

# The Comeback of *Modell Deutschland*? The New German Political Economy in the EU

RICHARD DEEG

*Since the early 1990s four institutional weaknesses have taken turns as the popular ‘whipping boy’ for Germany’s economic ills: a backward-oriented, bank-dominated financial system; an insider-dominated corporate governance system; rigid labor markets and inflexible unions; and an overly expensive welfare system. This paper surveys a wide range of the reforms that have been undertaken to redress these weaknesses. While there is still a clear need for further labor market and especially welfare state reforms, Germany’s institutional reforms to date represent successful adjustment to more global and competitive capital and product markets – one that preserves an economic model capable of combining relatively high social equality with long-term competitiveness. In this sense Germany has laid the foundations for a comeback and may still serve as a model for all of the European Union.*

## INTRODUCTION: THE FOUR WEAKNESSES OF *MODELL DEUTSCHLAND*

Since the early 1980s there have been (at least) four regularly cited weaknesses of the German model. These weaknesses have been regular topics of discussion – varying over time in intensity – by politicians, policymakers, the press, business and labor. The first finger of blame has pointed to the financial system. Germany’s bank-dominated system, so the charge goes, is poor at financing innovation and entrepreneurship and thus limits Germany’s ability to move to the cutting edge of high-tech sectors. Proponents of this view have regularly cited Germany’s relative dearth of venture capital as evidence of this deficiency. Further, the German stock market was lethargic and controlled by the (conservative) banks, thus cutting off German firms from more risk-friendly sources of investment capital. The second finger of blame pointed at Germany’s corporate governance system. Here the charge was that the cozy relationships among the largest banks and industrial corporations – cemented by cross-shareholdings and criss-crossing networks of interlocking directorships – inhibited the dynamic restructuring of firms and industries that would keep Germany in front of international competition. In short, *Deutschland AG* (Germany, Inc.) had become a liability in a more integrated European and global economy.

The third and probably most damning finger of blame has been leveled at the trade unions and the industrial relations system more broadly. The unions are charged with defending a system that raises wages to non-sustainable levels and inhibits much-needed corporate restructuring. In the course of the 1990s Germany’s unions became increasingly isolated by many – including the media – as the major ‘problem’ of

the German economy. Closely related to this, the generous social welfare state has been viewed increasingly as a drag on the German economy and unions are frequently blamed for resisting cost-saving changes.<sup>1</sup>

In contrast to the still common perception of Germany as the 'sick man of Europe', in this paper I will argue broadly that the institutions governing the German economy have undergone quite dramatic change. In several respects Germany is arguably leading the broader European economy toward new institutions and a new accommodation between labor and capital. A wide range of liberalizing reforms have been undertaken which impart new sources of flexibility to German institutions without giving up the strengths of the traditional model. This strength is evidenced by the growth, profitability, and continued export strength of the traditional core sectors of the German economy.

Germany's remaining problems are significant, but need to be isolated so that specific – not blanket – solutions can be pursued. There is little doubt that Germany's recent economic struggles are at least in part a result of structural problems. But I will argue that many of these have already been addressed by wide-ranging reforms and innovations. The primary remaining structural problem is to stimulate employment in the service sector and low-skill jobs more generally. But often overlooked in debates is the fact that Germany's recent struggles are also in good part a result of two adverse exogenous shocks – German reunification and excessive fiscal and monetary restraint induced by European Monetary Union.

This paper will substantiate these arguments by highlighting key reforms that are clearly new sources of dynamism and flexibility. Since a comprehensive review would require more than one paper, this one will focus primarily on reforms in the corporate governance and industrial relations systems. When it comes to modernization of corporate governance, Germany is no laggard among continental European countries and the result in terms of corporate restructuring, investment and management strategies are far-reaching. The paper will also examine the changing role of labor in corporate governance. Substantial research has already demonstrated that the institutions of codetermination and works councils in Germany are facilitating corporate restructuring and economic dynamism. Thus Germany's labor institutions are hardly a barrier to a more dynamic European economy and may, indeed, be a model for others to emulate. Thus, Germany is well prepared to facilitate further economic integration and growth in Europe through a new or increased openness to cross-national mergers and acquisitions and flows of capital, labor and investment. In the next sections I will present a summary review of many of the key institutional reforms intended to redress these weaknesses. Following this I will examine evidence on the relative performance of the Germany economy and evaluate the sources of its problems.

#### FINANCE AND CORPORATE GOVERNANCE: FROM BANK DOMINATION TO MARKETS

The reform and transformation of the German financial and corporate governance systems goes back to the mid-1980s when the large German banks launched a concerted effort to promote Germany's 'underdeveloped' securities markets.<sup>2</sup> This effort accorded with the beginnings of a major reorientation in the banks' business strategies from a traditional focus on commercial banking to a focus on securities market-oriented investment

banking. During the 1990s many large non-financial firms also became reform supporters because they, no longer relying on bank loans for external funds, instead preferred to see the introduction of modern capital market products in Germany that could increase their financial flexibility.<sup>3</sup> Because German investors could not be expected to increase their demand for securities as rapidly as the banks needed, the strategy came to rest importantly upon wooing foreign institutional investors.<sup>4</sup> The reform coalition thus found itself increasingly compelled to adopt many of the Anglo-Saxon market regulations and norms demanded by these investors.<sup>5</sup>

While reform efforts had begun in the late 1980s, a major step forward was the passage in 1990 of the first of four Financial Market Promotion Laws subsequently promulgated. All of these omnibus laws contained numerous and wide-ranging statutory additions and amendments intended to stimulate the supply and demand of securities. The 1990 law, for instance, eliminated various taxes considered hindrances to securities trading.<sup>6</sup> Efforts to develop and promote securities markets in Germany became even more intense and focused in the early 1990s, partly because capital market integration in Europe was now unfolding and banks expected it to accelerate during the run-up to monetary union. But more importantly the German state itself now took an intense interest in these issues in order to increase its influence over evolving international norms and regulations governing capital markets and to make Frankfurt a global player among increasingly competitive financial markets.<sup>7</sup> Thus in early 1992 the German Finance Ministry, in coordination with the pro-reform coalition, launched the highly publicized *Finanzplatz Deutschland* campaign (Finance Center Germany).

One of the first successes of this campaign was the long-sought reorganization of the stock exchange system into a publicly traded company, the Deutsche Börse AG, in 1993.<sup>8</sup> Since then the German exchange has become a leader in many key securities markets in Europe. The next big success was the Second Financial Market Promotion Law in 1994 that harmonized the content and form of German regulation with international norms and EU Directives on financial services. It also moved Germany away from the traditional self-regulation of securities markets and exchanges with the creation of an independent Federal Supervisory Office for Securities Trading. The new state agency, modeled after the American Securities and Exchange Commission (SEC), was charged with enforcing a new legal ban on insider trading and newly stringent information reporting requirements by issuers of securities and traders. Over the course of the 1990s the new norms of transparency and openness clearly spread as an ever growing number of large firms began quarterly reporting, opened investor relations departments, and adopted more transparent international or US accounting standards.

