations, would in fact be prevented from doing so because of the prohibitive tax rate that would be imposed on their proceeds. Thus, unless the tax burden could be significantly overcome due to some other economic or

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256 See further below.
257 This tax has now been abolished. See section 3.8.1 below.
strategic reasons, holding stakes that do not bring the equity returns that investment in other companies could give has been the normal choice for German shareholders.

This, nevertheless, does not mean that the market for corporate control in Germany is completely inactive. On the contrary, there is convincing empirical evidence that large equity-block trades, which are not always friendly, do occur. Jenkinson and Ljungqvist (1997) have identified 17 such trades and hostile stake buildings and 139 firms that could become targets for such activity. However, they distinguish such transactions from the Anglo-American takeover where management turnover is the classic outcome, because the buyer’s motive can merely be to gain influence or co-operation rather than acquiring majority control in the target firm. It is indicative that from the seventeen identified cases only two involved a complete dismissal of incumbent management. The main argument in this discussion, therefore, is that for the above reasons the hostile-takeover has not had a significant role as disciplinary mechanism for German managers.

**Corporate Finance**

From the discussion above it is not surprising that the German stock market has remained largely underdeveloped in comparison to other developed economies. Sufficient liquidity and outside-shareholder protection, the two main prerequisites for stock market growth, have not been present in Germany. Ljungqvist’s finding that German initial public offerings’ (IPOs) post-issue performance is negatively related to the degree of ownership that is retained by the original owners is indicative of the effects insufficient investor protection may have in raising equity costs and, as a result, in reducing the incentives for German corporations to use securitised finance.
It is not surprising therefore that the capital market has never played an important role in German corporate finance.

There are eight stock exchanges in Germany with the \textit{Frankfurter Wertpapierbörse} being by far the largest and most important of them with approximately 75% of total turnover of transactions. Nevertheless, the total market capitalisation as a percentage of GDP has been very low (31.4% in 1997) in comparison to most other major economies (Figure 3.1). The number of listed companies has also been very small. At the end of 1997, there were merely 700 listed AGs out of a total of over 3,000 in Germany, when the respective numbers of listings on the London and the New York Stock Exchanges were 2,046 and 2,271 (Figure 3.2).

\textbf{Figure 3.1. Stock Market Capitalisation as a Percentage of GDP in Major Economies 1997}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{Figure3.1.png}
\caption{Stock Market Capitalisation as a Percentage of GDP in Major Economies 1997}
\end{figure}

\textit{Source:} Deutsche Aktieninstitut (1998), Graph 05-2-a.

\footnote{See also Bessler, Kaen and Sherman (1998). However, see Goergen (1998) to the contrary.}
Figure 3.2. Listed Industrial Corporations in Five Major Exchanges in 1997.

![Bar chart showing listed industrial corporations in five major exchanges in 1997.](image)

*Source: Deutsche Aktieninstitut (1998), Graph 02-2-a.*

Figure 3.3 shows that the largest percentage of corporate finance for German corporations is generated internally in the form of retained earnings. Although this is not a distinctive characteristic for Germany, the use of internal funds by German companies has been above average (Mayer and Alexander 1990; Corbett 1996).

**Figure 3.3. Corporate Financial Structure**  
*(Percent of Total Financial Resources, Annual Averages 1984-1992)*
As regards external finance, issues of equity have not been as significant as in other economies like the UK. The same can be said about securitised debt in the form of bonds and can be explained by similar factors as those that have hampered the development of the stock market, i.e. information asymmetries between inside and outside investors. On the contrary, the percentage of intermediated debt, i.e. bank borrowing, as part of external finance has been high constituting the second most important source of corporate finance (Table 3.7).

Table 3.7. Patterns of External Gross Financing by Instrument

<table>
<thead>
<tr>
<th>Instruments</th>
<th>70-74</th>
<th>75-79</th>
<th>80-84</th>
<th>85-89</th>
<th>90-96</th>
<th>70-96</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>USA (% of Physical Investment)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal Finance</td>
<td>71</td>
<td>82</td>
<td>83</td>
<td>93</td>
<td>103</td>
<td>89</td>
</tr>
<tr>
<td>Bank Loans</td>
<td>64</td>
<td>61</td>
<td>64</td>
<td>75</td>
<td>62</td>
<td>65</td>
</tr>
<tr>
<td>Non-bank Fin. Inst. Loans</td>
<td>15</td>
<td>19</td>
<td>19</td>
<td>26</td>
<td>36</td>
<td>25</td>
</tr>
<tr>
<td>Bonds</td>
<td>39</td>
<td>38</td>
<td>37</td>
<td>55</td>
<td>62</td>
<td>49</td>
</tr>
<tr>
<td>Commercial Paper</td>
<td>4</td>
<td>4</td>
<td>7</td>
<td>11</td>
<td>15</td>
<td>9</td>
</tr>
<tr>
<td>New Equity</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>15*</td>
</tr>
</tbody>
</table>

| **Germany (% of Physical Investment)** |       |       |       |       |       |       |
| Internal Finance       | 77    | 96    | 94    | 98    | 83    | 88    |
| Bank Loans             | 62    | 74    | 76    | 76    | 75    | 73    |
| Insurance Companies’ Loans | 10 | 11    | 10    | 10    | 8     | 9     |
| Bonds                  | 7     | 5     | 5     | 7     | 8     | 7     |
| New Equity             | 3     | 3     | 3     | 4     | 5     | 3     |
Thus, even though there seems to be some controversy\textsuperscript{259} regarding financing patterns in Germany and the significance of different sources of finance for corporate investment, it would be a safe assumption to regard securitised finance (i.e., equities and bonds) as of minor importance for German corporations. Tax advantages for intermediated debt finance, particularly due to high securities transfer taxes, may also provide an explanation for the low level of corporate finance securitisation (Edwards and Weichenrieder 1999: 20). Moreover, unlike US banks, most German banks have not faced any significant regulatory restrictions regarding their geographical and services expansion.\textsuperscript{260} This allowed them to grow into large all-purpose financial institutions that could provide more financial capital than their counterpart in some other countries, and therefore an alternative source of industrial finance to securities. Nevertheless, this argument does not undermine the significance of all the factors analysed in the preceding discussion explaining the underdevelopment of German securities markets.

In sum, securities markets have not had a significant role in corporate finance or governance in Germany. Hostile takeovers have not played a constraining role in


\textsuperscript{260} The US Glass-Steagal Act prevented US banks from expanding beyond their states and maintained a strict separation of the deposit and loan operations of banks from the securities business. Such restrictions have not been present in Germany’s universal banking system.
managerial decision-making since the position of outside-shareholders has been too weak to exert any pressure through the market for corporate control. This raises the issue whether shareholder supremacy is enforced directly through shareholder "voice". This has indeed been a common suggestion by many observers who argue that large blockholders and banks are the key players in corporate control and therefore they constitute an "alternative" to the market for corporate control mechanism of aligning the interests of management with those of shareholders. This hypothesis will be investigated and refuted next.

3.4.5. Types of Blockholders and Corporate Governance

In terms of influence the significance of blockholdings is analogous to the size of the block. Thus, a block of at least 25% carries with it veto powers for significant company decisions such as charter amendments, supervisory board changes as well as profit- and control-transfer agreements. In firms with otherwise dispersed ownership such a stake should normally have even greater influence. A block of at least 50% plus one share gives majority control and therefore control over management subject to the existence of a blocking minority with a 25% stake. A block of 75% and over means that the blockholder has absolute control over all company activities apart from preventing a 10% minority to bring a corporate action against management. Consequently, the role of blockholders may be of large significance for corporate governance in Germany.

261 Recent legislation has reduced this threshold to 5%. See discussion on KonTraG in section 3.7.2 below.
Certainly, one possible outcome of concentrated ownership is that the shareholder-manager “agency” problems that arise in firms with dispersed ownership may become irrelevant. Blockholders, due to the size of their stakes in the company, may have the incentives to control management because the costs of free-riding may be higher than monitoring costs (Shleifer and Vishny 1997). As noted in section 1.4.2 above, the larger the stake, the more firm-specific the shareholder’s investment and, therefore, the higher his incentive to establish the necessary institutional mechanisms to safeguard it. However, one needs to be cautious before reaching such a conclusion automatically. This is because the possibility of such monitoring can depend on the identity of the blockholders. In the case of German firms this particular point is also emphasised by Edwards and Fischer:

It is not obvious that the existence of a large shareholder—one with a holding of 25% or more—will result in sufficient monitoring of the management of the AG to ensure that it acts in the interests of the suppliers of equity finance when the large shareholder in question is another AG with widely-dispersed share ownership. In such a case it cannot be assumed that the managers of the latter AG will necessarily use the large shareholding in the former AG in the interests of suppliers of equity, since these managers may themselves not be subject to monitoring and control. (Edwards and Fischer 1994: 187)

Accordingly, Edwards and Fischer rely on the evidence produced by Schreyögg and Steinmann (1981) in their study of a sample of 300 non-financial firms which has shown that about 50% of them were manager-controlled and therefore could not be presumed to have sufficient incentives to monitor other firms in which they owned equity. As manager-controlled were assumed to be those firms that are controlled by other AGs with dispersed ownership (about 10% in the sample). Thus, Edwards and Fischer (1994: 189) claim that, even though the number of companies with dispersed ownership is rather small, such firms are usually large, owning significant equity stakes in many other companies and, as a result, create agency problems between
shareholder and managers. This latter claim is enforced by the empirical evidence provided in a study by Bayhurst, Fay and Schreyögg (1994) who find that firm size is positively related to control by management.

It is not surprising therefore that the degree of influence of different blockholder types in corporate governance and performance has become the subject matter of extensive discussion. Recent empirical evidence provided by Edwards and Weichenrieder (1999) shows that the existence of some blockholder types, such as individuals or families, banks and foreign firms, has a positive impact on the company's market value and that the benefits of close monitoring for minority shareholders outweigh the costs of private benefit extraction by blockholders. However, other types of blockholders, more specifically, non-bank companies and public sector bodies have a negative effect. Edwards and Weichenrieder explain this by the fact that managers of such blockholder entities lack the necessary incentives to monitor because the market value of the companies they invest in is not tied to their wealth. This constitutes strong evidence for the validity of the presumption that cross-shareholdings are a significant management insulation device against the pressures of the stock market. In conjunction with the high level of corporate ownership by non-bank firms as opposed to individuals and banks, Edwards and Weichenrieder's findings also suggest that the issue of alignment (or rather the lack of it) between outside shareholders' and managers' interests in Germany may not be irrelevant after all.

This last finding leads to the examination of the role of banks in German corporate governance. As already mentioned universal banks are not only the main providers of external corporate finance, but are also allowed to hold equity as well as to control proxy-votes. Allegedly, this gives them great powers and influence with
regard to corporate control particularly as there are bank representatives sitting on German company boards. The mainstream view therefore is that, despite being manager controlled institutions themselves,\textsuperscript{262} due to this two-fold relationship with their borrowers banks are actually able and willing to commit themselves to corporate monitoring and, as a result, mitigate any shareholder-manager agency problems arising from the separation of ownership and control. This form of relationship banking internalises capital markets and thus reduces the costs of information asymmetries that exist in external capital markets due to deficient disclosure and transparency. That is, firms with a relationship-bank (\textit{Hausbank}) have a relatively easy access to intermediated finance in the form of bank loans, as opposed to market finance, and also enjoy the long-term commitment of their creditors even in situations of financial distress (Elston and Albach 1995; Elsas and Krahnen 1998). The structure of German corporate finance seems to support these presumptions.

Nonetheless, banks have also been accused of using their voting power to further their interests as creditors rather than as shareholders and, thus, hold back corporate performance in current shareholder value creation instead of improving it (Wenger and Kaserer 1997; Edwards and Fischer 1994: 214 \textit{et sec.}). Firstly, banks may lack the incentives to enhance current profit maximization (shareholder value) because it carries no direct financial benefits for them as creditors. Additionally, in order for \textit{Hausbanken} to commit themselves to a long-term relationship with a customer firm, they should expect to receive adequate returns in the form of private gains such as customer loyalty and rent extraction.\textsuperscript{263} Accordingly, two studies have shown that two-thirds of short- and medium-term loans are collateralised and that for

\textsuperscript{262} According to Bayhurst, Fay and Schreyögg (1994) 100\% of banks are manager-controlled.

\textsuperscript{263} For example there is empirical evidence showing that \textit{Hausbanken} tend to require more collateral from their debtors in order to increase their bargaining power and exclusivity as creditors; see Elsas and Krahnen (1999). Private gains for banks may also come as a result of insider trading see Standen (1995).
long-term loans the degree of collateralisation can be even higher (Drukarczyk, Duttle and Rieger 1985; Drukarczyk 1993). This means that banks may lack the incentives to actively engage in corporate monitoring, especially in the case of large firms who have the ability to diversify their borrowing by having many creditor banks.

The above presumptions have led the long-standing debate on the impact of universal banking and relationship-lending on corporate performance. Nevertheless, the empirical evidence on this matter is anything but conclusive. The first empirical study was conducted by Cable (1985) who found that in his sample, comprised of the 100 largest German companies in 1974, ownership concentration and bank voting power were positively related to firm performance. However, two subsequent studies by Edwards and Fischer (1994: 221-226) and Gordon and Schmid (1996) have disputed Cable’s results due to some flaws in his methodology and find no significant connection between bank involvement and corporate performance. Edwards and Fischer, in particular, interpret Cable’s findings more as evidence of a positive relation between performance and ownership concentration rather than monitoring by banks. Nibler (1995), on the other hand, finds a significant negative relation between bank influence and corporate performance. Moreover, Edwards and Fischer’s (1994: 198 et sec.) study shows no significant connection between banks’ proxy-voting rights and the appointment of bank representatives on the Aufsichtsrat, which may mean that banks are not using their voting power to monitor management. This does not appear to be the case, however, when banks are also shareholders, since ownership of shares is positively related to Aufsichtsrat representation (Franks and Mayer 1997). Nevertheless, it has already been shown above that banks’ shareholdings in non-financial companies are relatively small. Thus, even if there is a link between bank shareholdings and managerial accountability, it is bound to be of
minimal practical importance. Additionally, Gerum, Steinmann and Fees (1988) claim that banks’ Aufsichtsrat representation is rather insignificant in terms of influence, firstly, because even if all bank representatives acted in concert they would still be a small minority against other shareholder representatives\textsuperscript{264}, and, secondly, because they would still have to rely on management-controlled inside information. This is illustrated by the case of Karstadt AG where two of the Großbanken could not remove the CEO, even though they held a 20% stake between them in the company and were also represented on the Aufsichtsrat.\textsuperscript{265}

Thus, if one conclusion can be drawn from the empirical evidence available so far, it should be that the mainstream view about the corporate control role of German universal banks seems to be somewhat misplaced. There is no clear connection between control rights owned by banks and shareholder value maximisation. However, the explanation for this may simply be that banks do not intervene unless there is clear evidence of a crisis, such as an insolvency situation. This point has been emphasized by Hackethal and Tyrell (1998) who argue that the strong creditor orientation in German insolvency law gives banks, at least theoretically, the incentives to involve themselves in corporate rescue operations and reorganisations. This of course could give a competitive advantage to firms with a Hausbank vis-à-vis those without and therefore positively affect performance in the long-run. Nevertheless, the empirical evidence does not provide any clear support for such an assumption. Rent extraction and conflicts of interest between banks and shareholders may be the explanation for this. Indeed, private benefit acquisition as a result of a reorganisation may constitute the main incentive for bank involvement. Thus, the role of Hausbanken may simply be to “sell” liquidity insurance rather than maximize

\textsuperscript{264} In 1979 bank representatives occupied 16.4% of shareholder seats and 8.2% of all Aufsichtsrat seats in AGs with 2,000 employees and over. See Gerum \textit{et al.} (1988).

\textsuperscript{265} Figures reported by André (1998: 146).
corporate performance, however that is measured, through continuous monitoring. For large and established firms, however, the value of Hausbank relationships should be lower than it is for smaller ones, because the risk of insolvency for such firms is smaller. Empirical support for this contention can be found in Harhoff and Körting’s (1998) study of firm-bank relationships where it is shown that smaller firms tend to rely more heavily on exclusive lending relationships than larger ones. More significantly, Edwards and Fischer (1994: 142) find that in the case of large listed firms competition amongst creditors is higher and a Hausbank is “seen as the first among equals in a group rather than a monopoly supplier of financial services”. This means that, even where there are no alternative external sources of capital to bank finance, banks’ leverage over management is much less than some observers would like to believe. Thus, as the synthesis of the empirical evidence in this and the previous section has demonstrated, banks should be seen more as manager-controlled organisations who are willing to provide support to their industrial clients and co-members of the German big business network rather than as their watchdogs and champions of current shareholder value maximisation.

3.4.6. Macroeconomic and Competition Policy

In the managerial models presented in chapter 1 above effective demand conditions were projected as a vital element that complements the microeconomic structure. What makes Germany particularly interesting, however, is that, while its basic corporate governance structure as described above is clearly managerial, contrary to “textbook” Keynesianism the role of government agencies in macro-
management has been less significant than one would normally anticipate. In fact, demand targeting has not been a central feature of German macropolicy-making during the post-war era as it has in other countries. A general aversion to excessive statism due to the experiences of the totalitarian Nazi rule and the Allied occupation gave rise to a preference for a self-regulating private sector within the general framework of the Sozialmarktwirtschaft (Allen 1989). The powerful and independent Bundesbank was more concerned about inflation rather than full employment and so it followed a tight monetary policy with a focus on keeping money supply stable.

However, it is misleading to assume that, since demand management has not been a fundamental goal for the federal government, German managerialism could operate in a demand-constrained environment. Firstly, the very essence of the Sozialmarktwirtschaft has been a well-developed social welfare system which benefited working classes and tempered the effects of joblessness. Secondly, while unemployment in the immediate post-war years was high, gradually high annual GDP growth rates until the late 1960s not only increased employment but also raised wages. The role of codetermination and collective bargaining institutions has been instrumental in this as they provided the basis for the setting of wages at appropriate levels linked to overall productivity. Thirdly, government spending on infrastructure, education and business subsidies has been generous and contributed greatly to the reconstruction and competitiveness of industry (Smith 1994: 117-118) – Marshall Plan assistance has been highly significant too in this respect. Fourthly, managerial discretion combined with other fiscal measures gave the private sector the incentive to plough profits back into production, as the financial system encouraged savings which were channelled to industry mainly through banks (Allen 1989). Last but not

266 For a detailed overview of the evolution and main features of the German welfare system see Smith (1994: ch.5).
least, great emphasis was placed by the authorities on export-led growth, in that Germany promoted and relied on the post-war liberalised regime of international trade under GATT and later the EU in order to tap effective demand in the US and other European countries for its products so that current account and trade surpluses were the norm.

In sum, while textbook Keynesianism tends to concentrate on external government intervention in the market mechanism in order to temper its destabilising effects, the German system has provided a framework facilitating coordination from within the private sector (Allen 1989). Hence, full-employment and demand targeting by monetary authorities did not become popular simply because it was not necessary. On the contrary, due to the expansionary tendencies of the managerial microstructure the independent Bundesbank and its restrictive policies were important constraints balancing the economic forces within the system. Thus, high industrial investment and growth, wealth redistribution through a complex system of fiscal, labour and welfare institutions of the Soziale Marktwirtschaft, and a combination of domestic and foreign effective demand led the German economy to a Kaldorian virtuous circle of cumulative causation for most of the post-war era.