By the second half of the 1990s the campaign for developing the securities market had achieved broad support and momentum among business, the public and the political parties (see Table 1). This did not, of course, mean there were no significant disagreements over the details of specific reform initiatives. For example, the 1998 Law on Control and Transparency in Enterprises (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, KonTraG*) was perhaps the most controversial reform legislation in the last seven years (and the first major revision of company law since 1965).<sup>9</sup> The law sought to support the growth of securities markets by limiting the influence of banks in firms and instead increasing corporate transparency, management

TABLE I  
MAJOR REFORMS IN FINANCIAL AND CORPORATE GOVERNANCE LAWS AND  
REGULATIONS

Reform	Key effects
1990 German Futures Exchange	Financial product modernisation
1990 Financial Market Promotion Law	Stimulate supply/demand for securities
1993 Creation of Deutsche Börse AG	Reform of stock exchange
1994 2 <sup>nd</sup> Financial Market Law	Creates Federal Securities Regulator (BaWe) and corporate disclosure regulation
1995 Securities Trading Law	Requires disclosure of holdings over 5%
1997 <i>Neuer Markt</i> begins	New exchange for high-tech startups
1998 Law on Control and Transparency in Enterprises (KonTraG)	Limits placed on bank use of proxy voting, abolished unequal voting rights/caps; share options permitted
1998 Law to Facilitate Equity Issues (KapAEG)	Increase corporate transparency through use of IAS or US GAAP
2000 Eichel Tax Reform	Encourage break up of cross-shareholdings
2001 Takeover Law	Regulate and ease takeover process (mandatory bidding; neutrality duty), fair treatment for minority shareholders; but takeover defenses permitted
2002 Corporate Sector Transparency and Publicity Act (TransPuG)	Strengthen Supervisory boards, increased disclosure

accountability and protection for minority shareholders.<sup>10</sup> Not all of the initial proposals were embraced by the large banks and firms, but the FDP, then coalition partner with the CDU in government, pushed hard for the measure and gained support from the opposition SPD (and the unions as well). The FDP and SPD were motivated in particular by a desire to strengthen the ability of capital markets to put pressure on firms, i.e. to undermine what they saw as excessive concentration of corporate power.<sup>11</sup> The KonTraG represents the beginning of a more sustained effort to move beyond financial market reform into the very heart of German corporate governance, i.e. the rules determining the rights and responsibilities of owners, managers, and employees in the firm. The two realms are intimately linked: further gains in developing securities markets were unlikely to be realized unless more thoroughgoing changes were made in corporate governance – chiefly to increase transparency of firms and the possibility for shareholders to protect their rights vis-à-vis management – through strengthening the supervisory board. The KonTraG made German corporate law among the more minority shareholder-friendly ones in Europe. For example, it eliminated unequal voting rights and abolished voting caps in shareholders' meetings – two features still common in other EU member states.<sup>12</sup>

Indeed, since coming to power in late 1998, the SPD has paradoxically been the more aggressive pro-market reform party and one that has on more than one occasion taken the initiative ahead of the large banks and firms. The SPD sees these as part of a strategy to modernize and revitalize the German economy and a strategy that realizes a long-standing aim of the party – the deconcentration and 'democratization' of corporate power. In other words, since 1998 reform and modernization of finance and corporate governance has been the poster child of the German left, not the right. Taking advantage of the permissive environment created by the tremendous surge in stock markets in the late 1990s and the spectacular success of the *Neuer Markt* (a new

electronic exchange for fast-growing technology firms introduced in 1997), the SPD completed numerous key reforms during its first term in office: In 1998 the Third Financial Market Promotion Law was passed. Also in 1998, a law to facilitate equity issues (*Kapitalaufnahmeerleichterungsgesetz*, KapAEG) was promulgated which, among other things, allows German firms to balance their books using the international (IAS) or American accounting standards (US-GAAP).<sup>13</sup> The SPD also put together a neo-corporatist commission (Cromme Commission) to develop a corporate governance codex. Published in 2001, the codex seeks to encourage firms to adopt 'good' corporate governance practices (with a strong emphasis on minority shareholder interests).

While the German government was widely criticized for vetoing the European Commission's takeover directive in July 2001, the irony is that it did so because Germany's wide-ranging financial and corporate governance reforms had made the German system *more liberal* than most other systems in the EU. This meant that, under the EU Takeover Directive, German firms would have been significantly *more* vulnerable to hostile takeovers by foreign corporations than firms in many other EU members which enjoyed stronger anti-takeover instruments.<sup>14</sup> Shortly after rejecting the EU directive, Germany promulgated its own (and first) Takeover Law based on the work of a neo-corporatist commission; and it is still among the more liberal takeover laws in Europe.<sup>15</sup>

In 2002 the corporate governance codex – while it already had broad support – was given more authoritative status through the Corporate Sector Transparency and Publicity Act (TransPuG).<sup>16</sup> In an effort to further modernize and strengthen state market regulation, in that same year the federal government also consolidated all financial market regulation – banking, securities, and insurance – in one federal agency (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin). Within the EU only Britain has so far gone this far. The Cromme Commission continues to revise and update the Code; recently focusing on developing ad hoc information disclosure rules, executive pay disclosure rules, and board director independence.<sup>17</sup>

All of these reforms set the stage for Germany to participate in the global stock market boom of the late 1990s. Starting with the partial privatization and initial public offerings of Deutsche Telekom in 1996, stock prices soared as Germans poured money into the markets as never before. Spurred on by the *Neuer Markt*, the number of initial public offerings (IPOs) jumped to unprecedented levels: in 1999 alone there were more IPOs than in the ten years from 1988 to 1997.<sup>18</sup> Venture capital funds, which had been growing strongly since the early 1990s, soared dramatically in the late 1990s: From 1996 to 2002 total portfolio volume grew from €3.1 billion to €16.6 billion.<sup>19</sup> More than that, German venture funds came to act like American funds through a growing focus on technology start-ups and early stage financing. In short, the financial market and corporate governance reforms of the 1990s worked. As elsewhere, the decline in the stock market from 2001 to 2003 put a damper on these developments. The most notable casualty was the *Neuer Markt*, which collapsed in 2003 amidst a moribund IPO market. While the travails of the early 2000s were a setback in several ways for the development of the stock market and 'equity culture' in Germany, market capitalization relative to GDP and venture capital funding remain well ahead of where they were at the start of the boom. As the stock market recovers, Germany is likely to continue the prior direction of change (although at a

slower pace than in the late 1990s).<sup>20</sup> In keeping with trends elsewhere, private equity fund activity has surged recently in Germany, thus carrying forward the finance-led restructuring process begun in the late 1990s.

By the turn of the millennium it was clear that the most fundamental change of the decade was perhaps the transformation of bank–large firm relations. Relationship banking, i.e., a mutual emphasis on a long-term relationship between a firm and its main bank(s) is being replaced by more arms-length, transaction-oriented exchanges.<sup>21</sup> From the firm side, this change was driven by evolving product market and financial strategies. For example, in the 1990s several large German firms began internationalizing their investor base (in part by listing on the New York Stock Exchange which better positioned them to make acquisitions in the US).<sup>22</sup> As a result the shareholder base of numerous large German firms (and banks) has become more widely dispersed and internationalized, thus weakening domestic shareholder control and bank connections. Like the US, institutional investors (e.g. pension funds and investment funds) and their preferences for corporate transparency have become increasingly important in Germany.<sup>23</sup>

The internationalization of the investor base is connected to a growing emphasis by such firms on shareholder value, i.e. managing the company so as to maximize return on equity (as manifested in share prices and dividends).<sup>24</sup> In the past, German firms often focused more on expansion of the firm's revenues and market share while profitability, though important, was not the driving force of managerial decisions. This conventional focus was sustained by the fact that most large firms have been controlled by insiders who, while wanting a return on their equity investment, did not usually pressure management to pursue profit maximization as the foremost goal.<sup>25</sup> In a shareholder-oriented environment, takeovers – including hostile ones – become more likely. Corporate managers also face more pressure to sell off divisions or close operations more quickly than they would have in the past if they are not generating sufficient return.<sup>26</sup>

The transformation of bank–firm relations was also driven on the bank side. Beginning in the late 1990s, large German banks (and the major insurers) reduced the size of their equity stakes in individual non-financial firms.<sup>27</sup> First, the banks were interested in reducing their exposure to the risks associated with large equity stakes in other firms. Second, like other large German firms, the banks want to redeploy long-held equity investments 'locked up' in traditional relationships into more profitable investments.<sup>28</sup> As part of its broad program to modernize corporate Germany, in 2000 the Federal Government passed a Corporate Income Tax Law that made the sale of long-term equity stakes held by large firms and banks in other firms tax free after 1 January 2002.<sup>29</sup> This measure gave further impetus to the already ongoing sell-off of big industrial shareholdings and large-scale reshuffling of corporate assets.<sup>30</sup> Even before these tax changes, the 1990s had twice the level of mergers and acquisitions as during the 1980s.<sup>31</sup> The number of capital ties among the 100 largest corporations declined from 169 in 1996 to 80 in 2000:<sup>32</sup> the percentage of corporate equity held by other German non-financial firms fell from 45.8% in 1995 to 32.5% by 2003.<sup>33</sup> Banks have also greatly reduced their direct involvement in corporate governance via board representation.<sup>34</sup> In sum, the traditionally tight equity and personal linkages among German firms has been greatly reduced. To be clear, though, many large German

firms still have several large, long-term shareholders; the difference is that now many also have a large number of institutional and retail investors who are interested in shareholder value.<sup>35</sup>

Altogether, this new direction represents a notable break from the old model in which banks and other large firms were long-term shareholders providing 'patient' capital and protecting firm management from unwanted outside influences and takeovers. But one must be careful not to exaggerate change. The German capital market is still comparatively small relative to German GDP while small and mid-sized firms continue to rely heavily on bank loans. Thus, the traditional commercial finance role of banks remains quite significant.<sup>36</sup> Moreover, the German corporate governance system remains distinct from those of the liberal market economies of the UK and US. German company and codetermination laws continue to ensure that workers have formal representation and codetermination rights within firms. Thus it clearly cannot be argued that the stakeholder model is completely gone (or likely to disappear anytime soon).

Nonetheless, the changes highlighted above make clear that shareholders have gained both formal (legal) and practical power within firms, and corporate management in Germany is much more attuned to share prices, profitability, and the demands of its shareholders. Vitols labels this hybrid 'negotiated shareholder value', since empowered shareholders must still negotiate firm goals and major decisions with the other key stakeholders, labor and management in particular.<sup>37</sup> One might take this as an argument that the German economy has therefore yet to adopt the deep structural reforms needed to become competitive. However, as we shall see in the next section, the continued role of labor in corporate governance does not hinder corporate restructuring. Indeed, there is much evidence to suggest that it has facilitated restructuring in a manner that preserves high wages while enabling management to make profitability enhancing changes in production and investment.

#### REFORM AND FLEXIBILITY IN INDUSTRIAL RELATIONS

There are two fundamental pillars to the German system of industrial relations: codetermination, which is institutionalized primarily in works councils and company supervisory boards, and centralized collective bargaining. The German system has long been characterized as 'social partnership' in reference to the generally consensual nature of labor-management relations. The institutionalized political and market strength of labor – a standard element of the highly successful postwar German model – was for a long time accepted by business as a 'fact of life' that need not hinder competitiveness. Indeed, many firms (especially large ones) at times regarded this as a source of competitive strength. A strong role for labor was also acceptable to business because the size, organizational strength, and tradition of social partnership meant that unions traditionally linked wage demands to inflation plus productivity gains. In other words, wage gains were generally affordable and did not cut into profits. Moreover, labor and management traditionally formed a productivity coalition in that each party gained from productivity enhancing measures in firms. Thus, German unions have historically been relatively open to firm internal reorganization and restructuring. German firms focused on high value-added production using high-skill labor and were therefore able to sustain high wages.<sup>38</sup>

Given this long-term success and relative flexibility of German unions, why have they come to be viewed as a barrier to economic success? The answer is complex and what I present here is a partial one at best, but a major reason for the changing perception of labor in Germany is the intensification of competitive pressures on German firms. While German firms have long sought to minimize the disadvantages of their higher costs by competing in high value-added markets, in the course of the 1980s and 1990s these markets were increasingly competitive. New producers, notably from Asia and more recently Central Europe, were increasingly able to close the quality and value-added gap to German products while undercutting them in prices (due to a lower cost structure). In short, the traditional 'safe haven' for German firms has been shrinking, thus putting strong cost pressures on them. These pressures have led many employers to grow increasingly disgruntled with high wages and above all social benefit (non-wage labor) costs in Germany.

Over the last decade rising unemployment has increasingly been blamed on high wages and labor market rigidities. But the German industrial relations system has been far from inflexible in responding to these and other economic pressures. Wages in Germany remain high; in this respect little has changed. But the institutions of the industrial relations system have undergone far-reaching – if often obscure when looked at individually – transformation (see Table 2). The general thrust of all these changes has been a gradual decentralization of labor–management relations which has aided firms by allowing them increasingly to tailor labor relations and agreements to firm-specific needs. Thus labor and the industrial relations system have indeed shown considerable flexibility and, arguably, have helped preserve the traditional sources of German competitiveness while enabling German firms to confront the cost problems they face. In this section I look first at some adaptations in the collective

TABLE 2  
NEW SOURCES OF FLEXIBILITY IN INDUSTRIAL RELATIONS

Key reforms/actions	Key measures/effects
Hardship and Opening Clauses (early '90s) 1993 – 0.5 m workers; 1999 – 7 m	Permit wage deviation from collective agreements
Firm Pacts or Alliances ( <i>Betriebliche Bündnisse</i> )	
a. wage reduction investment agreement	
b. wage reduction employment agreement	
c. productivity enhancing investment agreement	
d. work redistribution employment agreement	
1990 – 1% of Rehder Sample (120 large firms); 2000 – 46% of sample	
primarily manufacturing: metalworking (auto), electronics, chemicals	
Supervisory Board Codetermination	Unions support transparency laws; support restructuring through M&A, corporate spin-offs (Höpner)
Works Council Legislation (1999)	Creation of works councils in small firms eased; created options for divisional council
Hartz Reforms/Agenda 2010 (2004)	Reduced unemployment benefits; eased employment protection, job acceptance requirements raised; restructuring of employment offices; creation of Ich-AGs, extension of low-tax 'mini-jobs'

bargaining pillar of the industrial relations system since the 1990s, in particular the growth of firm-level pacts or alliances.<sup>39</sup> I then turn to changes in the second pillar – codetermination. The section concludes with a brief review of the recent Agenda 2010 reforms.

The 1992–93 recession was in many ways the key catalyst of the growth of firm-level pacts and deviations from collectively bargained agreements. Recession coincided with the end of the post-unification boom, the completion of the Single Market and emergence of new sources of labor and production in Central Europe. The movement began with hardship and opening clauses (*Härte- und Öffnungsklauseln*) in eastern Germany which allowed firms to deviate from collective agreements, especially to pay lower wages. The growth of these pacts was explosive: In 1993 about a half million workers in industry and construction were employed by firms which concluded such clauses; in 1994 there were about four million workers subjected to such clauses and this figure rose to nearly seven million in 1999, or nearly one in five workers.<sup>40</sup>

The movement to these clauses was soon joined by a related movement to firm-level pacts or alliances (*Betriebliche Bündnisse*). These pacts had their roots in American concession bargaining of the 1980s, but only took off in Germany – and in adapted form – in the 1990s. Pacts are generally concluded between works councils and management and increasingly deviate from union-negotiated collective agreements. In her in-depth study of more than 100 of the largest German firms, Rehder identified four kinds or types of pacts (which run from three to seven years):<sup>41</sup>

1. *Wage reduction investment agreement.* In these pacts workers typically accept measures to reduce wage costs by accepting pay below contract, elimination of pay above contract, elimination of bonuses in exchange for an *investment* agreement by the employer, i.e., the employer promises to make specified investments in German production sites.
2. *Wage reduction employment agreement.* Works accept measures to reduce wage costs by accepting pay below contract, elimination of pay above contract, elimination of bonuses in exchange for a job protection agreement.
3. *Productivity enhancing investment agreement.* Workers agree to such measures as more overtime, more production shifts, a reduction of sickness days, new work organization, and performance-oriented pay in exchange for investment agreement by the employer.
4. *Work redistribution employment agreement.* Workers accept such measures as shorter working week or more flexible deployment of labor in the firm in exchange for job protection and training agreements.