Complementary to this type of coordination of the German economy has also been competition policy which has generally allowed cooperation between firms. Indeed, cartelisation and market concentration in vital industries had been widespread during the first half of the 20th century as successive German governments were sceptical about the detrimental effects of excessive competition (Smith 1994: ch.8). Even after the legislative programmes of decartelisation and deconcentration implemented by the Allies after World War II, competition law enforcement was lax in accordance with the a rather dubious notion called “workable competition” that
was developed during the early 1960s (Hoffmann and Schaub 1983: 105). Price competition was not seen as a central goal of competition policy and this was reflected in the Gesetz gegen Wettbewerbsbeschränkungen 1957 (Law Against Restraints of Competition (GWB)) which protected resale price maintenance; this did not change until 1973. Similarly, until the 1973 amendments to the GWB came into force, merger control was virtually non-existent and did not prevent inter-firm cooperation and the development of extensive cross-shareholdings. According to Smith (1994: 426), even after 1973 few mergers have been prohibited by German competition authorities. Subsequent amendments during the 1980s and 1990s have widened the scope of the GWB and combined with parallel developments in EU merger control have established a more restrictive competition environment, but they came too late to prevent concentration in German industries (ibid.: 430). It is not surprising therefore that German industrial strength has not been built on price competitiveness in world markets, but on the superiority of German products in terms of quality. As Wengenroth (1999) explains the leitmotif of German manufacturing has traditionally been “competition abroad-cooperation at home”.

3.4.7. The German Managerial Model as a Workable System of Complementary Institutions

Despite some ambiguities that may still exist regarding the role of different types of blockholders, it is sufficiently clear that a simple analysis of corporate control in terms of managerial accountability to shareholders cannot provide an

\[267\) For an analysis of see Galanis (1996).
accurate assessment of German corporate governance. The preceding discussion in this section has shown that German corporate governance has not been based on the idea that managers act solely in the interests of shareholders. Deficient disclosure and minority shareholder protection rules as well as codetermination provisions have been a reflection of the fact that shareholder interests do not enjoy the absolute supremacy that a neoclassical economic model would assume.

As the shareholdings' analysis shows, the most common blockholders, especially in larger firms, are other non-financial companies whose wealth is not necessarily tied to equity value. Moreover, banks, despite their strong presence in financial markets and in General Meetings as custodians of proxy-votes, do not seem to have been exercising the corporate control role that has often been attributed to them. Their role has been more as a shield against stock market pressures and as liquidity insurance providers rather than as management monitors. The argument presented here therefore is that the German model of corporate governance is not bank-based, as it is often assumed, but managerial. As neither shareholders, either directly or through the market for corporate control, nor banks as proxy-vote custodians seem to be able or willing to enforce shareholder supremacy, managers in large German corporations are able to pursue their policies with relative independence from shareholder pressures. At the same time, the interests of other constituencies, especially employees and affiliated companies, are also very important so that the interests of no particular stakeholder are paramount in corporate decision-making and that a notion of long-term commitment exists between the company and its various resource providers.

This would not have been possible without the systemic aversion to arm's length relationships and the insignificance of the market for corporate control as a
disciplinary mechanism for management. Entrenchment devices have enabled German managers to deviate from a pure current shareholder-value orientation that could render stakeholder interests subjugated by the profit maximisation objective. In such a system shareholders can maximise the returns on their investments only if they become committed insiders. Banks can also receive private benefits from their corporate clients only when they commit themselves as long-term financial capital providers. In other words, the institutional framework encourages firm-specific investment which is the basis of insider dominance in German corporate governance.

Most importantly, the fact that financial capital in Germany has been "patient" with a long-term orientation is of great significance for the sustainability of stable employment relations because patient capital enables employers to invest in workforce training and retraining instead of seeking to hire or replace existing employees with new ones from external labour markets, who would not have sufficient firm-specific knowledge. If managers were subjected to capital market pressures and focused only on maximizing returns for outside uncommitted shareholders such investments with long-term maturity would not be easily sustainable. The internalisation of labour markets has led to high wage levels and relatively inflexible labour relations that discourage drastic cost-cuttings and encourage investment in the refinement of existing products. It is this ability to generate trust and commitment among different corporate resource providers that has been the driving force behind the German model’s success. As Mayer (1996) argues, the element of commitment is crucial for productive activities, such as complex manufacturing processes, that require involvement and investment by a large number of stakeholders. It is not surprising therefore the German corporate champions come
almost exclusively from the manufacturing sector (e.g. high-precision electrical machinery, industrial chemicals and road vehicles).

At the same time, competition policy encouraging inter-firm cooperation has been crucial for the German system’s workability. As Streeck (1995) claims, the German model’s success has not been based on its ability to withstand price competition or on fast product turnover. Stakeholder commitment cannot accommodate this easily. On the contrary, German industry has established its leadership because of its ability to “evade” price competition by relying on product quality and innovation instead. This dedication to quality improvement would not have been possible without the continuous improvement of firm-specific labour skills which, as already explained, is dependent on the availability of patient capital. This shows how important the workability of complementary subsystems is for the stability and success of the German model. Hand in hand with this, by following a pattern of export-led growth, German industry has relied on the competitiveness of its products abroad and on global demand conditions. So long as those remained high, German managerialism was able to sustain its high investment-high growth levels.

Thus, the German model of corporate governance has been based on the workable complementarity of its institutional components as described above. The interaction between underdeveloped capital markets, corporate ownership concentration, co-determination provisions and collective bargaining, and the role of universal banks has provided the foundations for a workable system which performed extremely well for most of the post-war era and has achieved and maintained a high level of social welfare and cohesion (Schmidt 1997). While managers have enjoyed considerable discretion vis-à-vis shareholders as a corporate constituency, the set of institutional constraints and incentives in the three major sub-systems – the financial
system, the industrial relations system and the macroeconomic structure have ensured that managerial autonomy was used for the efficient balancing of stakeholder objectives, i.e. the promotion of the interests of the company as a real entity.

However, as the theoretical analysis in chapter 2 above demonstrated, institutional complementarity also implies that a change in one or more of its component subsystems may cause the destabilisation of the system as a whole. The discussion in the following sections will show that as a result of globalisation, the long-term commitment between major company stakeholders described so far is being subjected to increasing pressure to reform and that the first signs of change are already visible.

3.5. GLOBALISATION, COMPETITIVENESS AND COMMITMENT IN INDUSTRIAL RELATIONS

Given its strengths in promoting social stability and cohesion together with economic success, one possibility could be that the German model of corporate governance could be exported as it is through the process of global isomorphism. However, this is unlikely for two reasons. First, the German model derives from and has been designed for the particular needs of a domestic market. The complementary institutions described above emerged from a complex combination of arrangements and concessions among institutional actors in specific historical circumstances that are particular to Germany. It may be difficult, if not impossible, for these circumstances to be reproduced in full outside the German socio-economic environment. Second, global markets have been evolving in such a manner that they
undermine the sustainability of managerial systems. As the analysis in chapter 2 above demonstrated it would be unrealistic to think that a balance among institutional actors, such as that sustaining German managerialism, could be reached at least in the foreseeable future, due to the nature of forces in the current globalisation wave which are not conducive to managerialism.

As a result, the German model’s ability to adapt to the pressures of the emerging global economic order must be seriously questioned as problems are already visible with potentially severe destabilizing effects.268 The nature of competition in global markets now makes fast product turnover and flexibility of business and industrial relations more necessary than in the past. As a result, the balancing of high labour costs with the advantage of high quality products has become more difficult to achieve and therefore cost-cutting in the form workforce reductions and/or the option of moving low-skill jobs to low labour-cost countries have become more attractive.

The first signs of a systemic crisis in Germany begun to appear in the late 1970s and early 1980s. The dramatic increase of unemployment has been the most important due to its direct relation to the workability of the German model. As O’Sullivan (1998) reports, by 1983 about 40% of the jobs in the consumer electronics industry that existed during the 1970s had been lost. Obviously, the German model was beginning to face a competitiveness crisis. Streeck (1995) claims that this phenomenon could be attributed to labour market rigidities, high labour costs in a slow growth environment, and deficient product innovation, the latter a result of decreasing profits. The emergence of foreign competitors, such as the Japanese or

268 Apart from the pressures arising from globalisation, the reunification of Germany may have also been a factor contributing to the destabilisation of the German economic model. However, the signs of systemic change away from the traditional path were already present prior to 1989. If anything, reunification simply exacerbated the pressures that German capitalism was already faced with since the 1970s.
later the Koreans and other “Asian Tigers”, who were able to produce high quality products faster and more cheaply, meant that German producers could no longer rely on their quality competitiveness to outweigh higher production costs. The intensification of global competition begun to challenge directly the superiority of German manufacturers in traditional industries, such as iron and steel, coalmining, shipbuilding, consumer electronics, and motor vehicles (Esser and Fach 1989: 240; Bosch 1990: 54). In other words, German firms were beginning to lose their export markets to foreign rivals, an issue with direct impact on the system’s viability. Indeed, by the late 1980s and early 1990s Germany’s share of total world exports was in decline and a current account deficit appeared for the first time (see Table 3.8).

Table 3.8. Trade and Export Performance of Germany

<table>
<thead>
<tr>
<th>Year</th>
<th>Trade in Goods and Services % of GDP</th>
<th>Visible Exports % of Total World Exports**</th>
<th>Trade Balance % of GDP</th>
<th>Current Account Balance % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>54.9</td>
<td>12.0</td>
<td>6.5</td>
<td>4.0</td>
</tr>
<tr>
<td>1994</td>
<td>51.0</td>
<td>10.1</td>
<td>2.7</td>
<td>-1.1</td>
</tr>
</tbody>
</table>

Note: 1988 West Germany, 1994 unified Germany.
* Trade data calculated on a balance of payments basis.
** Exports calculated on an international transactions basis.

Source: Streeck (1995), Table 1.

A way out for German industry could have been provided by placing more emphasis on product development and turnover in order to meet the standards of foreign rivals. However, the institutional arrangements in the German model do not encourage such an approach, because commitment to long-established relationships
between resource providers, especially between employers and employees, does not allow sufficient flexibility. Accordingly Herringel claims:

Each time a new product or a new technology is introduced—as opposed to an old one that is customized for a customer—the various roles that each of the categories of skill and management will play in the production and development of the new product must be bargained out. [...] Few producers, large or small, have had success up until now in being able to overcome the opposition of entrenched groupings of skilled workers threatened with the loss of status through incorporation into teams that deny the boundaries of former jurisdictional specializations or of independent departments, reluctant to have their functional areas of power within the firms redefined and diluted through recomposition with other areas. It is difficult, after all, to tell workers and managers who with considerable legitimacy understand themselves as having contributed significantly to the traditional success of high quality manufacturing in Germany that their roles have become obstacles to adjustment. (Herringel 1996: 42-43)

Thus, due to such path dependence problems, the general inability of German companies to restructure their basic organizational methods by adopting techniques such as lean production, and exploit new business opportunities in high technology sectors also affected their chances of reversing the decline in profitability and investment rates. The very strengths of traditional organisational arrangements in Germany which in the past contributed to the creation of accumulated organizational knowledge now seem to have become impediments to the development of high technology industries which are more dependent on entrepreneurial rather than organizational skills (Block 1998).

At the same time, a constrained government could not fill the investment gap by increasing public spending. Thus, in 1993 Germany entered its worst and longest recession in the post-war era which was followed by slow growth during the rest of the 1990s and still rising unemployment.

During the 1980s, German companies had been able to smooth the pressures from global competition by taking advantage of the European Community's
protectionist measures against non-Community exporters which were already in place since 1977 (Tsoukalis and Strauss 1987) and by resorting to reductions in working time, leisure allowances, retirement and hiring-freeze policies. However, in the early nineties such actions had already reached their limits.\(^{269}\) Thus, German employers begun to abandon their commitment to stable employment relations by resorting to mass dismissals. According to an estimate by the Kiel Institute of World Economy, as much as 1.3 million jobs accounting for 15 percent of Germany's manufacturing employment was lost between 1991 and 1996 (cited in *New York Times* 1996), while the current number of unemployed is well above the important threshold of 4 million. Rising unemployment and job insecurity have indeed been direct blows to the *Soziale Marktwirtschaft* and thus the German model as a whole. Just as German traditional industries were losing ground in global export markets, high unemployment aggravated aggregate demand conditions further and made the sustainability of high cost-high output managerialism even more questionable. As Figure 3.4 shows while reunification gave an initial boost to domestic demand conditions in 1990, the effect was only temporary and overcapacity levels continued to increase and remained high during the 1990s.

\(^{269}\) It must be noted here that the reunification shock exacerbated even further the effects of the crisis. This does not mean, however, that it was the only factor that led to the economic slump in Germany since, as it was mentioned above, *ibid.*, the symptoms of the recession were visible even before 1989.
However, as national boundaries have become less significant for economic activity and mobility of production factors more intense with the post-war free trade and investment agreements, German employers have become less dependent on their domestic high-cost workforce and general institutional framework. Thus, low labour-cost locations, especially in the post-communist Central and Eastern Europe, have become more attractive for the allocation of production plants by German companies. For instance, countries like the Czech Republic, Slovakia, Poland and Hungary which are close enough for just-in-time production and can also offer labour skills similar to those in Germany but at a much lower cost, have become particularly attractive production locations for low and semi-skilled operations (Streeck 1995). Accordingly, the scientific advisory board to the Ministry of Economic Affairs in its analysis of “long-term unemployment” has commended:

Sustained unemployment is above all a concomitant of increasing competition in a rapidly-integrating world economy. [...] Germany as a location (Standort Deutschland) competes internationally with its institutional framework and its factor cost for mobile capital that creates new jobs. Those countries that fall short in competition have to face unemployment, a declining propensity to invest and lower growth rates. (Bundesregierung 1993)
Thus, the problem of unemployment must be considered also in relation to the option of transferring labour intensive production abroad which trade liberalisation has opened up for German employers who have been keen in the past decade to take it rather than follow the traditional route of investing in production innovation (Welge and Holtbrügge 1997: 337). The rising gap between inward and outward FDI flows in favour of the latter is indicative of the production globalisation strategies undertaken since the late 1980s (Figure 3.5). This is also reflected in the increasing significance of employment in foreign affiliates as a percentage of total employment (Table 3.9).

While much of German FDI outflows are demand driven since they are directed towards other developed economies in order to secure export markets, the significance of cost-driven FDI cannot be ignored. In a 1996 poll among 7000 firms, mainly from the industrial sector, 62 percent of those industrial companies who intended to expand their production abroad identified high domestic labour costs as their main motive (Deutsches Institut für Herrenmode 1996).

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**Figure 3.5. German Inward and Outward FDI Flows 1980-1998.**

![Graph showing German Inward and Outward FDI Flows 1980-1998](image)

*Source: UNCTAD (1999), Annex Table B4.*
For instance, Veba, RWE and Thyssen, three of the largest domestic conglomerates in Germany, in the 1990-1997 period changed dramatically the ratio of their domestic to international employment in favour of the latter (Bendt 1998: 41). It is worth noting that for Veba and RWE, in particular, this was combined with the first workforce reduction in their entire history. Siemens has also followed a similar trend by reducing its employees in Germany from 203,000 in 1996 to 194,000 in 1998 and increasing its international workforce from 176,000 to 222,000 in the same period (Siemens AG 1998: 57). And while German firms’ investments abroad accelerate, foreign firms seem unwilling to offset these outflows by investing in German factors due to high wage and non-wage labour costs and prefer locations such as Portugal and the UK where the relative costs are comparatively lower. As rising unemployment can only have a negative effect on domestic demand, it can give rise to a vicious circle of economic slowdown and thus encourage further cost-driven FDI and so on.

**Table 3.9. Significance of Employment in Foreign Affiliates of Manufacturing Firms (Thousands of Employees and Percentage of Total Workforce)**

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>United Kingdom</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>638.0</td>
<td>1058.0</td>
<td>677.1</td>
</tr>
<tr>
<td></td>
<td>6.6%</td>
<td>13.0%</td>
<td>13.7%</td>
</tr>
<tr>
<td></td>
<td>Japan</td>
<td></td>
<td>United States</td>
</tr>
<tr>
<td></td>
<td>78.1</td>
<td>163.1</td>
<td>1455.2</td>
</tr>
<tr>
<td></td>
<td>0.6%</td>
<td>1.2%</td>
<td>7.0%</td>
</tr>
</tbody>
</table>

*Source: UNCTAD (1999), Annex Table A.1.7.*

This “rationalization” process in German industry has resulted in a clear shift in stakeholder priorities as profit generation and competitiveness are becoming
antagonistic to employment stability, the backbone for the German model and its past successes (*Economist* 1998: 63). The exit opportunities that globalisation creates go against the German governance model since their effect is to neutralise and undermine the institutions upon which the intra- and extra-firm consensus between capital and labour was based.

Given these pressures what has the institutional response within the German industrial relations system been? A close look at the developments since the 1980s reveals a somewhat mixed picture. The first reformist attack on codetermination institutions was attempted by the coalition led by the Christilch Demokratische Union (CDU) – CDU being the traditional ally of employer interests against the union sponsored the Sozialdemokratische Partei Deutschland (SPD) - that came into power in 1982 and aimed at the weakening of works councils’ influence by containing the dominant role exercised by the DGB within them and by establishing potentially rival firm-level bodies representing middle management. These legislative proposals gave rise to a fierce and prolonged debate among stakeholder representatives and their political counterparts.270 The length and the intensity of this debate could only be expected due to the large stakes involved and therefore the high adaptation costs most of which would have to be borne by the labour’s side. Not surprisingly, due to major concessions that had to be made to gain the support of several interested parties over the four years of the political contest, the initial proposal was significantly modified. What is startling, however, is the ultimate course that negotiations took. According to Wood (1997), employers’ fears that as a result of the reforms the intra-firm consensus could break down with severe economic consequences, e.g. by blocking employees’ incentives to adapt to technological changes, led them to finally resist an attack on

270 See Wood (1997) for an analytical overview of the events surrounding the debate.
codetermination even if ideally they would have preferred it to be a voluntary institution. Thus, once the mandatory codetermination provisions were to remain intact, employers preferred the maintenance of existing workable institutional arrangements; despite its disadvantages, as they perceived them, they recognised the superiority of a workable system over an unworkable one. Thus, the final version of the law which was eventually passed in 1988 was so different from the initial legislative proposal that it barely had any effect on the spirit and function of codetermination or the role of the unions in it.

Path dependence in the development of codetermination, however, does not stop at legislative institutional inertia. Recent legislative developments show that interest groups supporting the current orientation of the formal institutional framework in German industrial relations is still powerful. Following strong union pressure and the recommendations of a report by Kommission Mitbestimmung (1998) set up in 1996 by the Bertelsmann and Hans Böckler Foundations, the SPD government that came into power in 1997 initiated negotiations for actually strengthening the role of works councils. This time the government succeeded in passing a new Works Constitution Reform Act (BetrVerf-Reformgesetz) which came into effect on July 2, 2001. Among other things, this new piece of legislation has made possible the formation of inter-group works councils (e.g. a joint works council for several plants or a regional works council for separate parts of a company), has increased the number of councillors, has included temporary employees and teleworkers in the works council constitution and has strengthened the participation and co-determination rights, particularly with regard to qualification decisions and job security (Addison et al. 2002).
The new Works Councils legislation should be considered as a great victory for labour in Germany because it comes as a *formal* response to significant *functional* changes in industrial relations that have been going on since the 1980s as employers have been trying to reduce their wage and non-wage labour costs. According to Hassel (1999), during the past twenty years both firm-level codetermination and macro-level collective bargaining have been losing ground in terms of employee coverage. For instance, by 1997 only 14.4 per cent of West German and 12.3 percent of East German plants were covered by a valid collective agreement and a works council, whereas as much as 29.5 and 46 percent of plants respectively had neither (*ibid.*: 487). Thus the coverage of private sector employees by works councils has shrunk from 52.4 percent in 1981 to 41.6 percent in 1994 (*ibid.*: 488). Simultaneously, there has been a decentralisation tendency in collective bargaining which is indicated by the fact that the number of legally binding agreements has been increasing; the corresponding figures between 1990 and 1997 are from 2100 to 3300 in the west and from 2700 to 5000 in the east (*ibid.*: 493). Withdrawals of employers from their representative associations and therefore from centralised collective bargaining have also been on the increase, since membership has dropped from 57.5 percent in 1980 to 42.8 percent in 1993. Similarly, unionisation has also been in decline due to the increase of part-time workers, the rising share of employment in services as opposed to traditional industries and, of course, due to high unemployment. It is indicative that faced with financial problems and apprehending their waning power most unions in the services sector decided to merge into what is now the *Vereinigte Dienstleistungsgewerkschaft*, a super union with more than 3 million members (Prevezanos 2001).
Generally, it seems that formal and functional changes in German industrial relations have become antithetical. While legal change is highly path dependent and leads to the fortification of codetermination provisions that were already in place, functional changes move in the opposite direction. The effect of this process is that as the intensity of codetermination increases, its incidence and therefore the number of those who benefit from it seem to be in decline. Moreover, even with the new amendments to the *Betriebsverfassungsgesetz*, recent difficulties in reaching agreements on wage increases through collective bargaining and the increasingly adversarial nature of negotiations show that the macro-level consensus cannot be taken as a given. A series of strikes during May and June 2002 affecting Germany’s most influential industries and companies like DaimlerChrysler (Williamson 2002) is evidence that cracks are beginning to appear in the German industrial relations system. Even the construction industry did not remain unaffected, as building workers went on strike for the first time since World War II demanding higher wage increases, despite the severe hits the sector has received in recent years which led to the spectacular collapse of Holtzmann.271 As unemployment rises and remains at record levels—4.2 million in October 2002—the pressures on German industrial relations can only intensify while at the same time a split within labour seems to emerge between those with a job demanding better protection or higher salaries and those without a job seeking changes that will create employment. Adaptation costs will eventually need to be borne by someone; either by those possessing low skills and have to stay out of work for long periods of time and those in work but who do not fall within the scope of codetermination, or by those who are covered by codetermination and therefore have a vested interest in maintaining the status quo.