In Rehder's study, less than 1% of her sample firms had any such pact in 1990; by 2000 nearly half (46%) had had at least one pact during the 1990s.<sup>42</sup> Pacts were especially popular in industry: during the 1993/94 recession all the major auto firms and many large supplier firms concluded pacts of one kind or another (or a combination of the pact types). In 2000 the majority of pacts was in the metal and electronics sector; followed by chemical and infrastructure. Since 1996 most pacts were predominantly of the investment type.<sup>43</sup> This last fact speaks to the willingness of German unions to accommodate dramatic reductions in employment during the 1990s. While this helped firms reduce costs, it had the obvious consequence of contributing to rising unemployment

since only the most important or core workers were secure in their jobs. A good portion of job reductions were reached through attrition and early retirement, thus avoiding mass layoffs in many cases. However, this merely externalized the cost onto the state, which has picked up much of the cost of early retirement.<sup>44</sup>

The emergence and spread of pacts or alliances was – not surprisingly – initially fought by the unions. This was so for several reasons: first, pacts generally involved concessions and thus represented a loss to labor; second, pacts lessened the influence and control of the unions over wages and the conditions of work (because they were concluded by works councils which are not official union bodies), thus threatening an erosion of their own institutional source of power (most importantly the collective bargaining agreement) and the class solidarity among workers which also underpins any successful labor movement.<sup>45</sup> From a macro point of view, pacts were short-term fixes that may have benefited some workers (namely those who kept jobs because of them), but in the long term threatened to undermine the labor movement. The unions tried to counter the trend to decentralized pacts by making them an issue for centralized collective bargaining and centralized neo-corporatist negotiation (most notably in the *Bündnis für Arbeit*) but this strategy largely failed. The unions have also attempted to shape or influence pacts through informal coordination with works councils but have had very limited success.<sup>46</sup>

In sum, the collective bargaining system has become more decentralized, flexible and infused with market-conforming elements. Under the old system firm-level agreements, such as they existed, were constrained by the collective industrial agreements, i.e. permissible deviations were limited (and almost always in favor of labor) and determined in the collective agreement. But now company agreements can go beyond them and are beginning to shape the contours of collective industrial agreements.<sup>47</sup> The utilization of pacts has been successful from the labor perspective inasmuch as they have moderated the downward pressure on wages and slowed job losses by finding other ways to lower costs for the firm, mostly through more flexibility in working hours/conditions, reduced hours or job sharing, elimination of premium wages above collective bargaining rates, and cuts in bonuses or overtime pay.

It has been widely noted, however, that this development divides the labor movement increasingly into ‘core’ and ‘peripheral’ employees: the peripheral employees are those who are laid off or subjected to wage reductions and thus end up ‘paying for’ the job security and high wages of core employees. The use of pacts also undermines the traditional division of labor between the two pillars of collective bargaining and codetermination, since works councils are increasingly assuming many of the functions long the domain of union-controlled collective bargaining. As noted already, this threatens to undermine class solidarity as workers become increasingly identified with – and economically tied to – their particular firms. Indeed, the new Works Council Law passed by the Schröder government is likely to further this direction, since it permitted the creation of divisional work councils (alongside the standard *Gesamt-, or Konzernbetriebsrat* – corporate or concern works council). This would further subdivide employee representation along product market lines.<sup>48</sup>

The changing role of works councils, as evidenced by pacts, points to the broader transformation of the second pillar of the industrial relations system – codetermination.

This second pillar is formed by the active role of works councils and worker representatives on supervisory boards in firm management decisions. As such this second pillar of the industrial relations system also forms part of the German corporate governance system. In other words, codetermination makes labor an important actor in firm-level governance and is what traditionally made the German system a stakeholder governance system. As the discussion of pacts already suggests, labor has generally not used codetermination to hinder firm restructuring, stop outward direct investment, or to fight the spread of shareholder values and an equity culture in Germany. Thus the transformation of the corporate governance system and industrial relations system largely reinforce each other.

First, unions and labor representatives on supervisory boards generally embraced the move to greater corporate financial transparency (e.g., use of international accounting standards) because it enhances their power vis-à-vis management. In other words, transparency provides labor more information about management and thus serves as a tool for codetermination: transparency gives workers a more complete financial picture of the firm and the ability to compare relative performance of different national subsidiaries.<sup>49</sup> The latter, for example, can be used by workers to fight against the relocation of work to foreign subsidiaries if it can be shown that the German production location is cost competitive. Consistent with this, unions supported passage of the 1998 company transparency law and the equity raising law. Along with shareholder groups, workers supported the introduction of variable compensation for top management – including share options – because it ties management pay to company performance, thus (presumably) strengthening management's incentive to maintain competitiveness (and ultimately jobs).<sup>50</sup> Unions (and works councils) have not also categorically opposed the more explicit use of profitability targets for management and operational divisions.<sup>51</sup>

Neo-liberal critics of the German system also presumed that workers would use codetermination to hinder firm restructuring via the sale of under-performing or non-core subsidiaries, through foreign investment, or by outside takeovers. But this, too, has largely been a red herring: Labor representatives on supervisory councils and works councils have more often than not supported such measures. During the 1990s, for instance, works councils in Mannesmann and ThyssenKrupp supported spin-offs and a return to corporate specialization in the belief that the long-run viability of the firm (and thus jobs) would benefit from it; the firm would be more successful in product markets and attract more investment.<sup>52</sup> And when Mannesmann became the object of a (ultimately successful) hostile takeover in 2000, labor reps on the supervisory board ultimately supported the takeover.<sup>53</sup>

Neither can it easily be argued that codetermination has been a barrier to cross-border mergers and acquisitions involving German firms. From 1994 to 2000, German firms purchased 1,545 firms in other EU states for \$377 billion, while EU firms bought 1,633 German firms for \$331.2 billion. These represented significant increases over the number and value of firms purchased (in both directions) in the immediate years preceding this period.<sup>54</sup> There is also little evidence to suggest that German firms have been slowed in their ability to outsource production to lower-wage countries or utilize foreign suppliers.<sup>55</sup>

Given this flexibility and the willingness on the part of labor to adapt to a more shareholder-oriented corporate governance system, it should not be surprising that

most large German firms – including the most shareholder-oriented among them – have not been clamoring to opt out of collective bargaining or dismantle codetermination.<sup>56</sup> While certain segments of the business community have been making a public issue in the last two years of the presumed burden of codetermination, surveys of German managers and managers of foreign subsidiaries in Germany make clear that codetermination is not widely viewed as a problem – nor has codetermination deterred international investors from buying in Germany.<sup>57</sup>

It is important to recognize that the unions were not simply passive actors in the adjustment strategies of German firms, i.e. that the existence of codetermination in Germany is largely irrelevant to the ultimate outcome.<sup>58</sup> A comparative study of German and French corporate governance by Goyer shows that large French and German firms adapted differently to the growing demands of international investors for shareholder value.<sup>59</sup> Whereas French firms chose typically to sell off underperforming or non-core units, German firms opted to satisfy investor demands by increasing their financial transparency (and eliminating voting restrictions). He attributes this differential response to the relative power of labor and the organization of work within the firm. Strong labor and high-skills, semi-autonomous labor in German firms make it difficult and costly (and less desirable) for managers in Germany to shed labor or subsidiaries. But the willingness of German workers to accept responsibility for the economic performance of the firm also made managers more apt and willing to increase transparency. The key point is that German codetermination did (and does) constrain the strategic options of German firms in their response to financial market pressures, but it does not prevent – indeed it even aids – effective responses.

That said, the 1990s and 2000s continued a trend already visible in the 1980s in which the codetermination function is increasingly aligned with the management function, i.e. enhancing productivity, cash flow and earnings. In short, labor is increasingly in a position of ‘co-management’ rather than codetermination. For many this means that the needs of workers are being increasingly identified with the needs of the firm as a commercial enterprise. Along the way the postwar development of ‘industrial citizenship’ is weakening or being transformed in its meaning from ‘constitutional rights’ to contractually negotiated rights (via firm pacts, for instance).<sup>60</sup> In other words, adjustments in the codetermination system are occurring through renegotiation in contractual agreements, not legal changes. The problem is that contractually negotiated ‘rights’ for workers are generally more tenuous than legally codified ones. This suggests that the continued influence of labor in codetermination (corporate governance) may not hold over the longer term. Also, as firms become more global in their employment, it is becoming harder and harder for employees to represent their common interests at the top level of the firm even when there is no formal change in codetermination (e.g., at the *Gesamt-*, or *Konzernbetriebsrat*).

Labor has also ‘bought’ its continued prominent role in codetermination (corporate governance) by agreeing to a shrinking core of secure jobs. Employment in the 100 largest firms declined 5.8% from 1986 to 1996, while their overall employment (globally) increased 10.3%.<sup>61</sup> It has also been maintained by accepting increased variability in compensation via the growth of contingent or performance-oriented pay for workers.<sup>62</sup>

Thus, one of the great ironies of the past decade is that despite all the calls for radical change in the labor relations system, it has remained broadly stable while

exhibiting notable flexibility. Indeed, most managers seem to want to avoid confrontation with labor over wages. There are several reasons for this: First, large firms have higher productivity than smaller firms and would face higher wage demands from unions if they opted out of collective bargaining; thus, second, staying in means they generally have decreasing *unit* labor costs; third, unions are stronger in big firms and more shareholder-oriented firms are subject to heavy international competition and thus can least afford labor unrest; finally, firm pacts have provided more flexibility to management.<sup>63</sup>

Nonetheless, there are several trends that may well further undermine labor's ability to play an important role within firms (and in society at large). First, the collective bargaining system is shrinking in its coverage as a growing number of firms have been defecting from employer's associations and instead seek to negotiate wages on their own: in 1995 72% of employees in the West were covered by collective agreements, by 2003 this shrank to 62% (in the East, it went from 56% in 1996 to 43% in 2003).<sup>64</sup> Second, a growing rift between large and small firms in their willingness to negotiate collective agreements and pay higher wages threatens to undermine employer solidarity as well. Without solidarity on the side of both employees and employers the German industrial relations system is threatened.

But this is not necessarily the fate of Germany. As Höpner argued:

It is conceivable that future research will emphasize the combination of shareholder orientation and codetermination as a precondition for economic success in post-millennium Germany, because only codetermination might allow employees to have faith in a process that would otherwise undermine quality production and incremental innovation.<sup>65</sup>

The future will also likely be affected by the recent Agenda 2010 reforms. In some respects the Agenda 2010 reforms have their roots in the failure of traditional German-style neo-corporatism to resolve the high unemployment problem. Shortly after coming to office in late 1998, the new Schröder government put together a permanent tripartite commission, the Alliance for Jobs (*Bündnis für Arbeit*). With representatives from government, unions and employers' associations, the commission developed a set of broad objectives designed to get the German economy back on track. But despite a series of regular meetings, the Alliance for Jobs failed to produce anything beyond minor reforms and tinkering with the industrial relations system. Thus Schröder's first term in office was widely regarded as marked by a failed economic policy. Thus in the run-up to the fall 2002 elections the government created another commission named after its chair, Peter Hartz. The Hartz Commission produced a series of more radical labor market reform proposals that were adopted early in the second Schröder government. Not satisfied, in March 2003 Schröder proposed a much broader and bolder reform package – Agenda 2010. Intended to jumpstart the German economy, the Agenda 2010 reforms took up the Hartz labor market reforms and supplemented them with reforms to the tax, healthcare, welfare, training, and pension systems. Agenda 2010 goals include reducing non-wage labor costs, boosting domestic demand and capital spending, assisting the unemployed find jobs more quickly, making labor markets more flexible (e.g. easing employment protection rules), and fostering innovation.<sup>66</sup>

The reform package was adopted in late 2003, after conciliation between the Bundestag and the Bundesrat (controlled by the opposition). Thus the reform was a product of broad partisan consensus. While unions complained, they did not take to the streets or threaten the SPD, perhaps because union members themselves were evenly divided in their support/opposition to Agenda 2010.<sup>67</sup> The protest demonstrations that emerged in the East quickly fizzled out. Employers applauded the reform but said it did not go far enough. Since implementation of the reforms only began in 2005, their long-term effects remain to be seen. However, the passage of these reforms, together with extensive income and corporate tax cuts,<sup>68</sup> is further evidence of both German reform capacity and the kind of model toward which the German system is evolving – a model that continues to insure formal labor representation and participation within firms, i.e. social partnership, and a high skills, high valued-added production model. But the evolving German model increasingly allows for greater diversity in wages and work conditions while shifting more of the cost and responsibility for social welfare, healthcare, and retirement saving onto individuals.

### *The Fruits of Reform*

Even without Agenda 2010, the finance and corporate governance reforms and labor flexibility discussed above have played key roles in helping German firms remain competitive – a fact often obscured in the generally negative discourse on the German economy. Over the eight year period from 1994 to 2001, for example, German corporate profitability, while lower than the Eurozone average, showed more or less steady improvement, and in 2001 was only slightly behind that of the US.<sup>69</sup> In 2004, the 30 largest listed companies doubled their collective profits over the previous year to nearly €36 billion and dramatically raised dividends, all while reducing domestic employment by 35,000.<sup>70</sup>

Despite the steep rise in the euro exchange rate over the last few years, German exports have risen steadily for years and German firms are increasingly price competitive within the Eurozone.<sup>71</sup> In 2004 exports rose 10% over the previous year to €731 billion – making Germany once again the world's number one exporter – while the trade surplus reached €155 billion (almost 20% more than the prior year's record surplus).<sup>72</sup>

For the 13 years up to 2003, Germany ranked second only to the US in global patent applications (it led all countries with three German firms among the top ten globally). In 2003 Germany slipped to third place, behind Japan.<sup>73</sup> At both the beginning and the end of the 1990s, Germany ranked ahead of the US in number of patents per million population.<sup>74</sup> Innovation remains especially strong in Germany's traditional export-oriented sectors. In biotechnology and information and communication technologies, however, Germany lags behind its main competitors. This may be partly a result of a decline in R&D spending relative to GDP during the 1990s, though Germany remains above the OECD average and R&D spending has been rising again since 1999.<sup>75</sup>

In the latter 1990s labor productivity growth, while positive (1.8% per year between 1995 and 1999), was only average among the OECD countries.<sup>76</sup> But firm pacts and labor-management cooperation have boosted Germany's performance dramatically. Over the decade from 1993 to 2003, German labor productivity rose nearly 2% on average and was only slightly behind that of the US.<sup>77</sup> Even *The Economist*,

a long-time critic of the German model, recently wrote that ‘in the past five years Germany has boasted faster growth in labour productivity than the euro-area average, combined with the zone’s slowest growth in wages . . . The popular notion that high wage costs have left Germany uncompetitive no longer seems to be true’.<sup>78</sup> In terms of multi-factor productivity, which assesses the joint effects on productivity of capital and labor, Germany averaged 0.98% average annual increase from 1990 to 2001, only marginally behind the UK at 1.06% and the US at 1.01%.<sup>79</sup>

In short, while corporate Germany has numerous challenges in front of it, the fact is that it has been doing relatively well in terms of growth, profitability, and competitiveness. What German firms are not doing is creating domestic jobs, and this leads us to the bigger problem: what is good for corporate Germany is not unequivocally good for the German economy as a whole, at least in the short term.<sup>80</sup>

#### IF GERMANY HAS BEEN SO GOOD, WHY DO THINGS SEEM SO BAD?

So, if Germany has indeed undergone successful and far-ranging institutional adaptation, its labor market institutions have demonstrated flexibility, and corporations are remaining profitable and competitive, why is it performing so poorly in macroeconomic terms? In this section I present a modest and partial explanation for this. But the first task is to actually take quick stock of Germany’s relative performance in key indicators. Germany’s primary problems are low GDP growth, high unemployment (and low employment), and rising budget deficits.<sup>81</sup> To a great degree all three of these are interdependent, e.g. low growth exacerbates the other two problems.