271 See BBC (2002). On Holtzmann’s collapse see section 3.8.1 below.
The former group are affected by functional change, the latter would be affected by non-path dependent formal change.

In the light of these findings, the rigidity of statutory institutions cannot be objectively regarded anything more than a Peirian victory for labour as a whole. It should be seen as an illustration of a system which selects inefficient inertia instead of inefficient change. Either way, in a globalisation process (large) employers are in a better position to adapt than are employees because they are able to relocate production wherever it is more suitable to them. Still, so long as unemployment remains high as a result of such relocation, it is doubtful whether legal inertia will continue to characterise German industrial relations, since a point may be reached where unemployed labour refuses to bear the lion’s share of adaptation costs. In other words, lower or more divergent wage rates may become more preferable to unemployment, especially now that the government is required to reduce welfare spending due to the mounting budget deficits occurring recently.²⁷²

3.6. GLOBALISATION, MONETARY POLICY AND THE PRESSURES FOR FINANCIAL MARKET REFORM

Apart from the challenges with regard to long-established organisational and production-related institutions, Germany has also been facing pressures in its financial system as a result of financial globalisation. The German economy, being one of the largest in the developed world as well as one that is highly integrated into

²⁷² Germany’s budget deficit is poised to breach the 3 percent EU Stability Pact threshold for the first time since its inception. See http://news.bbc.co.uk/2/hi/business/2334471.stm.
the international trade regime, could not remain unaffected by the globalisation of financial markets.

Despite any Keynesian concerns about capital movements, post-war Germany has generally not used fully the discretion that the Bretton Woods system allowed for the imposition of capital controls and has been one of the first countries to liberalise its capital markets, mainly because of its typical current account surpluses. For example, many capital movement restrictions - e.g. on FDI and on purchases of foreign securities - were largely lifted by the end of the 1950s and interest rates were liberalised as early as 1967. Relatively small inflows of foreign capital allowed the Bundesbank to keep money supply and inflation under control.

However, as current account surpluses continued, during the late 1960s and early 1970s capital inflows largely due to speculation about the Deutsch Mark’s (DM) revaluation intensified and Germany was faced with the dilemma of either hurting its export industries by revaluing its currency or imposing capital controls (Goodman and Pauly 1993). Initially, the authorities tried to tackle the problem with the imposition of controls some of which, as Smith (1994: 366-367) claims, remained in place until as late as the mid 1980s preventing the complete globalisation of the German economy. Most importantly, a 25% coupon tax on non-residents’ income from bonds introduced in 1965 was not abolished until 1984. Moreover, non-residents were not allowed to issue DM denominated bonds unless the lead manager was a German bank and the actual issue took place in Germany. However, as speculative flows into Germany continued to grow, necessitating two consecutive revaluations, in 1973 the government was forced to float the DM.

While the currency’s floatation temporarily eased the tensions, the increasing role of the DM in the world economy, not least due to Germany’s large surpluses, led
to the deregulation and globalisation of German financial markets (Goodman and Pauly 1993: 62-63). Capital controls were abolished in 1981 in response to short-lived deficits after the second oil shock, but when the current account showed a surplus again in 1982 the liberal policies were not reversed. On the contrary, as the globalisation of the German economy continued, the pressures for further liberalisation intensified. The vast development of the Eurobond markets in the early 1980s became a direct challenge for German monetary authorities, since a large market for German bonds was created that was outside their control. For example, by the late 1980s virtually all German government bond transactions took place in London, Luxembourg and Paris (Deeg and Lütz 1998). In order to keep their business, German banks established subsidiaries in those less regulated markets from where they conducted those activities that were not permitted in Germany (Smith 1994 368). For instance, in 1984 Deutsche Bank who dominated the German capital market moved all its capital market operations to London thus giving a clear signal to policy makers that something had to be done to prevent large financial institutions' exit (Goodman and Pauly 1993: 64).

As a result of these developments, the only choice the Bundesbank and the government were left with was to continue the deregulation of financial markets in order to bring German bond transactions and financial business in general back under their control. Thus, since April 1984 foreign banks were gradually allowed to underwrite DM Eurobonds, the requirements that all bond issues should be governed by German law and listed on a German stock exchange were abolished, restrictions on different types of bonds were lifted and the restrictive tax regime for securities was reversed. Consequently, financial liberalisation made issues of DM Eurobonds more
attractive and less costly and contributed to the development of Germany as an international bond market and a financial centre in general.

The liberalisation and growth of the German bond markets could not leave the stock market unaffected because of the increased liquidity that emerged. Moreover, tax disincentives as well as minimum reserve requirements for equity issues were gradually removed. Thus, irrespectively of the aforementioned institutional factors explaining the minimal significance of the stock market in Germany, since the late 1980s there has been a stock market boom as a result of financial liberalisation and the increasing liquidity in capital markets. Moreover, the introduction of the Euro is also bound to have a positive effect on the development of the stock markets in the Eurozone. For instance, about €370 billion were expected to move from the bond markets into stocks in 1999 (Finanzplatz e.V. 1999). It is reasonable to assume that a substantial amount of these funds went to Frankfurt as the major financial centre within the Eurozone.

Stimulants for further development of the stock market have also originated from the increased capital needs of German companies. Global competition has resulted in an increased need for capital. The economic downturn of the 1990s anything but facilitated the ability of German firms to draw sufficient finance in the domestic market. As Waller observes:

Germany’s traditional capital account surplus has swung into a deficit and companies are realizing that they will be competing with the cash-hungry state for capital throughout the 1990s. (Waller 1993: 11)

Thus, large German companies could not continue to rely merely on domestic capital markets in their struggle to compete in the global marketplace because, as they pursued their globalisation strategies with FDI and gross border M&A, their financial
needs had begun to outgrow the potential of German capital markets – neither banks nor the domestic securities markets were able to meet the increased demand of large corporations for capital. Lack of transparency and information weaknesses, high transaction costs as well as the unavailability of risk-management financial products prevented sufficient entry of global investors who could provide the necessary liquidity in the German stock market. In this regard financial liberalisation created new financing opportunities for large firms since it enabled them to tap foreign markets with larger investor bases. Thus, as Deeg and Lütz (1998) report, already in 1990 the most liquid German stocks’ trading in London was equal to about 13% of their turnover in Germany.

The clear implication from this is that, since the liberalisation of capital controls, German stock exchanges have been facing direct competition from abroad with which they have been unable to cope so long as the traditional institutions responsible for their underdevelopment remained in place. For example, in 1989 the Chairman of the International Stock Exchange in London proposed the creation of a pan-European equity market based in the City (Story 1997: 257, 265). This intensified the pressures for reform in Germany. The largest German exchanges realised the need for financial change and, thus, began to implement development programmes. In 1990, in an effort for modernisation and expansion, the Frankfurt Stock Exchange was turned into an AG which in 1993 became the core subsidiary of Deutsche Börse AG, the holding company for all German exchanges. This provided the basis for major efforts to promote securities markets as a source of corporate finance in Germany and the emergence of the Finanzplatz Deutschland (“Germany as a Financial Centre”) concept which was formally announced with a package of reforms in 1992 by the then finance minister Waigel. (Financial Times 1992). Fierce
competition, not only between different European financial centres, but also between cities and regions within Germany, for the allocation of the European Central Bank (ECB) was also another pressure factor for financial "modernisation". The final bid for Frankfurt would have been unsustainable without developed and transparent securities markets in place.

However, it was not only German securities markets that were affected as a result of financial globalisation and liberalisation. The ability of large German firms to draw funds from foreign financial markets meant that banks had been losing their big business customers. This is something they could not afford due to the increased competition by foreign banks and the decreasing profits from the loan business.\textsuperscript{273} Moreover, because of their increased investment banking needs, non-financial companies preferred foreign investment banks to their traditional domestic financial partners who lacked sufficient expertise (Fischer 1997; Harris 1998: 5). In response, and fearing that they were becoming laggards in the global financial markets, German banks begun to acquire foreign investment banks especially in London and New York. For instance, Deutsche Bank acquired the UK firm Morgan Grenfell in 1992 and the New York investment banking house Bankers Trust in 1998, whereas Dresdner Bank bought Kleinwort Benson in London. Thus, German bankers, especially the Grossbanken, became some of the most committed proponents of stock market modernisation as they realised that investment banking was essential to their survival both domestically and abroad due to the increased returns involved compared to the deposit and loan business (Moran 1989).

In June 1989, November 1994 and April 1998 the First, Second and Third Finanzmarktförderungsgesetze (Financial Markets Promotion Laws) were passed.

\textsuperscript{273} The recession and the increased capital reserve requirements for banks imposed by the Basle Accord were major factors constraining the ability of banks to finance "big business". Declining profit margins due to increased competition in financial markets were also instrumental.
with the objective of enhancing the attractiveness of Germany as a place for conducting financial business. The first law intended to promote the development of a new futures market in Germany, the DTB, which started operating in January 1990. The creation of such a market had the dual effect of enabling investors to hedge against risks in the equity market and therefore facilitate investment in stocks. The second law\textsuperscript{274} was the long-awaited implementation of the EEC Large Holdings and Insider Dealing Directives. This measure tightened disclosure requirements and prohibited insider trading which in 1994 became a criminal offence. The Third Financial Market Promotion Law\textsuperscript{275} among other things implemented important amendments to the stock market and securities trading legislation as well as the law governing investment companies ("KAGGs") and venture capital firms ("UBGs"). Another important development was the introduction of a new market segment, the \textit{Neuer Markt}, at the Frankfurt Stock Exchange in 1997 for small and medium sized innovative companies, thus making access to equity finance for such firms easier. All these measures were intended to promote market finance and investment in equities by increasing the scope, transparency and confidence in the quality of the stock market and, thus, improve the competitiveness of German financial markets as part of the \textit{Finanzplatz Deutschland} project.

Despite these regulatory reforms, changing the German investment culture was not an easy task. During the post-war period the German public had a general aversion to risky investments, mainly as a result of past monetary instability experiences, which was conductive to a preference for fixed-income securities. However, the bullish stock market during the 1990s made investment in equities more attractive and helped to increase the flow of funds into stocks. Private investors began

\textsuperscript{274} See analysis in section 3.7.1 below.
\textsuperscript{275} For comments on the draft law see Baums (1997).
to buy shares either directly or indirectly though investment funds, so that, as the data in Figure 3.6 show, between 1990 and 1998 direct shareholdings of private households rose by 277.4% reaching €250.8 billion, and indirect shareholdings saw an almost tenfold rise from €7.2 billion in 1990 to €67.3 billion in 1998. At the end of 1998, out of €2.9 trillion of private household assets almost 11% was invested in equities either directly or through investment funds – these figures were previously unheard of in the German context (Finanzplatz e.V.1999b). This increase in stock market liquidity has also served large privatisation programmes, such as the Deutsche Telecom IPO in 1996. That particular share-issue was five times oversubscribed so that more than €4 billion could have been raised just from private investors (Rosen 1997). Further privatisation programmes - e.g. Deutsche Bahn and Deutsche Post- have continued to attract more investors into the stock market.276

Figure 3.6. German Households' Investment in Equities 1990-1998

a. Value of Shares and Investment Funds Owned by Private Households (Billion Euro)

276 Although, the crash in world equity markets since September 2001 will have had an effect on investor enthusiasm.
All this shows that an equity culture has been gradually emerging in Germany. Most active in the stock market are the younger generations since it is estimated that 40% of German shareholders are under 35, which reveals that the traditional aversion to equities may be fading away (Smith 1994: 372; Deutsche Bank Research 1999), but also that there is much uncertainty in young generations about their retirement income from state pensions. Thus, in 2000, an average of 6.2 million individual investors owned shares directly compared with just 3.1 million in 1988. Shareholders made up 9.7 percent of the population over the age of 14 in 2000, compared with 6.8 percent in 1988 (DAI 2000). A reflection of this is that the German stock market capitalisation has jumped from just 31.4% of GDP in 1997 to 59.51% in July 1999 (ibid.) which, although may not seem impressive relatively to the equivalent figures in other economies, is not only a percentage never seen before in Germany but also constitutes a dramatic increase (approximately 100%) within the very short period of two years. Moreover, while the regime of high tax rates on capital gains (about 50%) has constituted a major handicap for the development of the stock market in the past,
the government has now managed to pass a law for its abolition which came into
effect in January 2002 as part of the German tax reform (Steurreform). It should be noted here that the pending reform of pensions provisions will also have an enormous impact. Due to decreasing employment, cutbacks in government spending and demographic reasons – i.e. increasing older population combined with decreasing younger population - there is a growing need for a shift from the traditional pay-as-you-go to an at least partially funded pension system (Sinn 1999). In addition, developments at the international level are also under way. Thus, recently proposed European measures, namely the EU Pensions Directive, are also intended to establish pan-European US-style pension funds as part of the internal market initiative and as a solution to the EU-wide pensions’ crisis. At the moment pension fund assets in Germany compared to the US and the UK are minimal (see Figure 3.7).

Figure 3.7. Financial Assets of Pension Funds in 1997 (in Billion Dollars)

![Financial Assets of Pension Funds in 1997](source: Rosen (1999), Table 5.)

On the effects of the capital gains tax abolition on cross-shareholdings see 3.8.1 and 3.8.2 below.
However, the pressures to restructure the pension system are bound to increase over time, due to both domestic and international reasons, and this could lead to enormous funds being invested in shares and other securities in a similar fashion as in the US and the UK. Accordingly, Werstschulte, a director in Bayerische Hypotheken -und Weschsel- Bank has predicted that:

Pension funds could total between DM1,600bn and DM2,000bn in 10 years if the right legal and tax conditions were created. This could double the size of the present equity market. (Financial Times 1997)

It currently seems that the realisation of such developments is only a matter of time. Without underestimating the significance of the demographic issues or the other causes of unemployment, globalisation has also been one of the factors contributing to the retirement provision crisis. Company pension funds in particular have been severely hit by the implementation of cost-cutting policies in German firms and are now in a state of erosion. While company pension funds in 1976 covered two-thirds of the employed, in 1990 their share had decreased to 50% and is still declining. (Finanzplatz e.V.1998). Thus, the Working Committee on Company Pension Funds has recently proposed that the current Law Relating to Company Pension Plans be amended to provide for the creation of "Investment-oriented Pension Funds" which will be governed by the Law on Investment Companies (KAGG) and be similar to those in Anglo-Saxon counties. According to Professor Gerke, Chairman of the Working Committee:

the proposed system will strengthen the competitive position of Finanzplatz Deutschland, and as a new means of implementation, investment-oriented pension funds in particular offer the benefits of foreign pension funds, without breaking with the tried-and-proven fundamental principles of company pension plans. (Gerke 1998)
As the increasing value of assets controlled by private investment funds show (Figure 3.6 above) retirement funding needs also require greater reliance on private pension schemes. With regard to this, the Third Finanzmarktförderungsgesetz allowed the creation of pension plan investment funds that are obliged by law to invest at least 51% of their assets in equities and real estate. In general, pension reform in Germany will definitely contribute greatly to the development of the stock market in the near future. Most importantly, it will foster the growth of domestic institutional investors as owners of stocks, a development that could alter the nature of shareholdings and through it the direction of corporate governance as it did in the UK and the US.

To summarise, financial markets globalisation has been a driving force behind a number of important reforms in German financial markets. All these changes in financial market regulation and structure have had and are expected to have a significant impact on the German equity market by making it broader, deeper and therefore more attractive to both domestic and international investors. They also result in decreasing transaction costs and consequently increase the incentives for German firms to use equity issues as a source of finance. However, despite all these developments and regulatory changes, the systemic aversion to outside-shareholders described in section 3.4 is detrimental for the Finanzplatz Deutschland project. Thus, in recent years, the discussion on the enhancement of the Aufsichtsrat's monitoring role, the role of takeover regulation and the significance of globally acceptable accounting principles and disclosure rules has gained momentum in Germany and has even led to important institutional reforms. The direction and potential impact of those reforms will be discussed next.
3.7. RECENT LEGAL REFORMS SHIFTING THE BALANCE TOWARDS THE OUTSIDE-SHAREHOLDER

As the effort to transform Germany into a global financial centre continues, market transparency and investor protection are gradually becoming widely accepted values and, as this section will demonstrate, specific regulatory measures are being designed and implemented for a more outside investor-oriented corporate governance, even if elements of path dependence are also observable in some areas. The mere fact that corporate governance issues have reached the legislative stage reveals the importance German regulators and business people are beginning to attribute to them. The most important regulatory developments with regard to corporate governance are the amendments to the Wertpapierhandelsgesetz (Securities Trading Law (WpHG)) as part of the second Finanzmarktförderungsgesetz\textsuperscript{278}, the Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (Law on Control and Transparency in the Enterprise Sector (KonTraG)) amending the Aktiengesetz, the passing of the Kapitalaufnahmeerleichterungsgesetz (Facilitation of Capital Raising Law (KapAEG)) amending the Handelgesetzbuch (German Commercial Code (HGB)) and the adoption of a voluntary Übernahmekodex for listed AGs (takeover code (Kodex)) later replaced by a controversial Übernahmegesetz (Takeover Law). These measures and their significance for German corporate governance will be discussed next.

\textsuperscript{278} Gesetz Über den Wertpapierhandel und zur Änderung Börsenrechtlicher und Wertpapierrechtlicher Vorschriften, 1994 BGBI I 1749.
3.7.1. Strengthening Disclosure and Insider Trading Rules

It was previously noted that on January 1, 1995 the second Finanzmarktförderungsgesetz came into effect as part of the Finanzplatz Deutschland programme. The first purpose of this legal instrument was to transpose the EEC Large Holdings Directive into German law with the enactment of Articles 21-30 WpHG which tighten the disclosure requirements with regard to ownership and control. Its second purpose was to make insider dealing a criminal offence and thus bring domestic law in line with the EEC Insider Dealing Directive as transposed in Articles 12-20 WpHG. Moreover, the WpHG provided the legal basis for the creation of the Bundesaufsichtsamt für den Wertpapierhandel (German Securities Trading Commission (BAWe)) which was to have the responsibility of the implementation and enforcement of regulations relating to insider trading, ad-hoc disclosure of price relevant information and of the supervision of securities houses and markets in general. It is noteworthy that the actual implementation deadlines for the two Directives were January 1, 1991 and June 1, 1992 respectively. The long gap between these dates and the actual implementation of the WpHG reveals that, contrary to Coffee’s expectations (see section 2.4.2 above), even securities markets promotion measures are affected by the forces of path dependence, due to opposition by entrenched interest groups. Nonetheless, and despite the three-year delay, German securities markets reform did take place eventually.