In unemployment level, Germany was long below the EMU average, though the gap began closing after 1996. Still, until 2001 German unemployment remained below the EMU average (7.8% versus 8%).<sup>82</sup> But during 2002 German unemployment rose above the EMU average and reached 9.2% at the beginning of 2004 (versus 8.8% for EMU).<sup>83</sup> During 2004 unemployment continued rising and jumped into double digits (partly for statistical reasons) at the beginning of 2005 with the introduction of the Agenda 2010 reforms. In mid-2005 unemployment was trending down again but stood at 11.3%.<sup>84</sup> More troubling, though, is the long-term picture: Over the last three decades there has been a progressive increase in unemployment, thus revealing structural unemployment problems. Even when the German economy was able to generate 1.7 million jobs between 1997 and 2000, it did so without significantly increasing the number of hours actually worked, i.e. there were more people employed but there was hardly any increase in work per se.<sup>85</sup> In sum, the German economy has a long-term record of a relatively weak capacity to generate jobs – labor force participation (among young and old workers) continues to decline even as unemployment rises. The immediate future does not look bright either, as a growing number of German firms, including even mid-sized firms, are increasingly apt to create new jobs (or even move jobs) outside of Germany, especially in Central Europe and Asia.<sup>86</sup>

In terms of GDP growth, during the 1980s Germany, with 1.9% average annual GDP growth, lagged behind the present Eurozone countries, which averaged 2.3% (between 1980 and 1989).<sup>87</sup> German growth was strong during the early 1990s as a result of the unification boom, but since 1995 Germany has once again lagged behind the EMU average (by about .5% per year). Since 2001 German growth has been truly

anemic – less than 1% per annum (OECD 2002), though it began to pick up in late 2004.<sup>88</sup> Since the early 1990s, slow growth has dropped German GDP per capita substantially relative to the EU and the US.<sup>89</sup> Slow growth is, arguably, the biggest economic problem Germany confronts.

As for its budget deficit, before the mid-1990s Germany was considerably below the EMU average but is now above it.<sup>90</sup> While Germany's budget deficit is still not particularly high by international standards, it has been rising sharply since 2001. Moreover, for the last two years and the next two Germany will violate EMU's 3% growth and stability pact deficit ceiling (though it is hardly alone in this category).

In sum, given that Germany was on the whole among the strongest economic performers in Europe prior to the mid-1990s, its relative macroeconomic underperformance since then means that Germany has become 'average' within the EU – hardly a reason to rejoice, but an important perspective to maintain. Nonetheless, several years of underperformance need explanation and I next suggest two important explanatory factors: The first is the drag created by East Germany. The second is overly restrictive and pro-cyclical monetary and fiscal policies to which the German economy has been subjected.

In the early 1990s, the eastern boom raised overall German GDP growth rates, but then came the post-unification bust and since 1997 the East has become a drag on the overall GDP growth. The European Commission estimates that one-third of the growth gap between Germany and the rest of the EU is accounted for by the fiscal burden of unification.<sup>91</sup> However, true as this may be, West German GDP growth has been very low in the last three years and thus low German GDP growth cannot be attributed solely to problems in the East.<sup>92</sup> In the unemployment picture, in contrast, the East is clearly a major drag on German performance; West German unemployment has remained well below the EMU average since the early 1990s and was slightly above 6% in 2002, while the EMU average was 2% higher at just over 8%. It was East German unemployment at 14% which brought overall German unemployment to nearly 8%.<sup>93</sup> In mid-2005 national estimates show unemployment in western Germany at 9.5% and in the East at 18.5%.<sup>94</sup> For 2003 the IMF (2004) estimates West German structural unemployment at 5.2% – slightly below that of the US (5.3%) – and East German at 15.4%: In other words, West German labor markets are as flexible/efficient as those of the US; the East is a different story.<sup>95</sup> Among the policy mistakes made in the East was the decision to fund welfare transfers through taxes on wages, thus further raising the non-wage costs to employers in the West and putting more pressure on jobs.<sup>96</sup>

In terms of the budget deficit, reunification and continued high subsidies to the East are a well-known drain on German finances. Since reunification fiscal transfers have averaged 3–4% of GDP. Even after tax increases are accounted for, the conclusion that the German budget deficit would be significantly lower without these costs seems inescapable.<sup>97</sup>

The important conclusion here is that a good part of Germany's key macroeconomic problems stem from reunification. In other words, the East German factor points the finger of blame away from supposed internal institutional problems of the German model and toward an unexpected and unusual economic shock; a shock that would generate difficulties for even the most dynamic economy. Yet this is clearly not the whole story. The key German problems of slow growth and unemployment can also be attributed to a significant degree to restrictive monetary and fiscal policies.

While Germany may benefit from EMU in the long term, in the short term EMU has had a powerful *adverse* effect on Germany. Since 1998 the German economy has been confronted with short and long-term real interest rates that are higher than the EMU average, thus acting to dampen investment and growth.<sup>98</sup> This is happening because German inflation rates have been significantly *lower* than the EMU average – during 2002 and 2003 Eurozone inflation hovered around 2% with Germany around 1%.<sup>99</sup> The problem is that the ECB has to target average EMU growth and inflation rates. This translated into overly restrictive monetary policy for Germany. Thus even from a strong anti-inflation policy position, lower nominal interest rates could be justified for Germany and this would undoubtedly add stimulus and growth to its economy. Like reunification, monetary union has introduced an adverse exogenous shock to the German system. Since mid-2004 German inflation has risen closer to the Eurozone average as the economy began to recover. With little concurrent change in monetary policy, this suggests that the German recovery may be attributed to structural reforms made during the previous years.

In theory, German policymakers could attempt to counteract this tight monetary noose through a looser fiscal policy, i.e., fiscal stimulus. However, Truger, looking at the primary government deficit ratio (PDR) argues that fiscal policy in Germany has been restrictive (and increasingly so) since the late 1990s, not least because of the Growth and Stability Pact restrictions.<sup>100</sup> Truger also claims that fiscal policy has been relatively more restrictive during periods of economic slowdown, thus acting in a pro-cyclical fashion. He goes on to finally argue that restrictive fiscal policy, combined with a declining adjusted wage share (share of wages in total GDP), mean that domestic demand has been weak and lower than the EMU as a whole.<sup>101</sup> Relatively weak demand and declining wage share are also a result of the fact that, since 1994, annual increases in unit labor costs in Germany have been less than the EU-12. Declining wage share and low unit labor cost increases are also clear indicators of relative wage moderation in Germany.<sup>102</sup>

## CONCLUSION

At the beginning of this paper I briefly enumerated four presumed weaknesses of the German economy: insufficient capital for innovation (banking); the inefficiency of *Deutschland AG* (cozy relations among banks, firms); rigid labor markets; and excessive welfare state spending. The body of this paper demonstrated considerable change in the institutions governing the first three areas. The financial system was transformed to facilitate more risk-friendly investment through increased venture capital and a more vibrant stock market. The corporate governance system was reformed to give owners more transparency and thus encourage their investment in German firms. Corporate governance and other reforms also initiated the unwinding of corporate interlocks and made managers more accountable for firm performance. Organized labor showed considerable flexibility by allowing and engaging in more decentralized labor-management relations which fostered cost reductions and firm restructuring. There is much evidence that these reforms have worked as intended and thus represent successful institutional adaptation and policy change.

The final section of the paper attempted to put Germany's poor performance into perspective. First, Germany's labor market problems are significant but concentrated – in the East, among young and old workers, and among the low skilled. Future reforms need to target these segments, especially by reducing non-wage labor costs and stimulating demand for labor. Second, it is clear that a good part of Germany's economic problems were not due to inherent institutional deficiencies of the German model but to two exogenous shocks – German reunification and European Monetary Union. Without these the German economy would in all probability look much stronger; so much so that it might no longer be viewed as the 'sick man of Europe'. Nevertheless, Germany faces no other choice but to invest in redeveloping eastern Germany and remains committed to EMU. Thus it must adjust to these shocks and it has done quite a bit in this regard. Should it have done, or should it still do, more radical institutional and policy reform?