281 Following the adoption on 22 April 2002 of the Law on Integrated Financial Services Supervision, the BAWe has become part of the Bundesanstalt für Finanzdienstleistungsaufsich (BAFin), the umbrella authority for financial market supervision.
282 Supra. note 279, Article 171.
283 Supra. note 280, Article 14.
The old regime had been problematic because of the high thresholds for disclosure. Thus, the AktG provided for the disclosure of all stakes owned in an AG that are above 20%. Moreover, the GWB required the disclosure to the Bundeskartellamt (Federal Cartel Office (BkartA)) of very detailed ownership structure information when companies file a change in their share or voting control that is above 25% or 50% of total share capital or votes. It is noteworthy that these provisions applied to all AGs and therefore there was little difference between disclosure rules of listed and non-listed corporations. Moreover, the thresholds for disclosure under the pre-WpHG regime were so high, as mentioned earlier, that it was very difficult to determine who controlled German companies. This is indicative of how little significance was attributed to the protection of minority investors in the stock market from undisclosed controlling blockholders who could then exploit their dominant position.

In this sense the enactment of the WpHG should be regarded as a breakthrough from the past regime of insufficient investor protection. Pursuant to Article 21 the disclosure requirement is now triggered when the voting rights owned by a natural or legal person exceed or fall below 5%, 10%, 25%, 50% or 75% of the total votes of an AG listed on the official market segments. Moreover, Article 22 imposes a mandatory disclosure requirement on votes controlled by a person indirectly, e.g. through a company, a voting trust, a family pool etc. Such indirect control can also arise when the voting rights are owned by a company controlled by the person in question, by a third party in the interests of the person in question or a company controlled by it, or by a third party and a contractual voting agreement with the person exists, if the person can exercise a purchase option with regard to the

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284 For all other AGs the requirements are less strict according to the old regime.
votes, and if the votes are deposited with the person who can exercise the rights in its own interests. As regards the last case, it is worth noting that bank proxy-voting does not fall under Article 22 because banks are legally obliged to vote in accordance with the interests or under the instructions of the actual shareholders and not on their own will.285 Finally, for the purposes of the WpHG, disclosure means that after receiving the report by the shareholder who acquired the stake in question, the company is required to publish the information in one of the selected newspapers designated by the stock exchange. The BAWe accumulates all publication references and makes them publicly available every two months on its Internet site.

Although, the new regime constitutes a significant departure from the pre-1995 situation, the WpHG is far from radical and some authors have criticised it for its remaining shortcomings as an instrument that is intended to promote ownership transparency. Becht and Boehmer (1999) provide a number of examples where either because of inadequacies in the formulation of the legal provisions or due to the BAWe’s inefficiencies, the WpHG fails to provide sufficient corporate control information. They show that a number of loopholes still allow German listed companies to bypass disclosure rules.286 The most common method is through the use of pyramids with non-listed firms as holding companies (ibid.). In such cases, even though the immediate owners are visible, the identification of the ultimate owners is a difficult task since the WpHG applies only to listed AGs. It is always possible, however, that these gaps in the law be filled after constructive interpretation of the legal provisions by the courts of law.

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285 Some changes on banks proxy-voting powers have been effected with the enactment of KonTraG (see section 3.7.2 below).
286 By 1996 there were no disclosure reports for 34 out of 436 AGs trading in the German official markets which equals to 7.6% of all listed AGs that come under the WpHG (Becht and Boehmer 1999).
As regards the regulation of insider dealing, the WpHG is a novelty for the regulatory system in German financial markets. The deficient regulatory regime due to the lack of strict and specific legal rules on insider trading was briefly mentioned in section 3.4.3 above. Even though the consequences of such activity were recognised in Germany as early as in 1968, when the Ministry of Finance instructed the creation of a special committee responsible for tightening the regulatory regime, the adoption of a set of Voluntary Guidelines in 1970\textsuperscript{287} was anything but effective in preventing the occurrence of insider dealing. Their voluntary nature and the absence of any form of penalties for those who breached them did not deter the occurrence of insider dealing. According to section 2 of the Guidelines, insiders were all the members and legal representatives of the \textit{Aufsichtsräte} of the company, its banks and its affiliates, owners of more than 25\% equity stakes, agents of a corporation who in connection with their agency function in the ordinary course of business obtain inside information, as well as investment advisors and consultants.\textsuperscript{288} However, as Standen (1995: 196) observes, the Guidelines not only did not cover the conduct of two most common inside information traders, namely tippees and secondary insiders, but they were also “dulled by a host of limitations and exceptions” (\textit{ibid.}: 197).

Obviously, this form of insider dealing regulation could not be maintained once the need to reform financial markets and promote the development of the securities markets appeared. The idea of \textit{Finanzplatz Deutschland} was incompatible with the frequent and unpunished occurrence of insider dealing. Moreover, criticisms from international investors and regulators as well as the legal pressures created by the impending direct effect of the Directive under European law could not be ignored by the German authorities. For instance, foreign investors had been deterred by


\textsuperscript{288} The last category was added by the 1988 amendments to the insider trading guidelines.
informational asymmetries they would have had to face vis-à-vis domestic investors when investing in German securities markets. Moreover, the US Securities and Exchange Commission had been challenging the German regulatory regime indirectly by prosecuting cases of US insider dealing laws’ violations which originated in Germany (Pitt and Hardison 1992). Under these direct and indirect global and international pressures, with the passing of the second Finanzmarktförderungsgesetz and the emendment of the WpHG, insider dealing became a criminal offence for the first time in Germany bringing past tolerance of such practices to an end despite initial opposition by entrenched interests.

The scope of the WpHG provisions are much broader than the Voluntary Guidelines and satisfy the Directive’s criteria. The sanctions, which go beyond the minimum requirements under the Directive, are strict and the law provides for imprisonment for a maximum of five years or fines up to €1.5 million. Nonetheless they are not flawless and there has been some criticism of the measures. For example, as Standen (1995: 204) states, the banks have managed to block far-reaching provisions of an early draft of the Finanzmarktförderungsgesetz and thus keep their disclosure duties to a minimum. However, on the whole disclosure requirements for the corporate sector are stringent and broad covering most kinds of price sensitive information about the financial position or the general business activities of the company. This minimises the possibilities for insider dealing and market manipulation in general, because the more quickly information becomes public, the more difficult it becomes for insiders to abuse their position. The information must be disclosed first to the BAWe and then to the public through an electronic information system or one of the national official stock exchange gazettes. The BAWe also makes
information available through teletext and its web site on which it provides updates. clarifications and guidelines for companies on a regular basis.

In general, despite some shortcomings that continue to exist, the BAWe has been quite an effective and vigorous supervisory authority. The first conviction under the WpHG insider dealing provisions took place in August 18, 1995 with the imposition of a total fine of €9,000,000. Moreover, according to its 1999 Annual Report, in 1998 alone the BAWe commenced 67 investigations for insider dealing and filed 16 cases of suspected violations with the public prosecutor’s office 13 of which were resulted in the imposition fines of up to €75,000 (BAWe 1999).

3.7.2. KonTraG

A series of spectacular corporate crises and collapses during the 1990s, involving high-profile companies, such as Daimler-Benz, Metallgesellschaft, Klocker-Humbolt-Deutz and, more recently, Holzmann and Kirch, has undermined the past confidence in the German governance model and has damaged the credibility of managers and the alleged governance role of universal banks. The case of Metallgesellschaft AG, in particular, apart from questioning the effectiveness of the Aufsichtsrat as a governance body, has also been a prime example of how easily the challenges of global financial markets can expose give rise to corporate control problems due to the increased risks involved. Thus, in the early nineties the New York subsidiary of the company adopted a high-risk strategy involving oil futures contracts in several American exchanges which eventually by 1993 it could not meet. Due to insufficient understanding of the subsidiary’s derivatives strategy,
Metallgesellschaft's Aufsichtsrat in Germany ordered the premature liquidation of most oil futures resulting to a loss of over $1bn for the group (Wenger and Kaserer 1997). Such failures undermined the confidence not only of domestic but also of foreign investors and stirred public criticism regarding the effectiveness of Aufsichtsräte and auditors. Simultaneously, German companies and regulators realised that the new financing opportunities arising from the development of domestic and foreign equity markets could not be exploited without “improving” corporate governance to meet outside investors’ demands. Accordingly, Ulrich Seibert, of the Federal Ministry of Justice, comments:

The turbulence on global financial markets at the end of last year has illustrated to us the extent to which financial markets have grown together. National capital markets are no longer isolated. Our quoted companies raise finance internationally. German stock corporations are in direct competition with other demands for venture capital worldwide.

[...] For the legal and political framework, this means that against a background of institutional competition, there is growing pressure for changes and adaptation of our company law, stock market law and accounting law. (Seibert 1998)

In this context, on 1 May 1998 the KonTraG was enacted amending the AktG with the aim of strengthening the governance role of the Aufsichtsrat. In particular, the new law amended the rules for governing supervisory boards, auditors and managing directors aiming at the improvement of information flows from the management towards the Aufsichtsrat. The KonTraG also covers other important corporate governance related areas, such as voting rights, share buy-backs and the use of stock options. The enacted instrument has not brought a revolutionary change in the fundamentals of German corporate structure, especially if one considers some initial proposals for the complete abolition of the two-tier board and its replacement by a unitary one (Grub 1999: 44). The adoption of such a change would have either
undermined codetermination or would have given labour representatives excessive powers against other stakeholders. Since radical change could have upset vested interests within the German corporation the KonTraG took a more path dependent form before its adoption. Nonetheless, it has been a major contribution to the furtherance of the corporate governance debate in Germany by emphasising the need for monitoring management and by providing the legal basis for an enhanced shareholder-orientation for German companies.

With regard to the Aufsichtsrat's operation prior to the KonTraG amendments there had not been any clear standard practice. Prigge (1998: 961-964) reports that issues such as the frequency of board meetings and the preparation of their agenda, the flow of information from management to the board and the time dedicated by board members had not been uniformly dealt with in German companies. If anything, the intensity of management monitoring by the Aufsichtsrat had been minimal. With the enactment of the KonTraG the German legislator has set a minimum standard with regard to the board's operation as a monitoring body. Thus, it provides that in listed AGs the members must meet at least twice each half-year.\(^{289}\) The total number of board positions that a member can have is still ten.\(^{290}\) However, chairmanships now count twice and are thus limited to a maximum of five.\(^{291}\) Moreover, disclosure of mandates in other Aufsichtsräte as well as of candidate board members' professional occupation is now mandatory in listed AGs in order to prevent any potential conflicts of interest. Furthermore, even though the establishment of board committees is not compulsory, the Aufsichtsrat in listed companies has to state whether such committees exist and report in writing to the AGM how many times the

\(^{289}\) Article 110 para.3 AktG. In non-listed companies the Aufsichtsrat members are advised to meet once a quarter and must meet once each half year.

\(^{290}\) The SPD parliamentary group had proposed the reduction of the number of mandates to five (SPD 1995).

\(^{291}\) Article 100 para.1 AktG.
board met both as a whole and at committee-level. According to Hopt (1998:242), committee work in Germany is still not as common as in the UK and the US where audit, remuneration and nomination committees are more or less mandatory. Nevertheless, the trend is to increase their use and KonTraG may be a driving force towards this direction.

As regards the flow of information, the new law requires more detailed Vorstand reports which should include matters such as future business prospects and policy, financial planning, investments and personnel. It also demands sufficient risk management and internal control systems to be in place. Of particular importance is that, contrary to previous practice, under the new law the contracts for the audit report are awarded by the Aufsichtsrat which now also determines the auditor’s remuneration. There is also a requirement for submission of the audit report to each member or to the audit committee and the auditor has to attend the relevant board or committee meeting where the annual and group accounts are discussed. The Aufsichtsrat examines the auditor and then reports in writing to the AGM. The KonTraG also contains provisions governing the form and content of the audit report. It requires that the report must be easily comprehensible, that special emphasis be given to particular risks that could jeopardise the existence of the company, and makes the inclusion of cash flow statements mandatory. Moreover, the person who signs the audit certificate must change every six years and the auditor is excluded altogether if he received more than 30% of his total revenue over the previous five years from the company in question. Finally, the level of the auditor’s maximum

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292 Article 171 para.2 AktG.
293 Article 111 AktG.
294 Article 171 para.1 AktG.
295 See also section 3.7.3 below on recent accounting standards changes.
296 The previous threshold was 50%.
liability has been increased from DM500,000 (€250,000) to DM2 million (€1 million) for non-listed companies and to DM8 million (€4 million) for listed companies.

In section 3.4.1 above it was stated that the position of shareholders vis-à-vis management under the old law has been somewhat disadvantageous. The minimum quorum that was required by the old law for the appointment of a special representative who would sue the management was very high and prohibitive for small minorities which, as it was shown above, are the most vulnerable to exploitation by strong blockholders.\textsuperscript{297} With the enactment of the KonTraG, the situation has now been changed and the scales have been tilted more towards the side of the small shareholders as the threshold has been halved, i.e. 5\% of the share capital or DM1 million (€500,000) nominal value of shares.\textsuperscript{298} However, for an action to be brought there needs to be a well-justified suspicion that the management has harmed the company (Grub 1999: 44).

The KonTraG has also brought radical changes with regard to managerial pay by making the use of employee stock option plans (ESOPs) easier. This form of remuneration is one of the most effective means for dealing with shareholder agency problems as it provides managers with the incentives to maximise current shareholder returns. Before the new amendments there were major legal restrictions rendering this form of managerial remuneration very difficult and expensive. Kalisch (1998), for example, identified a number of major legal impediments, such as severe limitations on the acquisition by a company of its own shares\textsuperscript{299} and the general prohibition of members of the Vorstand and the Aufsichtsrat participating in ESOPs.\textsuperscript{300} Consequently, German companies who wanted to award this kind of (share)

\textsuperscript{297} The old law required either a 10\% stake or DM2 million nominal value of shares.

\textsuperscript{298} Article 147 para 3 AktG.

\textsuperscript{299} Article 71 AktG para 1.

\textsuperscript{300} Article 202 para 4 AktG
performance-related remuneration to their management had to resort to the use of convertible bonds or warrants and the creation of “phantom” stock plans.

Since the passage of the KonTraG, shareholders can approve the disposal of shares outside the stock exchange as part of an ESOP for the company’s managers. This has been achieved with the amendment of Article 192 AktG, which states the purposes for which contingent capital may be created, so as to encompass the granting of pre-emptive rights to the company’s employees and management.\(^{301}\) Article 173 para.2 provides for a number of special requirements that need to be satisfied, such as minimum holding periods, the determination of the issue price, the distribution ratios, and so on. The little empirical evidence that exists so far suggests that since the change in the law an increasing number of German companies have resorted to the use of ESOPs. While in 1996 and 1997 there were only 6 and 10 firms respectively that awarded this kind of incentive remuneration to their senior executives, by September 1998 this number rose to 27 and it is estimated that in 1999 about 100 ESOPs were adopted (Figure 3.8.a) (Winter 1999). The vast majority of these plans cover just Vorstand members and other executives, whereas only a small percentage are awarded to all employees (Figure 3.8.b). As ESOPs can be considered a powerful tool for aligning management interests with those of current shareholders, then this early evidence may suggest that the institutionalisation of shareholder supremacy at board level has already begun in Germany, even if the KonTraG amendments as a whole were in some degree shaped by the forces of path dependence.

\(^{301}\) Article 192 para.2 no.3 AktG.
Figure 3.8. Use of Stock Option Plans by German Companies

a. Number of Implemented Stock Option Plans Until 1998

![Bar chart showing the number of implemented stock option plans until 1998.]

- Before 1997: 6
- 1997: 10
- 1998 (until Sept.): 27

Total = 43

b. Hierarchical Layers Covered by Employee Stock Option Plans

- Vorstand + other executives: 67%
- Vorstand + other employees: 12%
- Executives without Vorstand: 5%
- All employees: 14%
- Vorstand alone: 2%

Total ESOPs =


Another important aspect of company law that is related to the ability of a company to focus on current shareholder-value maximisation is that of share buybacks. A purchase of own shares can serve as a mechanism for increasing the market value of the stock or for returning excess cash flow to shareholders when no imminent investment opportunities exist. Before the KonTraG amendments the acquisition of own shares by a company, despite it being a common practice in other
countries such as the US for some time, was virtually prohibited under the old Article 71 AktG. With the amended Article, however, the restrictions have been significantly eased and the Aktiengesetz has been brought in line with "common international practice" as that is shaped by global institutional investors' demands. A share repurchase is now generally permitted provided a number of conditions are complied with and German companies seem to be willing to take full advantage of the new amendments. As early as in October 1998 there were over 50 firms which were already granted authorisations by their shareholders to proceed with share repurchases (Frankfurter Allgemeine Zeitung 1998). By July 1999 this number had risen to 77 with another 72 companies planning to seek authorisations. For that year the value of share buy-back programs reached DM30 billion or 1.6% of the market capitalisation compared with the US respective percentage of 1.9% for the same period (Finanzplatz e.V. 1999).

Another major area of corporate governance significantly affected by the KonTraG amendments is that of voting rights. In section 3.4.3 above it was shown that some German companies have used multiple or limited voting rights and voting caps as an anti-takeover mechanism with further repercussions for the development of the stock market. Article 5 para.1 AktG now provides that all multiple voting rights shall cease to exist within five years from the date when KonTraG took effect unless the majority of shareholders with no such rights vote to the contrary. Similarly, voting caps and limited voting rights are now prohibited for all listed companies and have

302 Only in 1996 the value of share repurchase programmes announced by US companies exceeded the sum of $100 billion dollars.
303 This Article contained a list of circumstances where a share-buy back was allowed, e.g. when it was deemed necessary in order to prevent serious and imminent harm to the company's interests, to offer shares to its employees or for compensating minority shareholders of subsidiaries wound up or absorbed by the parent. For a detailed analysis of the past regime see Stawowy (1994).
305 Article 71 para.1 AktG.
ceased since April 1, 2000.\textsuperscript{306} It is generally believed that this decisive move towards the “one share-one vote” principle will have a significant positive effect on stock market development and will make investment in shares more attractive as it links capital contributions by shareholders with their share of influence.

A further modification in the law concerns the power of banks. Section 3.4.2 above has shown that banks, especially the Big Three, are able to use their position as share custodians for small shareholders to help managers insulate themselves from outside shareholder pressures. During the discussions that preceded the passage of the KonTraG, the SPD had proposed the complete abolition of banks’ proxy voting rights as well as the limitation of bank shareholdings in industrial and insurance companies to 5% or under. It also recommended a partial deviation from the universal banking system by prohibiting banks from owning mutual funds (SPD 1995). However, the KonTraG amendments have been more modest. They have created a new legal requirement that a bank must inform its share depositors about alternative proxy-agents such as shareholder associations. Moreover, banks must disclose to their customers any board memberships and equity participations in the company in question. The most significant legal amendment, however, is the new Article 135 para.1 AktG which provides that, unless they receive specific instructions, banks are no longer allowed to exercise their proxy-votes in companies where they own more than 5% of the equity outstanding. As Emmons and Schmid (1998:27) point out, this provision discriminates against banks as voting custodians in favour of other non-bank vote custodians, such as the shareholder association Deutsche Schutzvereinigung für Wertpapierbesitz e.V. (DSW), who are not subject to this restriction, and thus reduces the attractiveness of banks as proxy-holders. It also

\textsuperscript{306} The first draft of KonTraG contained provisions abolishing limited voting rights for all companies irrespective of whether they were listed or not.
creates an incentive for banks to reduce any holdings they may have to levels below the 5% threshold. Finally, banks are required to vote in the interests of the “average customer” and submit their proposals on how they intend to use their voting rights. This requirement may serve as a disincentive for the continuation of the blind management-support approach of banks and, combined with the additional obligation to appoint one of their Vorstand members as the person responsible for the prompt exercise of proxy-votes, may push banks towards a more shareholder-friendly orientation in their votes which would then limit managerial discretion. Therefore, despite their relatively modest character, these amendments to the law are bound to have an effect on the traditional role of banks - i.e. as protectors of managerial discretion - in the German corporate governance system.

Apart from the power of banks as share-custodians, the KonTraG has also affected another management entrenchment device, namely that of cross-shareholdings. The new Article 328 para.3 AktG imposes a limit on the exercise of voting rights by companies with such holdings. Thus, a listed AG which knows about the existence of a cross-shareholding with another company is not permitted to use its voting rights with regard to the election of Aufsichtsrat members in that company. This reduces considerably the significance of cross-shareholdings as devices for preventing unwanted changes of control and therefore their practical usefulness. Thus, it is particularly interesting that between 1990 and 1998 such holdings by non-financial corporations have significantly declined from 41.6 percent to 30.5 percent (Deutsche Bundesbank 1999). While the KonTraG amendments regarding the use of votes may have been just one of many factors influencing the decisions of firms to reconsider inter-firm relationships - cross-border M&A, shareholder base

307 It will be shown below that such a process is already underway.
diversification and other strategic factors must have also been influential- their significance should not be underestimated since they have effectively turned cross-shareholdings into an obsolete managerial entrenchment device. Significantly, their effect should be seen in combination with the recent changes in capital gains tax regime, which also facilitates the unwinding of cross-shareholdings.

In general, if one were to characterise the KonTraG amendments to the AktG, it would be fair to say that they are not as radical and far reaching as many would want. Long-established institutional arrangements, such as co-determined boards and the ability of banks to hold shares in non-financial firms have not been affected. Indeed, as far as the highly political issue of board level co-determination is concerned, it would be impossible to imagine even the slightest direct or indirect modification, e.g. through the elimination of the Aufsichtsrat, due to the high adaptation costs involved and the powerful agents representing them. The implementation of the KonTraG, however, does reveal that the debate on corporate governance and its significance for competitiveness in a global market place has gained momentum in Germany. Some of the adaptation costs that cause systemic path dependence are offset by the fact that the past confidence in German corporate practices and managers is being severely challenged and a more transparent and outside-shareholder orientation is favoured as the only visible alternative. The facilitation of stock option plans for executive management as well as allowing share repurchases and the limitations on multiple or limited voting stock indicate a clear shift towards a corporate governance system that incorporates the goal of outsider investor protection as an implementation of shareholder supremacy. Certainly, the amendments mentioned here, especially those covering ESOPs and share buy-backs, rely on the initiative and ability of shareholders who are responsible for
institutionalising governance mechanisms that protect their interests. However, the first empirical evidence shows that firms have indeed taken advantage of the KonTraG amendments. But what it also significant about the new law is the highly prescriptive character in other areas such as information flows between boards and the use of voting rights on banks and non-financial affiliates. These constitute a direct blow on the managerialist spirit of German company law and to some extent institutionalise shareholder supremacy within the existing legally prescribed corporate structure.

3.7.3. Accounting Standards

While the KonTraG amendments aim for the improvement of information flows from management to the Aufsichtsrat and of the form of audit reports, more dramatic developments have been taking place regarding the quality of audits. Section 3.4.3 above mentioned that German accounting standards are creditor- or manager-oriented as opposed to shareholder-oriented. The ability of German companies to create hidden reserves not only undermines the level of transparency to outsiders with regard to their financial situation but also allows managers increased scope for deviation from shareholder supremacy in favour of a (stakeholder-) managerialist approach since it constitutes a form of excess cash flow retention. This is reflected in the evaluation of accounting information by investors (Keller and Möller 1992). Thus, the German GAAP never gained international acceptance and have been a constraint on German companies' ability to raise finance abroad, especially in
countries with more shareholder-oriented accounting principles such as the UK and the US.

Nonetheless, a number of German companies faced with the need to tap foreign stock markets in order to finance and realize their global FDI or M&A strategies had begun to file their accounts both according to the German GAAP as required under the HGB and according to the US GAAP or the IAS. This "dual reporting" practice, however, meant that German companies that were committing themselves to increased disclosure had to incur substantial additional costs. As a result, very few companies were able to prepare their financial statements in accordance with standards accepted by foreign investors so that functional convergence could not progress very far (Table 3.10). This urged the corporate sector to intensify the pressure for legal reform (Leuz and Verrecchia 1999: 7) so that they wouldn't have to bear all adaptation costs themselves due to dual reporting expenses.

Table 3.10. Distribution of DAX 100 Firms Adopting International Reporting Strategies Across Fiscal Years.

<table>
<thead>
<tr>
<th>Year of Adoption</th>
<th>Number of firms</th>
<th>Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>2</td>
<td>reconciliation (1); dual reporting (1)</td>
</tr>
<tr>
<td>1994</td>
<td>4</td>
<td>full report (1); dual reporting (3)</td>
</tr>
<tr>
<td>1995</td>
<td>5</td>
<td>full report (1); reconciliation (1); dual reporting (3)</td>
</tr>
<tr>
<td>1996</td>
<td>5</td>
<td>full report (2); reconciliation (2); dual reporting (1)</td>
</tr>
<tr>
<td>1997</td>
<td>5</td>
<td>full report (2); dual reporting (3)</td>
</tr>
<tr>
<td>1998</td>
<td>10</td>
<td>full report (7); reconciliation (3)</td>
</tr>
</tbody>
</table>

Source: Leuz and Verrecchia (1999), Table 1.

It was under such pressures from powerful (core) firms that the KapAEG amendments to the HGB took effect in April 1998 changing the situation particularly

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A common "accounting language" between the merging firms in the case of cross-border M&A can be as important as for portfolio investors seeking to invest across borders.

Daimler Benz AG was the first German company to adopt the US GAAP in 1993 due to it's listing on the NYSE.
for those companies seeking finance from foreign securities markets. The amended Article 292(a) HGB provides that listed companies that are the parent of a group may prepare their consolidated accounts solely in accordance to internationally accepted accounting principles, namely the US GAAP or the IAS. According to guideline 83/349/EWG the accounting principles followed must provide information which is of at least equal value to that under the German GAAP. The fact that the new provision only covers consolidated group accounts does not mean that individual company accounts remain unaffected. As Schmidt observes:

...the consolidated statements would in most cases not coincide with the financial statements of the corporation as a single entity. The result of this would be that the profit that would be available for dividend distribution would be accounted for by applying accounting standards which would differ significantly from the accounting standards being applied for the consolidated statements. It is difficult to imagine that such a disparity will be accepted by investors over a longer period of time. (Schmidt 1998: 748)

Therefore, the scope and effect of the new Article 292 HGB may prove to be broader than it appears at first sight. There is evidence that the KapAEG amendments have already begun to have an impact on German companies' reporting practices. As Leuz and Verrecchia (1999: 7) and Clark et al. (2001) report, in fiscal years ending between June 1998 and March 1999 over a third of the DAX 100 and more than half of the DAX 30 companies had prepared their financial statements in accordance with either the US GAAP or the IAS.

At this point it should be noted that the KapAEG is a measure which is transitional in character. The applicability of its provisions has a time limitation fixed on December 31, 2004. This is because by that date a new German GAAP were supposed to be implemented. A German Accounting Standards Committee was

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310 As regards the Neue Markt, all firms listed therein are required to follow the IAS, the US GAAP, or the German GAAP with reconciliation to the former two.

311 Article 5 KapAEG.
established in March 1998 under the provisions of the KonTraG\textsuperscript{312} with the task of representing Germany in international accounting standard committees and of formulating new accounting standards for German companies in accordance with established international practice. In the words of Jürgen Krumnow, Chairman of the Committee:

> In Germany itself, it is a matter of bringing German accounting practices up to an international level as soon as possible. It goes without saying that there are no plans to adopt international accounting regulations out of hand. But there is no reason to reinvent good regulations that have already become accepted accounting practice worldwide. It is in this sense that German accounting will then be able to acquire new global recognition. (Krumnow 1998)

However, given Krumnow’s statement and Germany’s influence within the EU, it is perhaps not surprising that on 13 February 2001 the European Commission came forward with a legislative proposal requiring the adoption of IAS by all listed corporations in European exchanges by 2005. The proposed measure was adopted by the European Council on 7 June 2002 in the form of a Regulation which will have direct effect in all Member States. Therefore, the German Accounting Standards Committee’s work and intentions have now been superseded by EU-wide legislation, so that once the Regulation gets the approval of the European Parliament all German listed companies will have to prepare their consolidated accounts in accordance with the IAS by 2005 at the latest.

Moreover, as already noted, the KonTraG has established a mandatory requirement for all listed AGs to include cash flow statements in their consolidated account statements as of December 31, 1998. Until that date such statements were not compulsory. Nevertheless, a large number of German companies had already begun to include cash-flow statements in their annual reports voluntarily since the early

\textsuperscript{312} Articles 342 and 342a HGB.
1990s, mainly in response to foreign and domestic stock market pressures, international standards and business consultants' recommendations (Leuz 1999). Thus, the KonTraG amendments followed a more or less broadly accepted practice of the German corporate sector and a steady trend towards increased disclosure. This is another clear example of formal convergence ensuing functional convergence.

To summarise, the recent changes in the law governing financial statements are all intended to enhance the informational value of company annual reports from the outside investor's perspective and bring German accounting standards in line with principles accepted by dominant (institutional) investor groups in global financial markets. Of course, a number of German firms under the influence or pressure of foreign investor expectations had committed themselves to increased financial disclosure before the enactment of the new laws. This means that the KapAEG and KonTraG amendments --and even the EU initiative--are the latest stages of a whole process that has begun since the early 1990s. The new provisions constitute a form of regulation facilitating the continuation and intensification of this process towards enhanced transparency of financial accounts to outsiders -- a vital precondition for an outside shareholder corporate governance system. For example, the ability to create hidden reserves under the US GAAP or the IAS as opposed to the existing German GAAP is substantially constrained.\(^{313}\) This move towards a more outside shareholder oriented accounting regime thus has a significant impact on managerial discretion.\(^{314}\) The constraint on managerial reliance upon hidden reserves to smooth annual earnings will undoubtedly affect the prioritisation of corporate objectives. For instance, a company that does not have large reserves as a cushion may be forced to

\(^{313}\) For an analysis see Deutsche Bank Research (1993).

\(^{314}\) For a case study see Kütting (1996). It is indicative that in its mid-1993 interim report Daimler-Benz AG showed a surplus of DM168million according to German GAAP but a loss of DM949million according to US GAAP.
review its positive attitude towards retaining employees in difficult times. Cost-cutting would automatically appear as the only way out of a crisis. Simultaneously, shareholders may take advantage of the increased transparency by demanding higher cash flow distributions either as dividends or as share repurchases.

Moreover, it would not be unreasonable to expect that increased financial transparency will affect the structure of shareholdings as well, by decreasing informational asymmetries between outside shareholders and managers and therefore by reducing the private benefits accruing from such large holdings. Indeed, there is empirical evidence suggesting a positive relationship between enhanced disclosure and dispersed ownership (Leuz 1999).

3.7.4. Takeover Regulation

The disadvantageous position of minority shareholders in cases of takeover bids and the ability of strong blockholders to appropriate benefits as a result of the lack of effective takeover regulation was noted in section 3.4.4 above. It was argued therein that, among other institutional factors, insufficient minority shareholder protection in takeovers was associated with the underdevelopment of German securities markets. With the vision of Finanzplatz Deutschland German regulators and policy makers could not ignore this vital aspect of investor protection. Thus, in the mid 1990s the Federal Ministry of Finance assigned the Börsensachverständigenkommission (Commission of Stock Exchange Experts (BSK)) with the task of devising a code of practice for takeovers. In 1995 the BSK

315 See also Hoffmann-Burchardi (1999).
introduced the Kodex which came into force on 1 October 1995, and the implementation of which was based on voluntary adoption by German listed companies. A Takeover Commission, whose members are appointed by the BSK, was created to monitor and promote compliance.

The formulation of the Kodex was along the lines of the London City Code on Takeovers and set four main principles: equal treatment of all shareholders, transparency of the takeover procedure (equal access to information for all shareholders), fair participation for all shareholders in the offer price and the requirement that the Vorstand remains neutral during the takeover. The most controversial rule in the code, however, was Article 16 which contained the requirement for a mandatory offer to all remaining shareholders if the bid exceeded the threshold of 50% of all voting shares. Corporate interests had claimed that this mandatory bid rule was too far reaching whereas investor interests disagreed and believed that the 50% threshold was too high. Despite the reactions of the industrial sector the latter won the argument and Article 16 was amended in 1998 so that the mandatory bid rule was strengthened. Under the amended rule it was not necessary anymore to obtain 50% of voting shares in order to trigger the rule. The threshold was the mere acquisition of control as that was defined in the old Article 22(1) WpGH which could be lower than the Kodex’s previous 50% threshold. Moreover, the offer had to be extended immediately and not after a maximum of 21 months that the original provision required.

In practice, however, the Kodex never fulfilled the expectations the BSK had when the code was adopted. Even though its rules provided satisfactory protection to

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316 For companies listed in the Neuer Markt adoption of the Kodex was mandatory. For all other signatory listed companies the code only constituted a set of contractual obligations.
317 Article 20 of the Kodex.
318 See comment by the chairman of the BSK Dr. Karl-Hermann in Bauman (1999).
minority shareholders in takeover transactions and although the Takeover Commission within four years of its inception processed 46 cases involving the code, the problem of enforcement remained. Despite the BSK’s persistent efforts and the Deutsche Börse’s requirement that all newly listed companies in the DAX and MDAX had to adopt the code, and a joint declaration by German banks not to cooperate with bidders who did not adopt the code, on December 1, 1998 only 348 out of the 758 listed companies had adopted the Kodex (Loehr 1999). It is indicative that prestigious companies like BMW, Hoechst, Viag and Volkswagen refused to adopt the code and withstood public criticism for giving priority to specific insider interests (Handelsblatt Interactiv 1999a). In the words of Dr. Karl-Hermann Baumann, chairman of the BSK, “this means that there is no guarantee for a level playing field” in the field of corporate takeovers (Bauman 1999).

Consequently, the BSK announced its was abandoning its efforts to gain universal voluntary acceptance of the Kodex and proposed that there should be mandatory legislation regulating takeovers (Börsensachverständigenkommission 1999). It suggested that the mandatory offer threshold should not be based on a fixed share-capital percentage but on the achievement of simple majority of votes present at the AGMs of the last three years, but that there should be no requirement for a mandatory offer when the bidder owns less than 30% of the share-capital.

Ironically, the successful hostile bid for Mannesmann by Vodafone changed the situation dramatically. Immediately after the takeover, the then Finance Minister Hans Eichel urged the EU to implement common takeover rules for all Member States (Atkins and Simonian 1999). The Thirteenth Company Law Directive proposed by the Commission for the establishment of common takeover rules within

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319 Between 1995 and 1997, this was achieved with 21% of the share-capital in DAX companies. See Baumann (1999).
320 See the discussion in the following section.
the EU had been pending for many years. Even though a political agreement for its adoption had been reached in June 1999, the Vodafone/Mannesmann takeover generated German opposition in the European Parliament on the grounds that, while the KonTraG has virtually eliminated multiple voting shares, other Member States were still using them in order to prevent hostile takeovers. The Directive was amended in December 2000 by the European Parliament, which introduced a clause permitting defensive action by management, and was eventually marginally defeated on 3 July 2001 (Dombey 2001). Only one week later the German cabinet approved the draft Übernahmegesetz which was eventually passed and took effect on 1 January 2002. Although the new law contains a mandatory bid rule once the 30% of voting shares threshold is reached, its Article 33 enables management to seek shareholder approval for defensive measures, such as “poison pills”, even if no bid is imminent. Moreover, under the same provision management is granted considerable discretion to employ post-bid defences with the approval of the Aufsichtsrat, i.e. without any direct shareholder involvement.

Thus, even though takeover regulation could be regarded as an area of a rather “technical” nature as part of securities markets regulation, path dependence forces during its evolution in Germany have been very influential. This, however, is not surprising when one recognises that the significant adaptation costs of establishing an active market for hostile takeovers would have to be borne by labour interests in an era of high unemployment – this is something that German politicians cannot easily ignore. Therefore, it seems that the argument of Coffee presented in section 2.4.2 above that convergence of securities regulation involves less adaptation costs and thus, as institutional complementarities transmit changes through the system, can drive corporate governance convergence needs to be qualified. Institutional
complementarities between different corporate governance subsystems - in Germany’s case between securities regulation, industrial relations - are also carriers of path dependence and this must be taken into consideration too before predicting automatic convergence. Sometimes, complementarities can be so strong that even securities regulation – part of which is takeover regulation – itself stops short of converging fully, even if many important changes do get implemented.

3.7.5. Preliminary Assessment

The preceding sections provided an overview of a series of regulatory instruments and legal amendments recently implemented in order to bring German law “in line with international standards and practice”.

Certainly, these developments, some of which are still on going, do not amount to a complete overhaul of the German system as that was described in section 3.4 above and to an instant transition towards an outside shareholder-oriented model of corporate governance. Two characteristic features of the legal corporate governance framework, the two-tier board structure and co-determination, not only are still in place but have even been enhanced. Particularly in the case of codetermination it would be completely unreasonable to expect that reform could begin from such highly political issues that are considered by German people as great social achievements.

Nevertheless, policy makers in Germany have realised that in order to sustain and expand the role of Finanzplatz Deutschland, a concept that is itself an outcome of global competition, a regulatory system which is compatible with the expectations of

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321 See comments of Seibert, supra. at 320, of Krumnow, supra. at 333, Bundesregierung, supra. at 294, and supra. note 304 and text.
foreign as well as domestic investors is necessary, even if that could be considered as
the outcome of a global regulatory race to the bottom. This has not only resulted in
the development of German securities markets but has also enabled the serving of
German companies' increasing financial needs directly from capital markets within
Germany rather than without it. A number of companies who sought to deal with the
challenges of globalisation were until recently facing significant hurdles within their
country due to the domestic introversion that characterised numerous financial
regulations. Simultaneously, as the largest firms could escape this situation by using
their reputation to raise finance abroad, regulatory arbitrage became a serious issue.
Therefore, the pressure for financial reform in Germany intensified.

Thus, German regulators have recognised and acted upon the need for a legal
framework governing listed corporations that is characterised by enhanced
transparency and investor protection, and which also provides the context for a more
shareholder-oriented corporate governance. Most important is the impact the new
regulatory framework that is emerging in Germany may have on investment
behaviour. More specifically, the patterns of concentrated ownership described in
section 3.4.3 may gradually become economically irrational, as the balance between
dominant blockholders vis-à-vis outside-shareholders has been shifting towards the
latter. A restriction in the opportunities for private benefit extraction by dominant
shareholders to the detriment of minorities amounts to a respective decrease in the
incentives for the acquisition of large blocks which carry with them the insider status.
To use Coffee's (1991) terminology, liquidity may become more preferable than
control. Moreover, the abolition of capital gains tax and the KonTraG amendments
with regard to cross-shareholdings, banks' proxy voting and voting limitations have
reduced the number of managerial entrenchment tools. The simultaneous
strengthening of foreign and domestic outside shareholders’ position and therefore of their governance influence can force German managers to follow a more market-oriented approach dictated more by current shareholder-value maximisation considerations. Where direct shareholder voice is practically impossible, crucial for the entrenchment of such a shareholder-value orientation are the legal instruments concerning share repurchases and managerial stock options, which as the next section will show are already popular measures implemented by German companies.