Agenda 2010 was a big step forward, but at the moment it appears that future reforms will more than likely be incremental rather than fundamental. Yet this may ultimately be for the best. More radical reform of the German economic model – such as a radical overhaul of labor market regulations – might very well lead to an erosion of the traditional German diversified quality production model – a model that still makes German firms global leaders in a wide range of industries, especially in manufacturing. Thoroughly deregulated labor markets would put heavy pressure on wages and most likely a decline in investment in skills would follow (given a decreasing return to investment on skills). Without high-skill labor, German firms would find it increasingly impossible to compete in their traditional product markets. What then would follow? The US road to deindustrialization?

Probably the best path for Germany is the present one; namely, introducing more flexibility into its institutions but in a manner largely consistent with its core principles of consensual labor–management relations (codetermination), high skills, wage moderation, and an emphasis by labor and management on productivity. While there is still a clear need for further labor market and especially welfare state reforms in Germany, Germany's institutional reforms to date represent successful adjustment to more global and competitive capital and product markets – one that preserves an economic model capable of combining relatively high social equality with long-term competitiveness. In this sense Germany may still serve as a model for all of the European Union.

#### NOTES

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1. For one comprehensive academic critique see Stephen J. Silvia, 'Reinventing the German Economy', AICGS Policy Report #8 (2003).
2. This section parallels the discussion in Richard Deeg, 'Change from Within: German and Italian Finance in the 1990s', in Wolfgang Streeck and Kathleen Thelen (eds.), *Beyond Continuity: Institutional Change in Advanced Political Economies* (Oxford: Oxford University Press, 2005).
3. Susanne Lütz, 'The Revival of the Nation-State? Stock Exchange Regulation in an Era of Globalized Financial Markets', *Journal of European Public Policy* 5/1 (1998), pp.153–68.
4. *Ibid.*
5. Richard Deeg and Susanne Lütz, 'Internationalization and Financial Federalism - the United States and Germany at the Crossroads?', *Comparative Political Studies* 33/3 (2000), pp.374–405.

6. For other reviews of finance and corporate governance reform see Nicholas Ziegler, 'Corporate Governance and the Politics of Property Rights in Germany', *Politics and Society* 28/2 (2000), pp.195–221; John Cioffi, 'Restructuring "Germany, Inc.": The Corporate Governance Debate and the Politics of Company Law Reform', *Law and Policy* (December 2002); Gregory Jackson, 'Corporate Governance in Germany and Japan: Liberalization Pressures and Responses during the 1990s', in Wolfgang Streeck and Koza Yamamura (eds.), *The End of Diversity: Prospects for German and Japanese Capitalism* (Ithaca: Cornell University Press, 2003); Sigurt Vitols, 'Negotiated Shareholder Value: The German Variant of an Anglo-American Practice', *Competition and Change* 8/4 (2004), pp.357–74.
7. Lütz, 'The Revival of the Nation-State?'
8. Ibid.
9. John Cioffi, 'Expansive Retrenchment: The Regulatory Politics of Corporate Governance Reform and the Foundations of Finance Capitalism', Paper presented at the German Studies Association, New Orleans, 18–21 September 2003.
10. The law places some limits on bank ownership of industrial capital and also allows German corporate managers to buy back their own shares, a technique commonly used in the US to boost share price. Closely tied to this are the newer regulations permitting firms to pay their managers with share options, again a widespread practice in the US but previously unknown in Germany. See Cioffi, 'Expansive Retrenchment' for more details.
11. Cioffi, 'Expansive Retrenchment'.
12. Ibid.
13. Ibid.
14. Many large firms in other states, for example, are protected by 'golden shares' held by governments which enable them to block takeovers. Such shares do not exist in Germany.
15. Martin Höpner, 'European Corporate Governance Reform and the German Party Paradox' (Unpublished paper, 25 November 2002); Cioffi, 'Expansive Retrenchment'.
16. The law also strengthened the power of supervisory boards vis-à-vis management (Höpner, 'European Corporate Governance Reform and the German Party Paradox').
17. Dieter Fockenbrock, 'Corporate Governance auf dem Prüfstand', *Handelsblatt*, 7 March 2005.
18. Stefanie Franke, Stefanie Grohs and Christian Laux, 'Initial Public Offerings and Venture Capital in Germany', Working Paper No. 2003/26 (Center for Financial Studies, Johann Wolfgang Goethe University, 2003), p.2.
19. Ibid., p.11.
20. For an opposing argument on the future, see Vitols, 'Negotiated Shareholder Value'.
21. Richard Deeg, *Finance Capitalism Unveiled: Banks and the German Political Economy* (Ann Arbor: University of Michigan Press, 1999).
22. By 2001, 16 German firms were listed on the NYSE (Jackson, 'Corporate Governance in Germany and Japan'). The number of listed firms in Germany rose from 436 in 1983 to 933 in 1999. Jürgen Beyer, 'Deutschland AG a.D.: Deutsche Bank, Allianz und das Verflechtungszentrum grosser deutscher Unternehmen', MPIfG Working Paper 02/4 (March 2002).
23. Between 1990 and 1998 the investment funds' share of all German shares rose from 4% to nearly 13%. Ulrich Jürgens, Joachim Rupp and Katrin Vitols with Bärbel Jäschke-Werthmann, 'Corporate Governance and Shareholder Value in Deutschland', Discussion Paper of the Social Science Research Centre, Berlin, FS II 00-202 (2000); and Martin Höpner, 'Corporate Governance in Transition: Ten Empirical Findings on Shareholder Value and Industrial Relations in Germany', Discussion Paper 01/6 (Max Planck Institute for the Study of Societies, 2001).
24. Jürgens *et al.*, 'Corporate Governance and Shareholder Value in Deutschland', p.15.
25. Compare Höpner, 'Corporate Governance in Transition', and Jeremy Edwards and Marcus Nibler, 'Corporate Governance: Banks versus Ownership Concentration in Germany', *Economic Policy* 15 (2000), pp.237–68. Jackson, 'Corporate Governance in Germany and Japan', shows that during the 1990s the proportion of shares held by 'stable investors' (banks, insurance firms, corporations, and the state) declined from 60.2% to 52.8%; while shares held by individuals, institutions and foreigners – who are much more likely to actively trade shares – rose from 39.8% to 47.1%.
26. Höpner, 'Corporate Governance in Transition'; Jürgens *et al.*, 'Corporate Governance and Shareholder Value in Deutschland'.
27. Aggregate equity holdings by banks held steady during the 1990s, but from 1999 to 2003 they dropped from 13% to 9% of all outstanding equity in German firms; insurance companies and other financial firms (mostly investment funds) more than doubled their holdings, from 6.6% to 13.2% and 6% to 13.5% respectively, but this was largely portfolio investment: Sigurt Vitols, 'Changes in Germany's Bank-Based Financial System: Implications for Corporate Governance', *Corporate Governance: An International Review* (forthcoming).
28. *The Economist*, 14 August 1999; *New York Times*, 13 August 1999.