In sum, it seems that due to horizontal complementarities, purely financial institutional reforms are now spreading to areas affecting corporate governance more directly in a process of cumulative institutional change. Just as this thesis argued in section 2.4.2 above, the areas affected by the recent legal changes, such as securities regulation and accounting standards, may be of a rather “technical” nature and surrounded by less political controversy than other institutions like co-determination. Still, contrary to Coffee’s convergence argument, the developments in German takeover rules reveal that this does not mean that changes even in those areas of technical regulation go unnoticed; financial system’s complementarities with more path dependent sub-systems can halt or delay the full re-orientation even of securities regulation.

Given this background, the next section will attempt to determine the extent to which traditional stakeholder relationships are being affected by the legal changes implemented so far, and the degree of penetration of shareholder value as a benchmark in German corporate governance.
3.8. NON-LEGAL CHANGES AND THE CONCEPT OF SHAREHOLDER VALUE IN GERMAN CORPORATE GOVERNANCE

It was mentioned above that in many respects legal reform followed change in business practice, i.e. functional change, caused by the redefinition of core firms’ preferences as they tried to exploit the opportunities arising from product and financial market globalisation. The intensification of foreign competition and the dilemma of global reorganisation or extinction have increased considerably the financial needs of firms that want to remain competitive. The globalisation of competition for securitised corporate finance means that companies now need their public (institutional) investors, domestic and foreign, more than they did in the past, when bank borrowing was sufficient to cover their financial needs. Moreover, the adoption of growth and re-organisation strategies based on cross-border M&A not only dilutes the structure of stock ownership but also brings in international shareholders with divergent expectations. This leads to increased pressures for the abandonment of established business practices and the adoption of rules and principles that are accepted internationally or, to be more specific, by investors in global financial markets. Banks, especially the Großbanken, are becoming more interested in increasing their global presence rather than maintaining long-established relationships with their corporate clients that may hinder their overall business strategy, hostile takeover bids have begun to take place where they were virtually non-existent, while shareholders, domestic and foreign, are becoming increasingly active in seeking to maximise their financial earnings by demanding a higher share of corporate cash flow. Furthermore, the enhanced bargaining power of outside shareholders and the simultaneous pressure on labour to conform to the new
economic realities by accepting a larger share of the adaptation costs involved has also contributed to the redefinition of stakeholder relationships. Since vertical complementarities between such functional changes and the legal reforms discussed above are strong and bi-directional, it is impossible to identify what took place first. As section 2.4.2 above has shown, institutional change is a continuous and complex process of cumulative causation so that it is almost impossible to identify with certainty its beginning or end. What is possible, however, is to treat legal and functional changes are mutually reinforcing, driving the German system in a particular direction.

Thus, the following sections will present some early evidence suggesting that German corporate governance is gradually changing from one based on consensus and stable relationships among stakeholders into a more adversarial one, where financial, i.e. shareholder, interests tend to prevail. As entrenchment devices wane, managerial discretion is being contained and replaced by higher accountability to all shareholders, insiders and outsiders, on an equal basis. It will be argued that the notion of shareholder-value as a measure of shareholder supremacy is beginning to infiltrate the German managerial model as that was described in section 3.4 leading to its slow transformation into one where outside shareholder interests are given priority.

3.8.1. The Changing Role of Banks

The developments in German financial markets and the banking sector more specifically discussed in section 3.6 above could not leave the relationships between banks and their industrial customers unaffected. Some general observations have
already been made above with regard to the inability of German banks to satisfy the
corporate finance and investment banking needs of those companies that sought to tap
international capital markets for funds and foreign banks' expertise. By turning to
foreign investment houses such companies began to break away from their long
established relational banking ties. This move has not been unilateral. Under the
pressure of increasing competition from foreign financial institutions since the
liberalisation of financial markets, large banks who wanted to remain competitive had
to reconsider the viability of their close ties with non-financial companies. The
increased financial needs as well as the potentiality of conflicts of interest\(^{322}\) have
made the maintenance of traditional links between banks and their corporate clients
difficult. The decreasing profit margins in the traditional deposit and loan business
have also been a significant factor.

One first indication of German banks' changing attitudes is the significant
reduction and reorganisation of their major equity participations in industrial firms in
recent years. As Schröder and Schrader (1997) found, the ten largest private banks
reduced their holdings in non-financial firms from 1.3% of nominal capital in 1976 to
just 0.4 in 1994. Most stakes in the 25%-50% range have been significantly reduced,
as banks now have to follow a more diversified strategy with regard to industrial
shareholdings. Such policies have already been announced and implemented by
Deutsche Bank, Dresdner Bank, Commerzbank, Bayerische Hypotheken-
The Big Three, in particular, are engaged in a process of selling most of their major
holdings. Deutsche Bank during the late 1990s significantly reduced its holdings in
Daimler AG, Holzmann AG, Karstand AG, Südzucker AG and Horten AG, all of

\(^{322}\) See discussion in section 3.8.2 below.
which have been long-term partners for many decades (Fischer 1997a, 1997b). It also
span off most of its remaining holdings by creating DB Investor AG, a subsidiary
company, which has the task of professionally managing the bank’s portfolio of
industrial stakes focusing on the bank’s interest as a shareholder rather than creditor
(Handelsblatt Interactiv 1998). Similarly, prior to its takeover by Allianz, Dresdner
sold its holdings in Degussa AG and Hapag-Lloyd AG (Frankfurter Allgemeine
Zeitung 1997c, 1997d), and Commerzbank in Karstand AG (Fischer 1997b).

It should also be recalled here that large sales of shareholdings have been
inhibited in the past by high tax rates on capital gains arising from stock trades
(Mülbert 1998: 471). The recent abolition of this tax has removed a crucial
institutional impediment to large reductions of stakes that are undesirable in the
emerging economic context, so while this trend seems to be part of a long-term
strategy of German financial institutions, it is now bound to intensify. For instance
the insurance giants Allianz and Munich Re, owning 24% of total holdings in the
DAX 30 - mainly in banks - almost immediately after the announcement of the tax
reform plans expressed their intention to take advantage of them by selling many of
their stakes in other companies (Major 2000; Financial Times 1999c). But even
earlier moves such as the creation of DB Investor should also be seen in the context
of the new tax regime. However, as section 3.4 above shows, banks’ role in industrial
corporate governance system derives mainly from their control of proxy votes rather
than their relatively small equity stakes. This leads to the next point, which is the

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323 The bank set its policy as follows: "By the reduction of existing holdings and acquisition of new
ones, professional and active portfolio management is to be conducted, but no new holdings
accumulated. DB Investor will act, for example, as a kind of midwife in repositioning companies on
the basis of value-increasing concepts for companies and industries (e.g. Hapag-Lloyd) or participate
in the restructuring and disposal of other companies' holdings which are no longer part of core
business, as in the case of DIVAG/Metro" (Deutsche Bank 1999). Deutsche Bank also reduced its
9.3% stake in Allianz by 2.3% as part of its program to increase shareholder value (Handelsblatt
Interactiv 1999f).
changing role of banks in hostile takeovers as an indication of their changing intentions in using their voting power to support managers.

For reasons already explained hostile bids have been virtually non-existent in Germany so that the market for corporate control has not been able to exert significant pressures on German managers and constrain their discretion. To a great extent this was attributed to the fact that banks have generally followed a supportive approach towards managements and management-defensive measures limiting the potentiality of successful hostile bids. However, the first signs of change began to appear in 1991, when Krupp launched a hostile bid for Hoesch. Even though the target's Chairman was Deutsche Bank's nominee and its CEO had received his office with the bank's involvement only three months prior to the bid, Hilmar Kopper, Deutsche's CEO at the time, approved of Krupp's move and encouraged Hoesch's chairman not to oppose the takeover irrespective of the management's opposing view. Deutsche Bank had been Hoesch's hausbank and controlled approximately 12% of the votes via proxies in the company. In the end, it was only after intense government pressure that an agreement was reached for a friendly merger between the two companies which took place on 8 December 1992 (Franks and Mayer 1998: 1392).

An even clearer illustration of the changing attitudes of German banks, however, is given by their role during Krupp's bid for Thyssen, where in spring 1997 the former announced its intentions to acquire its main competitor, which was larger but with diffused ownership, without the latter's consent. Krupp was financially assisted by Deutsche Bank and Dresdner Bank and advised by their investment banking subsidiaries in London - Morgan Grenfell and Kleinwort Benson respectively — with some additional help from Goldman Sachs. At the time of the bid a member of Deutsche's Vorstand sat on Thyssen's Aufsichtsrat while one active and one retired
member of Dresdner's Vorstand sat on the Aufsichtsräte of both the bidder and the target. A point that has to be stressed is that this incident occurred in the most traditional industry in the German economy, as Thyssen is a steel manufacturer governed by the full-parity co-determination regime under the Montanmitbestimmungsgesetz. Thus, added to the opposition from the management's side was the resistance of the workforce. The press was also very critical of Krupp's "wild west" tactics and even more of the banks who "dominated the country". Thus, after a decisive intervention by the Northrhine-Westphalia State Government and under the pressure from labour representatives from both companies and unions, an agreement for a "friendly" merger was achieved on the basis that no redundancies would take place. Nevertheless, Krupp's attempt was seen as a first significant and direct effect of globalisation in the heart of the German system and as a turning point in the way of doing business in Germany. As Bendt comments:

The German financial elite almost certainly had greater plans. The whole deal should finally prove that German Banks are just as able as their Anglo-Saxon counterparts to plan and manage such complex financial deals. (Bendt 1998)

The fact that the hostile takeover envisaged by Krupp and its financial partners during the event did not materialise as planned cannot overshadow the fact that the new investment banking role sought after by the Großbanken in the global financial market place is in direct conflict with the traditional model of German stakeholder-managerialism.

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324 As a result of the takeover attempt, a stalemate arose in Thyssen's Aufsichtsrat for the first time ever, thus breaking a long tradition of decisions based on full consensus.

325 The German newspaper Der Spiegel reported a member of Krupp/Hoesch's works council stating: "I can't globalize myself, I've got a flat here. Let us therefore march, in order to make sure that Deutsche Bank is no longer able to dominate the country"; cited in Bendt (1998).
Furthermore, banks are also becoming increasingly unable to keep up with their role as liquidity insurers or corporate rescuers. The recent events during the collapse of Holzmann AG, the second largest and most historic construction group in Germany, provides a prime example of the clash between the formulation of a global strategy and relationship banking engagements. Holzmann’s main financial partner had for almost a century\(^{326}\) been Deutsche Bank who even at the point of the collapse owned a 15.1% stake in it. The first problems emerged when Holzmann was unable to make a profit out of a number of projects it had completed in east Germany after 1989. As the debts began to mount - between 1995 and 1998 deficits had reached the level of about DM1.4 billion (Barber 1999b) - Deutsche Bank finally\(^{327}\) decided to intervene in 1997 by placing Carl Boehm-Bezing, a member of its Vorstand, as chairman of Holzmann’s Aufsichtsrat which undertook the responsibility of appointing a new management team that would restore the company’s financial health. Nevertheless, the plan eventually failed and in November 1999 losses of about DM2.4 billion were disclosed which brought the group one step closer to a collapse (Handelsblatt Interactiv 1999j). Deutsche Bank was severely criticised not only for not having used its influence to make sure that the company’s turnaround was successful but also for using Holzmann’s business dealings for its own benefit rather than for the company’s shareholders.\(^{328}\)

\(^{326}\) Since the beginning of the 20\(^{th}\) century a large number of Holtzmann’s projects, from the Baghdad railway (1907) to the new Reichstag building in Berlin, were completed with Deutsche’s financial help. Even Deutsche’s headquarters building was constructed by Holzmann.

\(^{327}\) In 1994 a hostile takeover attempt was made for Holzmann by Hochtief with the co-operation of Deutsche Bank who had agreed to sell 15.9% out of its 25.9% equity stake at that time to the bidder. The takeover, however, was blocked by the Bundeskartellamt on competition law grounds. This indicates that Deutsche Bank’s initial intentions were to terminate its longstanding relationship with its old industrial partner. For more details on the bid see Jenkinson and Ljungqvist (1997).

\(^{328}\) DSW, a shareholder association, called for chairman Carl von Boehm-Bezing to resign and called for a special audit investigating Deutsche Bank’s dealings with Holzmann. Commerzbank had also considered the possibility of filing a law suit against Holzmann’s board. See Handelsblatt Interactiv (1999g, 1999l and 1999m).
Despite the severe criticism against it and its level of involvement in the affair, Deutsche Bank was reluctant to engage itself into a fully committed restructuring operation that would rescue the company.\textsuperscript{329} It was determined to limit its participation in the rescue plan to only 18.5\% of the funds needed. This resulted into the failure of creditor banks to reach an agreement on their contributions to the rescue plan and to the subsequent initiation of insolvency proceedings in late November 1999. It was only after the direct intervention of the German Federal Government and a DM250 million state subsidy that a last minute agreement on a rescue package was achieved (\textit{Handelsblatt Interactiv} 1999\textit{h} and 2000\textit{b}).\textsuperscript{330} Again, it was not the banks’ commitment to their industrial parter that led to the bailout but direct government intervention.\textsuperscript{331} Nevertheless, Deutsche Bank as well as other major creditor banks of Holzmann had been planning to disengage from the troubled company after its rescue by selling their shareholdings and promoting the possibility of an acquisition (\textit{Handelsblatt Interactiv} 1999\textit{i}). Eventually, the steep downturn in the construction industry even after the rescue led a new crisis for the group and its eventual collapse in March 2002 as neither its bankers not the government this time were willing make any further contributions (Major 2002\textit{a}).

If banks’ attitudes towards their long-term industrial partners are becoming less supportive, in other cases they can also become aggressive as creditors. This is evidenced by Deutsche Bank’s stance in the collapse of the Kirch media empire in 2002, the largest in Germany’s history so far. Deutsche was again heavily involved.

\textsuperscript{329} The initially agreed rescue plan comprised a financial injection of DM1.25 billion from a capital increase and DM1 billion in the form of a syndicated loan.
\textsuperscript{330} The final rescue plan would also result in a reduction of the workforce by 3,500 out of a total of 17,000 and additional concessions on the part of employees such as five hours of overtime for free for one and a half years. See \textit{Handelsblatt Interactiv} (2000\textit{a}).
\textsuperscript{331} This was done after intense protests of German building workers outside Holzmann’s and Deutsche Bank’s head quarters and a threat of a nationwide strike. The coalition government’s political uncertainties were also a significant factor determining the Chancellor’s decision to intervene. See Major (1999).
Although it was Kirch’s second largest creditor with a €715m secured loan, it effectively welcomed the break up of the group in order to seize the collateral, a 40 per cent stake in publisher Axel Springer worth €880m, which it intended to liquidate and thus improve its own deteriorating profitability. Indicative of the strained relationship between the two sides is the lawsuit filed by Leo Kirch, the founder and then CEO of the media group, against Deutsche’s chairman Rolf Breuer for the latter’s negative comments in the media about Kirch’s creditworthiness when it was still struggling to avoid insolvency (Major 2002).

Furthermore, the increasing presence in the German market of foreign investment banking houses, that are not part of the domestic relationship network, also serves as a catalyst for functional change. It has created significant pressure for German universal banks to abdicate from old practices if they are to build a reputation as established investment houses. The recent hostile bid of the British mobile telecommunications giant Vodafone for the German conglomerate Mannesmann shows that takeover predators need not resort to one of the Großbanken in order to launch an unsolicited bid against a German target.332 When it launched the largest hostile takeover offer in German history, Vodafone employed as its main financial advisers the US investment banks Goldman Sachs and Warburg Dillon Read. Similarly, Mannesmann was advised mainly by Morgan Stanley Dean Witter, J.P. Morgan and Merryl Lynch. Thus, Deutsche Bank’s stance is of particular interest in this case. Although it also acted as a financial adviser to Mannesmann, it nevertheless avoided expressing its support for the target’s management directly. It refrained from giving a central recommendation to its local investment advisers with regard to whether retail investors should sell their shares to Vodafone or not. Deutsche Bank

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332 See further below for a more extensive analysis of the takeover.
restricted itself to a public relations comment that it was "not without emotion" for the particular hostile takeover attempt (Financial Times 2000). Most other major banks (e.g. Commerzbank and Dresdner Bank, but not HypoVereinsbank who issued a clear guideline in favour of Mannesmann’s management) followed a similar line and merely recommended that shareholders remain cautious until the last moment (ibid.). On the other hand, WestLB Panmure, Westdeutsche Landesbank’s investment banking branch, almost immediately supported Vodafone’s offer and described it as attractive to both companies’ shareholders (Financial Times 1999b).

One general observation that can be made from the above is that, even if some of the old practices are deeply rooted in the economics and politics of Germany, it is becoming increasingly obvious that the competitive forces in the global marketplace have already begun to cause cracks in the long-established relationships between banks and non-financial companies. It seems that German managers are losing the unconditional support of their large financial partners who are increasingly unwilling to use their voting power and overall influence to shield corporate managements against hostile takeovers or to finance their rescues in cases of distress. This is also evidenced by the slow but observable decline of bank representation on company boards since the late 1980s. The Bundesverband deutscher Banken (Association of German Banks) (1995) has revealed that, in 1993, banks held 99 Aufsichtsrat mandates in the 100 largest firms as opposed to 114 in 1986, that is a reduction from 8% to 6% in total. As the possibility of conflicts of interest arising from the banks’ dual role as providers of credit and investment banking services becomes more visible, it is reasonable to expect that board representation will become increasingly problematic. This issue became very obvious in the case of Krupp’s hostile takeover attempt for Thyssen, where bank representatives sat on the boards of both the bidder
and the target. Large German banks that are determined to follow a global strategy are now forced to face the dilemma of abandoning their old partnerships with industrial firms in order to proceed with their strategic plans or become laggards. Given the clear preference for investment banking to traditional deposit and loan business, this dilemma seems to be resolved in favour of the former case.

3.8.2. Global Market for Corporate Control

Traditionally, hostile takeover bidding has been taboo in Germany and has been perceived by managers and labour as the adoption of Anglo-American "wild west" business practices for the benefit of outside shareholders and to the detriment of long-term value and stakeholder interests. The events described above, however, reveal a gradual departure from these old perceptions. Even though it would be premature to believe that an active market for corporate control is already in place in Germany, it would not be an exaggeration to claim that managers are no longer as isolated from external financial pressures as they have been in the past. As the possibility of their companies becoming takeover targets has become more tangible in recent years, German managers have already begun to respond to the pressures from the financial market and be more aware of outside shareholder interests.

The case of Daimler Benz's reorganisation in the early 1990s and its subsequent merger with Chrysler may indeed constitute an illustration of the way the new economic environment may affect corporate governance through the global

333 A similar situation also arose in Pirelli's hostile takeover attempt for Continental in 1990. While Deutsche Bank had advised Pirelli on the potential merger with the German company, it later used Morgan Grenfell, its London-based investment banking subsidiary, to help Continental's management during the takeover battle. At that time the chairman of Continental Ulrich Weiβ was also a Vorstand member in Deutsche Bank. See Frankfurter Allgemeine Zeitung (1990).
market for corporate control. Under the leadership of Jurgen Schrempp, who succeeded Edzard Reuter, a long lasting conglomeratisation strategy of the firm came to an end in 1995. The new CEO, with the strong encouragement of Deutsche Bank, one of the main shareholders, implemented a restructuring strategy that would make Daimler Benz leaner and more focused on its main operations by spinning off unprofitable businesses. This process, combined with the company's increased stock liquidity after its listing on the NYSE in 1993 and the reduction of Deutsche Bank’s stake in 1994, rendered Daimler-Benz more exposed to the market for corporate control.