29. Mark H. Lang, Edward L. Mayhew and Douglas A. Shackelford, 'Bringing Down the Other Berlin Wall: Germany's Repeal of the Corporate Capital Gains Tax' (Unpublished ms, 21 January 2001).
30. The key financial firms at the heart of Germany's cross-shareholding system have reduced substantially since the mid-1990s their holdings in industrial firms. See Höpner, 'Corporate Governance in Transition', and Beyer, 'Deutschland AG a.D.'.
31. The value of M&A deals also increased dramatically relative to GDP: Martin Höpner and Gregory Jackson, 'Political Economy of Takeovers in Germany: The Case of Mannesmann and its Implications for Institutional Change', Discussion Paper 01/5 (Max Planck Institute for the Study of Societies, 2001).
32. Beyer, 'Deutschland AG a.D.'
33. Vitols, 'Changes in Germany's Bank-Based Financial System'.
34. From 1990 to 1996 of the number of chairs held by bankers in the 40 largest corporations was steady, at around 40%; from 1996 to 1999 the number dropped to less than 25% (Höpner, 'Corporate Governance in Transition'). In 2001 the Deutsche Bank announced its intention to give up all supervisory board chairs (Beyer, 'Deutschland AG a.D.'). In 1974 banks held 20% of the supervisory board seats in the 100 largest firms; by 1993 this percentage had shrunk to 6.3% (Lütz, 'The Revival of the Nation-State?').
35. The median size shareholding (as a percentage of all shares) held by the single largest shareholder in a DAX 30 firm was 21.5% at the end of 2002; this compared to 5.3% for the Dow Jones 30 (Vitols, 'Negotiated Shareholder Value').
36. For more on the continuities in the financial system see Vitols, 'Negotiated Shareholder Value'.
37. Vitols, 'Negotiated Shareholder Value'.
38. Wolfgang Streeck, *Social Institutions and Economic Performance: Studies of Industrial Relations in Advanced Industrial Countries* (London: Sage Publications, 1992); Kathleen Thelen, *Union of Parts: Labor Politics in Postwar Germany* (Ithaca: Cornell University Press, 1991).
39. Though this general process of decentralization originates in the 1980s (see Thelen, *Union of Parts*).
40. Britta Rehder, 'Pfadwechsel ohne Systembruch: Der Beitrag betrieblicher Bündnisse für Beschäftigungssicherung und Wettbewerbsfähigkeit zum Wandel der Arbeitsbeziehungen in Deutschland' (Doctoral Dissertation, Humboldt University, Berlin, 2002), p.275; Deutsche Bundesbank, *Monatsbericht* (Frankfurt: Deutsche Bundesbank Deutsche Bundesbank, February 2004), p.46. In the mid-1990s legal challenges to these clauses were invalidated by the Federal Labor Court, thus institutionalizing them as a new element of the industrial relations system, see Britta Rehder, 'Conversion caused by Layering: Institutional Change in the German System of Industrial Relations', Paper presented at the German Studies Association, New Orleans, 18–21 September 2003.
41. Rehder, 'Pfadwechsel ohne Systembruch', p.284.
42. *Ibid.*, p.259.
43. *Ibid.*, p.268.
44. Christine Trampusch, 'Institutional Resettlement: The Case of Early Retirement in Germany', in Wolfgang Streeck and Kathleen Thelen (eds.), *Beyond Continuity: Institutional Change in Advanced Political Economies* (Oxford: Oxford University Press, 2005).
45. Höpner, 'European Corporate Governance Reform and the German Party Paradox', p.33; see also Reinhard Bispinck, 'Kontrollierte Dezentralisierung der Tarifpolitik – Eine schwierige Balance', *WSI Mitteilungen* 57/5 (2004), pp.237–45.
46. Rehder, 'Pfadwechsel ohne Systembruch' and 'Conversion caused by Layering'.
47. Rehder, 'Conversion caused by Layering'.
48. Rehder, 'Pfadwechsel ohne Systembruch', Höpner, 'European Corporate Governance Reform and the German Party Paradox'.
49. Höpner, 'European Corporate Governance Reform and the German Party Paradox', p.27.
50. Firms that have become more shareholder-oriented and introduced variable pay for management, tend to do so also for regular employees (and employees welcome this). A study of the top 100 firms showed that, in the late 1990s, 70% adopted performance-related pay and 57% had employee stock ownership plans (ESOPs). Antje Kurdelbusch, 'The Rise of Variable Pay in Germany: Evidence and Explanations', Paper presented at the Annual Meeting of the Society for the Advancement of Socio-Economics, Amsterdam, 28 June–1 July 2001.
51. Höpner, 'European Corporate Governance Reform and the German Party Paradox', p.29. Though works councils are reluctant to support a shift by management to an emphasis on publicly-stated profitability targets, since these might be used to justify closure of particular plants or subsidiaries.
52. Höpner, 'European Corporate Governance Reform and the German Party Paradox', pp.29–30. Where firms have resisted (some) shareholders demands for more radical restructuring, this has just as often been because both labor *and* management opposed it.

53. Jürgens *et al.*, 'Corporate Governance and Shareholder Value in Deutschland'.
54. Michel Goyer, 'Corporate Governance, Employees and the Focus on Core Competencies in France and Germany', in Curtis Milhaupt (ed.), *Global Markets, Domestic Institutions: Corporate Law and Governance in an era of Cross-Border Deals* (New York: Columbia University Press, 2003), p.57.
55. OECD, *OECD Economic Survey: Germany* (Paris: OECD, 2004), p.29.
56. Höpner, 'European Corporate Governance Reform and the German Party Paradox'.
57. Silke Bothfeld and Karen Ullmann, 'Kündigungsschutz in der betrieblichen Praxis: Nicht Schreckgepenks, sondern Sündenbock', *WSI Mitteilungen* (May 2004), pp.262–7; Sigurt Vitols, 'Investitionshindernis als Drohkulisse', *Die Mitbestimmung* 12 (2004), pp.46–9.
58. Christel Lane, 'Institutional Transformation and System Change: Changes in Corporate Governance of German Corporations', in Glenn Morgan, Richard Whitley and Eli Moen (eds.), *Changing Capitalisms* (Oxford: Oxford University Press, 2005) argues that codetermination has become an empty shell, i.e. labor is coopted and has little power to affect outcomes.
59. Goyer, 'Corporate Governance, Employees and the Focus on Core Competencies in France and Germany'.
60. See Jackson, 'Corporate Governance in Germany and Japan'; Rehder, 'Conversion caused by Layering'.
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67. Helmut Hauschild, 'Starker Imageverlust für Gewerkschaften', *Handelsblatt*, 9 July 2004).
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77. OECD, *OECD Economic Survey: Germany*, p.25.
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79. OECD, *OECD Factbook 2005* (Paris: OECD, 2005).
80. Siemens is a good example of these trends. After far-reaching restructuring over the last decade, profits in recent years have been good and growing stronger. But over the past 12 years Siemens' employment in Germany declined from 253,000 to 167,000, while employment outside Germany grew 56% to 250,000. 'Siemens Searches for a Vision of the Future', *Financial Times*, 1 March 2004.
81. Compare OECD, *OECD Economic Survey: Germany*, and IMF, 'Germany: Selected Issues', IMF Country Report No. 04/340 (2004).
82. OECD, *Main Economic Indicators*, September (Paris: OECD, 2003).
83. Deutsche Bundesbank, *Monatsbericht*, p.46.
84. Source: Bundesverband deutscher Banken, <http://www.bankenverband.de>, downloaded 7 July 2005.
85. Silvia, 'Reinventing the German Economy', pp.4–5.
86. See 'Auch kleine Firmen wollen Jobs verlagern', *Handelsblatt*, 23 March 2004; 'Siemens droht massive Stellenverlagerung', *Handelsblatt*, 22 March 2004.
87. Silvia, 'Reinventing the German Economy', p.3.
88. From 1992 to 2002, German GDP growth averaged 1.4% while the euro-11 averaged 2.1% (Silvia, 'Reinventing the German Economy', p.3).
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90. OECD, *Economic Outlook* (Paris: OECD, 2002).
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92. Achim Truger, 'Germany's Poor Economic Performance in the Last Decade: It's the Macroeconomy, not Institutional Sclerosis', *WSI Diskussionspapier Nr. 118* (September 2003).
93. Truger, 'Germany's Poor Economic Performance in the Last Decade'. East German unemployment climbed to 18.7% by June 2003, thus adding considerably to the increase in overall German unemployment (Silvia, 'Reinventing the German Economy', p.5).
94. Source: Bundesverband deutscher Banken, <http://www.bankenverband.de>, downloaded 7 July 2005.
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101. Since 1996 German adjusted wage share has been declining faster than the EMU as whole, suggesting a greater decline in effective domestic demand in Germany (Truger, 'Germany's Poor Economic Performance in the Last Decade').
102. OECD, *Economic Outlook*; see also Jürgen Beyer and Anke Hassel, 'The Effects of Convergence: Internationalization and the Changing Distribution of Net Value Added in Large German Firms', *Economy and Society*, 31/3 (2002), pp.309–32. IMF data also show that, since the early 1990s, actual wage increases have been substantially below negotiated wage increases (IMF, 'Germany: Selected Issues', p.49).