While the goal of capturing the US market cannot be ignored, the fear of a takeover may have also been one of the reasons behind Daimler’s merger with the American carmaker Chrysler in 1998, the largest industrial merger in history at the time. The vast size of the merged entity, DaimlerChrysler, could stave off any potential predator. Nevertheless, even if this merger could be characterised as a managerial entrenchment move, the final outcome is by no means one that increased managerial discretion. At first sight the transaction appeared to be an effective acquisition of Chrysler by the German company (Logue and Seward 1999: 105). True, Daimler’s shareholders now own the majority of DaimlerChrysler shares. Nevertheless, the largest group immediately after the merger was by far American investors owning approximately 44% of the outstanding stock, compared to about 37% German-owned shares. Subsequently, US ownership declined to about 25% (Ball 1999). However, the most important sequence from the merger has been the

334 Deutsche Bank, who also faced a performance decline at the time, arguably benefited from Daimler's restructuring and increased profitability. See Logue and Seward (1999: 93). The bank’s attitude also signifies the change in relationships between financial and non-financial firms that has been occurring in Germany.

335 The NYSE listing can also be seen in the context of Deutsche Bank wanting to dispose its shareholding in Daimler.
dilution and globalisation of share ownership. For instance, Deutsche Bank’s stake in DaimlerChrysler is now a mere 13% with the remaining shares being distributed among numerous foreign and domestic investors. In sum, the company that has emerged from the merger with its multiple listings in New York, London and Frankfurt constitutes a significant departure from the German-style stable and passive ownership patterns towards a more uncommitted and return-on-equity oriented shareholder structure.

On the other hand, even if the German corporate establishment’s attitudes have not been transformed completely so as to have a wave of hostile acquisitions, foreign predators may fill the gap. In the past, foreign companies have found it difficult to launch an unsolicited offer for a German listed company. To see such an attempt ending within a couple of months with success for the bidder would have been unthinkable. Vodafone’s bid for Mannesmann in October 1999, however, was to change all this. Not only was it the first time a foreign company’s hostile takeover bid for a German listed firm ended successfully, but also the target was one of Germany’s largest and best performing conglomerate firms based in the “heart of German capitalism”, Nordrhein-Westphalen, home of the most important companies in the steel industry such as Krupp-Thyssen. Consequently, the whole affair deserves particular attention as the most significant evidence of the global market for corporate control’s impact in Germany.

Before Vodafone’s bid, Mannesmann, had been in the process of restructuring by splitting its unprofitable steel operations from its highly successful fixed-line and mobile telecommunications services and focusing on the latter. This strategy, however, gave rise to the possibility of the company becoming a takeover target since

336 This is exemplified by Pirelli’s bid for Continental, which not only lasted for two and a half years but also ended unsuccessfully. See supra. note 333.
a potential buyer could spin off operations with low short-term returns more easily (Barber 1999a). A global issue in 1998 of 20.7 million new shares, 48.4 percent of which was absorbed by non-German investors, was also significant, as it contributed to the global dispersion of the company’s shareholdings. Subsequently, Mannesmann acquired the British mobile operator Orange in spite of CEO Klaus Esser’s public statement that he would “not be bound in any decisions by consideration of whether they leave [the company] more vulnerable” (ibid.). Obviously, Esser was aware of the possibility of a hostile takeover attempt for his company – Vodafone being the main potential bidder at the time - and thus hoped that the deal with Orange would serve as poison pill for anyone who would try to acquire Mannesmann, since it would trigger EU competition and German company law rules (Rivlin et al. 1999; Financial Times 1999a; Barber 1999a; Hüpner and Jackson 2001).

All this, however, was not sufficient to inhibit Vodafone. On the contrary, the Orange purchase was perceived as an aggressive move against it within its home market. In response, and after the failure of negotiations for a friendly takeover, Vodafone launched an €119 billion all-share offer for the German group. Esser rejected the offer as “weak and extremely risky for [Mannesmann’s] shareholders” (Larsen 1999) and began a defensive campaign. The reactions from politicians as well as employee representatives were immediate and critical of Vodafone’s move. IG Metall, Germany’s most powerful union, mobilised the workforce through its representative on Mannesmann’s Aufsichtsrat but did not call for a strike, while Wolfgang Clement, State Prime Minister, and the German Chancellor Schröder were dismayed. The latter declared that hostile bids destroy the culture of the target

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337 Therefore, Vodafone’s takeover of Mannesmann can be regarded as a defensive acquisition of a competitor; see section 2.4.2 above.
338 In December 1999 a group of minority shareholders led by Adreas Dimke, a lawyer in Hamburg, filed a lawsuit against Mannesmann’s management claiming that its defensive tactics were prejudicial to shareholders’ interests.
company and that hostile bidders "underestimate the virtue of co-determination" (Larsen et al. 1999). Nevertheless, they did nothing to block the bid. The fate of the largest hostile bid in history was to be decided solely by shareholders. For Germany this was perceived as a breakthrough point, especially when Schröder’s interference in the battle between Krupp and Thyssen two years earlier, when he was state prime minister, is taken into account. The relatively muted response from the political, industrial, labour and financial circles was indicative that within just two years a significant change in mentality and attitude towards shareholder supremacy had occurred.

Thus, on February 3, 2000, Esser gave in under the pressure from the majority of Mannesmann’s shareholders (Handelsblatt Interactiv 1999k) and eventually agreed to the takeover after a slight improvement in Vodafone’s offer.339 A significant factor for the final result of the bid was Mannesmann’s ownership structure. Not only were shareholders dispersed – the largest blockholder owned 10% of the shares - but also 62% of them were foreign. Most significantly about 40% of them were American or British as opposed to a 39% of German shareholders. Nevertheless, even the latter, most of whom were institutional investors, were not supportive of Esser and his management team’s effort to oppose the takeover, as they had begun dumping their shares on the market even before the final agreement was reached (Boland et al. 2000).

It could be argued that Mannesmann finally “paid” for the shareholder value orientation it followed, since by separating its profitable telecommunications business from the seamless steel pipes and tubes activities in order, to use Esser’s words, to

339 According to the original offer, Mannesmann’s shareholders would receive 47.2% of the shares in the merged entity. Esser agreed after Vodafone raised its offer by an additional 2.3% and agreed to retain the fixed-line operations. See Handelsblatt Interactiv (2000c).
“create value for the shareholders”\textsuperscript{340} it became a takeover target. It also paid for the decision to base its expansion upon funds raised in stock markets at home and abroad. In addition, the acquisition of Orange, a company with dispersed foreign shareholders, contributed even further to the globalisation of Mannesmann’s shareholder base. In general, the Vodafone-Mannesmann affair serves as a prime illustration of how the opportunities and challenges of globalisation can translate into change in national corporate governance systems. It is plausible to suggest that the Vodafone-Mannesmann takeover will not be the last one. As German companies increasingly resort to the national and foreign capital markets, incidents similar to the Mannesmann or even the Thyssen-Krupp takeover are bound to reoccur.

However, the battle has not been decisively won in favour of shareholder supremacy. On the one hand the elimination of voting rights defences by the KonTraG, the adoption of more transparent accounting standards, the changing role of banks and the abolition of capital gains tax constitute important institutional changes that expose managers to the market for corporate control. On the other hand, however, the new \textit{Übernahmegesetz}, mainly a response to the Vodafone-Mannesmann takeover, reveals that the forces of path dependence in the area of takeovers in Germany are still strong. In other words, even though micro-interference by the government is diminishing, typical \textit{Soziale Marktwirtschaft}-type protective macro-coordination has now been introduced.

Therefore, it seems that, as regards the future occurrence of hostile takeovers in Germany, a lot will depend on the structure, identity and influence of shareholders, foreign and domestic. The most important developments in this respect are the gradual liquidation of cross-shareholdings and the institutionalisation of listed shares,

\footnote{\textsuperscript{340} Cited in Barder (1999a).}
which signify the replacement of traditional patient shareholdings by more return-on-equity oriented ones. Combined with the diminishing support of banks for managers, if these developments continue, they may even counterbalance the managerialist effect of the Übernahmegesetz. The changing attitudes of shareholders in German companies and the role of the stock market in transmitting their expectations to managers are discussed next.

3.8.3. Rising Significance of the Stock Market as a Channel of Direct and Indirect Shareholder Influence

Despite the fact that the number of listed companies in Germany is still relatively small compared to the US or the UK, the number of initial public offerings (IPOs) has shown a dramatic increase in the past two years. While in 1997 there were merely 33 IPOs, in 1998 the total was 78, while there were 86 during the first half of 1999 alone (DAI 1999). According to DAI’s estimates, some 1,500 German firms could go public in the near future (Rosen 1999).341 The Neuer Markt’s contribution is of great significance. While the total number of companies listed there was 41 in 1998, by July 1999 listings had trebled reaching 124 (Deutsche Börse Group 1999: 25; Handelsblatt Interactiv 1999d). The mere fact that small and medium-sized German companies are willing to comply with the stricter disclosure rules342 in the Neuer Markt is evidence of the changing perceptions among managers towards outside-shareholder interests.

341 Although the recent collapse in world markets has definitely had a significant effect on these estimates.
342 Companies listed on this market are required to prepare their financial statements on a quarterly basis and in accordance with the IAS, the US GAAP, or the German GAAP with reconciliation.
German listings on foreign stock markets are still relatively few but they comprise companies with major influence such as Deutsche Bank, Daimler-Benz, Allianz, Deutsche Telecom, Hoechst and Siemens.\(^{343}\) It appears that those companies that decide to expand their international activities and achieve the status of a global company need to list their shares on a major (Anglo-American) stock market and exploit the broader investor base and larger liquidity available therein. Such a move, however, entails two major implications. The first is the adoption of financial reporting and disclosure standards that are required in those markets. This is particularly the case in the NYSE where all firms have to adopt the US-GAAP with the already discussed consequences for managerial discretion. The second implication is that companies listed on Anglo-American stock markets have to adapt to the demands of the investor communities therein mainly comprised of institutional investors (see Tables 3.1 and 3.2 above). For instance, the large gap between the 12.8% average return on equity of German companies and the 23.2% of their US competitors (see Figure 3.9 below) creates significant pressures on the former to focus more on current shareholder value creation. The following quote illustrates this:

One of the largest investment houses in the world. The displaying board in the waiting area shows tightly organised appointments: “ten o’clock Schering, eleven o’clock Karstandt, twelve o’clock BASF”. Like schoolboys, the finance directors of the powerful German companies wait for their turn. In the analysts’ department one hour of embarrassing interrogation begins. The young investment experts, often not more that 30 years old, know no respect for the company bosses; they only know about return on capital: “Your division xy only brings 6 percent. Why did they not get rid of that a long time ago?” The cross-examination lasts exactly one hour. Then the finance director is dismissed. He has not even reached the door when the analyst turns to the

\(^{343}\) Deutsche Bank, Veba, Daimler-Benz, DaimlerChrysler, Deutsche Telekom, Adidas, Fresenius Medical Care, Hoechst, Pfeiffer Vacuum Technology, SAP, SGL Carbon, RWE (ADRs) are already listed in NYSE, whereas Siemens, BASF, Schering and Allianz intend to list in the near future. The German companies listed on the London Stock Exchange are Allianz, BASF, Bayer, Commerzbank, Deutsche Bank, Hoechst, Schering, Siemens, ThyssenKrupp, Volkswagen.

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investment banker in the corner and dictates his decision: "Alright, we buy $30 million of Schering shares today." (Wetzel 1997, author's translation)

Furthermore, the infiltration of shareholder supremacy in German decision-making does not result only from foreign listings. The influx of foreign investors into the German stock market, with US and UK institutions counting for over 70% of the foreign funds invested in 1999, also has an impact on managerial values (Table 3.11). As early as in 1993 about 40% of traded shares in German companies were owned by foreigners and this has continued to rise (Financial Times 1993). Cross-border M&As such as the merger of Daimler with Chrysler and the takeover of Mannesmann by Vodafone also contribute to the globalisation of shareholdings.

This does not mean that foreign (institutional) investors have already become major players in German corporate governance. Their holdings are usually too small to effect any direct changes and most of them follow passive indexing strategies. However, some foreign institutional investors such as the California Public Employees Retirement System (CalPERS), who are known for their activist policies in their countries, have already had an effect in Germany. As the first incident of foreign shareholder activism Bendt (1998) identifies CalPERS' proposal at RWE's annual general meeting in 1992 for the abolition of the multiple voting rights owned by German local authorities.344 Wenger and Kaserer (1997) also report that corporate failures in Germany have also generated criticism from Anglo-American investors who have threatened to withdraw their funds unless German companies improved their internal and external controls.

344 See also Waller and Dickson (1992).
### Table 3.11. Total Investments in German Equities in DM Billion.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Foreign Investments</th>
<th>UK Investments</th>
<th>US Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Purchases</td>
<td>Sales</td>
<td>Balance</td>
</tr>
<tr>
<td>1988</td>
<td>53.9</td>
<td>48.3</td>
<td>5.6</td>
</tr>
<tr>
<td>1991</td>
<td>86</td>
<td>82.9</td>
<td>3.1</td>
</tr>
<tr>
<td>1993</td>
<td>171.3</td>
<td>162.7</td>
<td>8.6</td>
</tr>
<tr>
<td>1994</td>
<td>167</td>
<td>165.7</td>
<td>1.3</td>
</tr>
<tr>
<td>1995</td>
<td>160.9</td>
<td>162.6</td>
<td>-1.7</td>
</tr>
<tr>
<td>1996</td>
<td>237.6</td>
<td>215.5</td>
<td>22.1</td>
</tr>
<tr>
<td>1997</td>
<td>385.5</td>
<td>358</td>
<td>27.5</td>
</tr>
<tr>
<td>1998</td>
<td>652.1</td>
<td>554.9</td>
<td>97.2</td>
</tr>
</tbody>
</table>

*Source: Deutsche Bundesbank (1999c).*

In 1996, having seen the positive results of its governance strategy at home, CalPERS decided to gradually expand its activism in foreign companies too. Thus, it formulated specific corporate governance principles that should be followed by companies in a number of countries, one of which is Germany (CalPERS 1996). Other American investors have also attempted to intervene from time to time (André 1998: 73). However, the CalPERS initiative is the first systematic effort to steer established board practices in German companies in order to promote shareholder supremacy. It has already started publishing target-lists of German companies with governance standards that do not satisfy its principles. Most importantly, it appears that the US pension fund intends to co-operate with domestic shareholder associations and activists. It is not coincidental that in Principle 2 of its International Governance Policy CalPERS calls for German companies to adopt and support the corporate governance recommendations of the German shareholder association DSW which ask for improvements in the Aufsichtsrat and the General Meeting auditors' independence, transparency in banks' proxy voting, and focus on shareholder

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345 Other major countries targeted by CalPERS include Japan, France and the UK.
Indeed, it was with the help of this particular shareholder association and other local shareholders that CalPERS finally effected the adoption of the one share-one vote principle in RWE (Atkins 1998).

This, mainly imported, phenomenon of shareholder activism is gradually gaining momentum even amongst domestic investors. There have, of course, been voices for increased shareholder protection and influence before CalPERS’ systematic involvement. For instance, Professor Ekkerhart Wegner of Würzburg Universität has been a critic of German corporate governance and an activist on several occasions during the 1990s. However, with the exception of DSW, such incidents were isolated and constituted evidence of minority shareholders’ aggravation rather than a systematic campaign of outside shareholders to change corporate governance in Germany. Nonetheless, more recently the shareholder movement appears to also involve large investors such as the DWS, Deutsche Bank’s powerful mutual fund, which in January 2000 commissioned the creation of a ranking list for German blue chip firms based on their corporate governance record (Davis Global Advisors 2000). The main criteria were quality of disclosure, extent of performance-linked remuneration, Aufsichtsräte quality and minority shareholder rights. This initiative constitutes a breakthrough for shareholder activism in Germany as it is the first time a target list is formulated domestically and it is also backed by the largest mutual fund in Germany with assets of DM87 billion. The list is used by DWS and other investors or shareholders’ associations as a guide for their investment and targeting strategies.

346 See www.das-wertpapier.de.

347 He is a member of Verein zur Förderung der Aktionärsdemokratie (VFA), an association of small shareholders which in 1996 filed a law suit against Daimler’s management for incorrect presentation of the company’s situation at the 1995 General Meeting. He has also brought an action in the same year against Deutsche Bank seeking the disclosure of the bank’s hidden reserves See Wenger and Kaserer (1997).
The role of Anglo-American institutional investors in this movement of shareholder activism that is slowly beginning to challenge company boardrooms in Germany is clear. It is not only the direct involvement of institutions, such as CalPERS, that has set the German corporate governance agenda for the near future. It is also their indirect influence, as German institutional investors and shareholder associations have begun to adopt policies and methods that some Anglo-American institutions have been following since the beginning of the 1990s in the UK and the US. Most importantly, the channels of co-operation between domestic and international activists that are gradually being established will be important drivers of change in corporate Germany.

3.8.4. Managers’ Response and the Development of the Shareholder Value Concept in Germany

The preceding discussion examined how the new (global) economic circumstances have been affecting the institutional environment and through that the position of managers as controllers of Germany’s largest and most influential corporations. While some formal path dependent institutions such as codetermination and takeover regulation have remained rigid, evidence was also provided showing that banks are distancing themselves from the old cosy relationships with their industrial clients, thus exposing company managers to external market pressures. Simultaneously, international and domestic shareholder activists have begun demanding an enhanced role in corporate governance in order to maximise their investment returns and minimise their risks. Therefore, the question that arises is what
the managers’ response has been to these changes in the institutional context of corporate decision-making? That is, have they started accommodating shareholders’ interests in their decision-making to a greater extent than in the past by focusing more on maximising shareholder value as opposed to balancing stakeholder interests?

The first observation that can be made is that the same conflict that arose in hostile bids with traditional business practice has also been present during the incorporation of the shareholder value concept in German corporate governance. Of course, in a hostile takeover the impact on the target company and its workforce is usually much more drastic and immediate than where there is a gradual re-orientation of business strategy. Even the decision by a “core” company, such as Daimler-Benz, to focus on shareholder value could not attract the same immediate attention of the public as a hostile bid for Thyssen or Mannesman and lead to government intervention. Nonetheless, in the long run the departure from long-established, consensus-based practice can have significant effects on different stakeholders; clearly, the adoption of shareholder value is a process of re-balancing intra-firm interests in favour of current shareholders. Thus, as the concept of shareholder value had begun to take root during the first half of the 1990s, with a number of companies embracing it as a benchmark for their strategies,\(^{348}\) by 1996 criticism by labour representatives (Munchau 1997), the press,\(^{349}\) academia,\(^{350}\) but also by some reluctant

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\(^{348}\) Daimler-Benz, Veba and Hoechst were the pioneers. Until 1995, they had all undertaken large restructuring programmes aiming for the maximisation of shareholder value. Many others followed and begun to see the first results in their share yields, which were higher than those of companies that did not embrace shareholder value. See Price Waterhouse (1997).

\(^{349}\) See Munchau (1996) and Financial Times (1996) emphasising the conflict between shareholder value and the interests of the workforce and the society at large.

\(^{350}\) See Werder (1998) for a critical view of the shareholder value concept questioning even its admissibility under German law.
senior managers, begun to intensify. The real impact of these reactions, however, is not very clear.

The case of Daimler is indicative. After its listing on the NYSE in 1993, Daimler-Benz officially announced its commitment to the principle of shareholder value maximisation. Under the guidance of a new Vorstand chairman, Jürgen Schrempp, the company gradually cut thousands of jobs worldwide, 80,000 of which were in Germany, and transformed itself into a “technology” group by divesting its non-core activities (Logue and Seward 2000). However, the criticism by the workforce, who also had the support of the press, was so severe that Daimler had to reconsider its new focus and Schrempp had to announce that the term shareholder value would not be used by the company in Germany but would be replaced by the more moderate “company value” (Werder 1998: 69). Nonetheless, under Schrempp Daimler-Benz continued to focus on shareholder value maximisation, according to White and Coleman’s (1998) report, as the merger with Chrysler was being finalised the “company value” pretence was dropped with the implementation of $3 billion cost savings involving a contraction of total employment in order to boost the share price.

Thus, despite some initial criticisms, DaimlerChrysler as well as an increasing number of German firms have continued to implement and expand their shareholder value-oriented policies even if they come under the term “corporate” or “enterprise value” instead (Vitols 2000; Jürgens et al. 2000). This is shown by the continuation of extensive restructuring programmes involving spin-offs of businesses and layoffs (Economist 1998: 63), the commitment to higher disclosure standards with the adoption of the US GAAP or the IAS.

Note for instance Hermann Franz, Siemens' Aufsichtsrat chairman, who commented: “All you need to do is announce that you make 20,000 workers redundant and your share price will go up” (author’s translation) cited in Werder (1998: 70).
Many recently implemented legal changes concerning voting, corporate disclosure, accounting, executive compensation, capital gains tax and so on have certainly facilitated the adoption of a shareholder value orientation by German companies. For instance, in the previous section it was mentioned that extensive share buy-back programmes and an increasing number of executive stock option plans have been adopted since the KonTraG came into force. The amendments to the law governing financial statements have also had an important impact on corporate governance culture. Thus, while in 1993 the adoption of the US GAAP by Daimler Benz was perceived as an “unpatriotic betrayal” of German corporate culture (Riley 1993), such a move by a company is now welcomed as a positive move towards transparency. Moreover, most listed companies have now become more active in enhancing their relations with global investors by publishing their annual reports in English, and by organising international road shows or private meetings with investor representatives, analysts and journalists.

Thus, it now seems that, despite some initial setbacks, the principle of shareholder value is gaining wider acceptance by managers in Germany. Indeed, Figure 3.9 reveals an identifiable reorientation of managerial goals with return-on-equity maximisation gradually becoming a basic benchmark for company performance and a tendency towards convergence to US return-on-equity levels. Even companies like Siemens, that until very recently were categorically opposed to the concept of shareholder value,352 have now embraced it as a rule of thumb. Europe’s largest electronics group realised that its planned listing on the NYSE would

352 See Hermann Franz’s comment, ibid.
not materialise unless a restructuring program aiming to increase shareholder value was implemented (*Handelblatt Interactiv* 1999c).\(^{353}\)

**Figure 3.9. Return on Equity and Capital in US and German Companies, 1993-1995.**

![Figure 3.9](image)

*Source: Berdt (1998), Figure 4.*

Nevertheless, this is still the beginning since German companies still lag behind their US and British counterparts in maximising value for their shareholders. Certainly, some firms, e.g. Deutsche Telecom, have already distributed payouts as much as 84% of their profits, but this practice is by no means universal (*Handelsblatt Interactiv* 1998b). It is indicative that in 1998 only 7 of the DAX 100 firms had implemented the shareholder value concept to strategic business areas (*Handelsblatt Interactiv* 1998a). This is because the full implementation of the concept below *Vorstand* level is a time-consuming process involving sweeping changes in corporate culture at all levels. This is exposed by the still relatively small number of firms worldwide that have fully implemented such policies (*ibid*). It seems that micro-level path dependence dynamics should not be overlooked when examining corporate governance change.

\(^{353}\) The intensified pressure from shareholders was also an important factor; see *Handelsblatt Interactiv* (1999b).
However, the fact that managers of "core" German corporations have begun to refocus their decision-making process by increasingly attributing shareholder interests a paramount importance over other stakeholders can by no means be ignored. It is simultaneously a cause and an effect of the macro-level institutional changes described in the preceding sections, which seem to have created an evolutionary trajectory away from the traditional consensus based governance practice despite the rigidity of codetermination and takeover laws. It seems that it is this reorientation of managerial objectives that drives the functional changes undermining formal industrial relations institutions as described in section 3.5 above. This in itself reveals a workability problem emerging in the German corporate governance system, which is also evidenced by the increasing unemployment and the persistent economic slowdown since the 1990s.

3.9. CONCLUSIONS AND PREDICTIONS FOR THE FUTURE

This chapter has examined the interaction between the forces of global isomorphism and German corporate governance institutions. It was shown that, while in the outsider models of the UK and the US the institutionalisation of shareholder supremacy took place relatively early, the equivalent process in the German insider system has proved slower and more cumbersome.

Firstly, it was shown that the most radical changes so far have taken place within the financial system as the role of securities markets in the mobilisation of savings has been gaining importance over the past two decades. As the liberalisation of capital controls progressed after the demise of the Bretton Woods exchange rate
regime, the interaction between domestic and foreign financial markets through regulatory arbitrage created a need for the gradual deregulation and reregulation of the German financial system according to a more market-oriented model. Simultaneously, increasing pressures on the German pension system, not least due to high unemployment, have also stimulated investment by households in securities either directly or indirectly through institutional investors in order to face the uncertainties of future retirement. Significantly, institutional control of financial assets also implies a change in equity ownership, though at a slow pace, with institutional investors gaining more influence as owners of stock. Certainly, this process is still in its early stages, but imminent pension reforms are bound to have a more visible effect. Another significant factor bringing shareholder structure changes has been the abolition of the capital gains tax, a measure that used to be an enormous obstacle to the liquidation of large shareholdings.

Simultaneous to the development of securities markets have also been legal reforms aiming for the enhancement of outside investor protection. These have given the German system a more outside-shareholder orientation since, by increasing information flows towards market investors, they aim at constraining the ability of insiders to extract private benefits. Moreover, they have removed legal obstacles for current shareholder value maximisation tools such as share repurchases and ESOP awards to managers. These legal changes have followed and been followed by functional transformations resulting from financial and non-financial firms' efforts to meet the challenges and exploit the opportunities of financial globalisation. Overall, vertically complementary legal and non-legal institutional changes have been undoing parts of the system that supported German managerialism by opening up corporate governance to outside shareholder influence either directly or via the national market
and global for corporate control. The Krupp-Thyssen and Vodafone-Mannesmann takeovers are clear illustrations of this.

However, the institutional reaction to the latter affair also demonstrates that path dependence forces have also been very strong within parts of the German system as they have resulted in a regulatory backlash with the enactment of the Übernahmegesetz. Similarly, legal industrial relations institutions have not only withstood pressure, but have even been strengthened by the BetrVerfReformgesetz, despite significant functional changes, such as the adoption of global production strategies by large employers and the contraction of the workforce covered by collective agreements and works councils. This conforms only with the first part of Coffee’s argument that if global convergence to an outside shareholder system of corporate governance can take place, it will begin from changes in “technically” securities regulation institutions and not from less technical ones that have immediately visible repercussions for the vested interests of labour or managers. But just as it was predicted in section 2.4.2, complementarities between different sub-systems can prevent full convergence even in the sphere of securities regulation, so that cumulative change stops short of producing a new workable system; the decisive factor is how complex institutional interactions resolve themselves each time.

Thus, the issue that arises is whether the transformations that have already taken place are sufficient to sustain a cumulative causation process of systemic change that will push the German corporate governance system away from its traditional managerialist path by establishing shareholder supremacy or another less workable model. As already explained, the outcome will depend on the nature of interactions between the remaining old institutions that have been supporting the stakeholder consensus in German managerialism and those newly implemented
enhancing the role of outsiders. The critical issue is whether the consensus between stakeholders within and outside the firm, two levels that are closely connected in Germany, remains intact as the backbone of corporate governance. If that breaks down because one particular constituency such as the shareholders is in a better position to enforce its objectives, according to the workability concept, complementary adaptation in labour markets will be needed. If the latter does not take place, Germany will end up with an unworkable hybrid system.

To some extent this chapter has provided evidence showing that, following the reorientation of institutional incentives, there is a redefinition of managerial objectives which leads to the erosion of the stakeholder consensus that characterised German managerialism in the past. Shareholder value has already gained some acceptance within large corporations as a reflection of significant changes in managerial constraints enhancing the position of outside shareholders. Moreover, there have been signs of a simultaneous degeneration of commitment in industrial relations from the employers' side. On the other hand, formal labour market institutions have been maintained and strengthened, albeit with a *de facto* diminishing scope. The combined effect has been high levels of unemployment and a division within labour between those with a (protected) job and those without one, at a time when the ability of government to compensate the latter is limited. Macro-economic growth and current account surpluses - or rather the lack of them - cannot compensate for unemployment as they did during the post-war era. Resulting aggregate demand problems further intensify the pressures on German managerialism and complete the vicious circle of slow growth which can only be broken by increasing reliance on foreign effective demand - something that is problematic since markets for German exports already seem saturated. In sum, these are signs that
recent changes triggered by globalisation have a negative effect on the German system's workability. If the globalisation process continues in its current form and the unemployment problem persists or intensifies, the long-term result may be that the adaptation costs even of path dependent institutions will decrease so that further moves towards the outside shareholder system can be anticipated. Whether this happens or not, the German corporate governance system as that was described in section 3.4, cannot work in the context of a globalising world economy; a conclusion that is consistent with the prediction of this thesis that globalisation undermines the sustainability of managerialism.
CHAPTER 4
CONCLUSIONS

The aim of this thesis has been to follow the evolution of corporate governance in the manager-controlled firm within the context of the current economic globalisation wave. After an extensive overview of the most influential theories developed to explain the nature of the firm it was argued that two competing visions of the corporation emerge: one that is based on the shareholder supremacy principle and that gives the corporation no real existence separate from its shareholders, and another that relies on managerial discretion as a tool for pursuing the corporate interest which cannot be identified with the interests of any particular stakeholder type. The former vision largely relies on justifications provided by neoclassical economic theory, while the latter draws on the institutionalist critique that models based on perfect markets assumptions are unable to provide any realistic conclusions about economic coordination. It is due to this lack of realism in neoclassical theory that this thesis has adopted the institutionalist methodology for the analysis of corporate governance by allowing the existence of market imperfections and transaction costs.

In section 1.4 a corporate governance system was conceived as the nexus of institutions determining the policy choices of those vested with the corporate control function. It was also argued that each particular system is characterised by a whole web of institutional forces the resultant of which determines the nature of corporate governance. It was then attempted to place the two visions of the corporation within their institutional contexts as static constellations of institutions shaping corporate decision-making. The aim of this “comparative statics” analysis was to investigate
how institutions determine corporate governance according to the shareholder supremacy or the managerialist ideal. Firstly, it was argued that, while company law through its basic doctrines could have easily ascertained the nature of the firm according to each of the two visions, it is so flexibly designed that where share-ownership and control are *de facto* separated it becomes indeterminate. Thus, a broader approach was adopted with the identification of three general component sub-systems of institutional constraints comprising each corporate governance system: the financial system, the industrial relations system and macroeconomic and competition policy institutions. It was argued that, given extensive vertical and horizontal complementarities within and between sub-systems, where the link between share-ownership and control does not exist two workable but not perfectly efficient systemic equilibria emerge corresponding to the two visions of the corporation.

In the first, the institutional framework emphasises market transactions by promoting the externalisation of corporate functions, such as corporate finance, human resources planning and competition, and tends to align managerial decision-making to the interests of shareholders mainly through the market for corporate control. In the second workable equilibrium there is a tendency towards the internalisation of corporate functions by the corporate organisation with enhanced managerial discretion being a crucial element for the sustainability of this sort of coordination. The crucial difference between these two institutional equilibria, i.e. the shareholder-oriented and the managerial, is that the former emphasises lack of commitment between stakeholders and exit from corporate relationships, whereas the latter relies on stakeholder commitment and voice. It is due to this difference that the managerial paradigm is more susceptible to price competition which involves cost-cuttings that may affect stakeholder relationships and therefore more reliant on stable
but relatively high macroeconomic growth rates and effective demand. The shareholder-oriented model, on the other hand, is more flexible and therefore less vulnerable to cost-based competition or adverse demand conditions. A central hypothesis of this project was that this fundamental difference between the two systems is a decisive factor behind their ability to survive within the current context of economic globalisation.

As chapter 2 argued, since the demise of the Bretton Woods system of fixed exchange rates and the subsequent abolition of capital movements restrictions, the world economy entered a process of gradual integration, especially in foreign exchange and short-term financial markets. This was combined with the lack of trade flows coordination, a relic of the post-war trade liberalisation regime under GATT. The result has been an overall increase of market forces as the medium of the world economy's coordination. Certainly, Chicago School economics would welcome this development and ask for further removals of government sponsored economic coordination institutions which it tends to regard as elements distorting the smooth operation of the market. However, once the reality of imperfect markets is acknowledged, the globalisation process as it has been evolving in recent years leads to increased economic instability due to recurrent imbalances and to slower economic growth. Resulting redefinition of opportunities and challenges as perceived by economic agents have an equivalent effect on stakeholder relationships that were established during the pre-globalisation golden age years of high growth and full employment. The gradual removal of economic barriers has brought national corporate governance systems in competition with each other with increasing emphasis being placed on cost-reductions and short-term investments due to slower
growth of aggregate demand and increased volatility. As it was mentioned above, this has a negative impact on the workability of managerial models.

Consequently, as the globalisation process continues, growth-oriented and demand-dependent managerial systems are subjected to increasing pressures to accommodate the new competitive challenges by redesigning important institutional configurations in a more flexible manner across national systems. This flexibility is antithetical to stakeholder commitment and the internalisation of corporate functions. Thus, adaptation to globalisation forces implies a trend towards a corporate governance model that resembles the Jensenian nexus-of-contracts paradigm where the firm is regarded as nothing more than a market. Competition in world markets may be gradually giving rise to a process of global isomorphism which forces national systems to adopt common institutions which seek to entrench the shareholder supremacy principle not because it is the most efficient solution but simply due to the more flexible character of the Jensenian model and the increased bargaining power of uncommitted outside shareholders and investors in general. The dilemma between high employment with low wages and low employment with high wages—especially for those with low skills—undermines the ability of labour to counterbalance power differentials that tend to favour capital. The main factor contributing to this is that while financial or factor capital is becoming increasingly mobile across national borders, labour remains geographically fixed. As a result, the more systems converge towards a shareholder-oriented model, the higher the ability of shareholders to expropriate employees' investments. That is, capital mobility renders labour the main adaptation cost bearer.

Nonetheless, while these pressures on corporate governance systems are real and often rather intense, different national systems do not necessarily adapt in the
same manner or to the same extent due to differences in their internal dynamics. Diverse institutional complementarities lead to differences in the allocation of adaptation costs and thus give a national “flavour” to the forces of global isomorphism. That is, cumulative causation cycles of institutional change differ both in scale and in scope depending on the balance between forces of path dependence and change transmitted through institutional complementarities within each system. As a result, complete convergence of corporate governance systems towards the same shareholder model, as a global choice cannot be guaranteed at least in the near future. In the meantime, provided the globalisation process continues in its current form, it is more realistic to expect that some national systems will converge more and others less, with changes in less path dependent areas such as financial markets and securities regulation taking precedence. However, due to workability problems even those systems that do not completely transform will probably have to face the dilemma of further adaptation towards what is perceived as global practice or of persistent underperformance. Where the general negative welfare effects of workability problems exceed the costs arising from the uncertain consequences of further systemic adaptation, convergence should be expected to progress. Ironically, this implies that those systems that are characterised by the highest levels of adaptive efficiency will be the first ones to converge towards a less efficient model of slow growth and unbalanced economic development.

In order to assess the validity of these insights, in chapter 3 the German system of corporate governance was used as a case study. The analysis of institutional arrangements influencing corporate decision-making revealed that, at least until the 1980s, managers of large German corporations have enjoyed considerable discretion. Moreover, numerous constraints, especially board representation and labour market
institutions, have been supporting a consensus between stakeholders, such as banks, shareholders, employees and affiliated firms, which has been the driving force behind managers' motivation to pursue the corporate interest. Generally, the German corporate governance system has been based on the element of commitment between stakeholders who have been forming inside relationships with the corporation. This important role of insiders is what makes German corporate governance particularly interesting as a subject matter, since it means that systemic adaptation to an outside-shareholder model should be more complicated than it would be for outsider-managerial models. Indeed, while in outsider systems such as those in the UK and the US shareholder supremacy became the dominant governance norm since about the mid 1980s, in Germany institutional adaptation has been taking longer as it has to go through more stages.

The first pressures from global isomorphism on the German system occurred in the area of monetary policy as a result of increased capital flows, which then spread to the financial system giving it a more market-oriented character with securities markets gaining significance as intermediated credit became a smaller source of corporate finance for large firms. Subsequent reregulation efforts and gradual redefinition of financial relationships between banks and industry seeking to endure increasing competition and exploit the opportunities of globalisation have been mutually reinforcing in altering the constraints on managerial decision-making and in enhancing the governance role of outsiders vis-à-vis insiders. While the lack of liquid US-style shareholdings still remains a general characteristic of the German system, some firms, especially those pursuing globalisation strategies have been detaching themselves from this norm and have become subjected to increasing pressures to focus on current shareholder value maximisation. The Vodafone-
Mannesmann takeover and Daimler Benz’ restructuring are the clearest indications of the impact of institutional changes during the 1990s.

On the other hand, there has also been significant evidence of path dependence forces in some legal institutions as the recently implemented Übernahmegesetz has revealed. Similarly, codetermination institutions have remained rigid. However, their scope in terms of employee coverage has been decreasing as have collective agreements, since in recent years the number of employers and employees participating in bargaining processes has been declining. In other words, functional change has been undermining those legal institutions which support codetermination. German firms facing increasing price-based competition from abroad have had to resort to extensive labour cost-cuttings while they have simultaneously been resorting to cost-driven FDI strategies. Resulting record levels of unemployment significantly affect the bargaining position of labour, especially those possessing low skills, while recent industrial disputes may constitute an indication that the capital-labour consensus, the backbone of the Soziale Marktwirtschaft, may be giving way to more adversarial industrial relations. So long as unemployment remains high, foreign and domestic demand low and therefore growth subdued, the German system is bound to face increasing pressures for further reform aiming for more flexibility in industrial relations. All this constitutes evidence that there are already workability problems between corporate governance subsystems that used to support Germany’s managerialist model.

Generally, the empirical evidence and theoretical insights presented and analysed in this thesis reveal that, while globalisation continues, there is an increasing need for more governance on a supra-national level. International organisations, such as those instituted by the Bretton Woods agreement, could become the main vehicles
for such governance. However, prior to that they would have to be reformed and democratised, because currently powerful nations use their global influence to turn them into their tools of global dominance.

Ironically, as the most influential nations that endorse the IMF’s and the World Bank’s operations seek to enhance their international role, they promote the globalisation process as one that is based on the discipline of unconstrained markets, which itself implies a loss of influence for the nation state. Perhaps this is reflected in the recent re-emergence of US and European protectionism as a threat to the liberal world economic order that was being formed during the past three decades or so (Thornton 2002). Though minor transatlantic trade wars have not been uncommon in the past, for many decades the world had not seen such controversial measures as the imposition of tariffs up to 30 percent on European and Asian steel products imported in the US. Unmanaged trade liberalization seems to be the cause of this as it has given rise to the enormous US trade deficits against major competitors. However, 20th century history teaches us that protectionism can be as catastrophic as the inability of free markets to establish “spontaneous orders”; two phenomena that are causally linked. The world felt the consequences of the former after the Great Depression that followed the first globalisation wave. It seems that the global consequences of the latter are also obvious now after the burst of the US “bubble” in 2001 and the series of corporate scandals that it exposed. Enron’s collapse is not just a failure of a formerly successful corporate giant. As Bratton (2002) argues, this landmark event for US and global capitalism is the collapse of a company that had shareholder value maximization embedded in its structure as it had adopted the Jensenian view that firms are fictitious entities that are no different than markets.
Keynes lived long enough to see his economics becoming at least partially implemented after World War II in a successful, though not flawless, plan for an international economic order based on cooperation between nations rather than on unmanaged competition. Tobin, on the other hand, irrespectively of whether his more moderate proposals for a tax on speculative capital flows are a realistic solution to the current problems or not, died this year with his economics still being generally regarded as the "economics of dissent".

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