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The German model of corporate governance: Basic features, critical issues, and applicability to transition economies

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THE GERMAN MODEL OF CORPORATE GOVERNANCE

**Basic Features, Critical Issues, and Appli-
cability to Transition Economies**

by

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November 1995



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ABSTRACT

The paper briefly sketches alternative models of dealing with principal-agent problems and compares major characteristics of bank-oriented versus market-oriented systems of corporate governance. The ownership structure in Germany is contrasted with evidence for other industrial countries. This forms the basis on which some critical issues of the German model of corporate governance are discussed. The analysis focuses on the role of banks in enterprise control, and on the limits which cross-shareholdings and the system of co-determination may impose on the effectiveness of outsider control. The pros and cons of the German model are evaluated in comparison with alternative systems. Finally, it is discussed whether transition economies are well advised to follow this model rather than market-based systems of corporate control.

JEL Classification: G 30

I. Introduction*

Renewed interest has emerged in the question of whether there is a first-best model of corporate governance since transition economies are dealing with restructuring and privatization of state-owned enterprises. The costs of transition might be reduced if the experience made elsewhere suggested that one of the alternative models was clearly best suited to the needs of transition economies. As a matter of fact, some governments in Central and Eastern Europe were rather eager to copy an US-type model of corporate governance by "quickly establishing and heavily relying on the stock market" [Grosfeld 1994, p. 2]. Such enthusiasm has provoked criticism by some Western economists who argue that, instead of following the US-type model with widely held equity and an active market for corporate control, transition economies should rather adopt the German-type system with strong universal banks and a stable core of large shareholders which are exercising effective control on management [e.g., Corbett and Mayer 1992; Mayhew and Seabright 1993; Frydman et al. 1993; van Wijnbergen 1994].

The latter advice tends to ignore, however, that the German model is under serious attack from within the country [e.g., Wenger 1992; Adams 1994]. Most notably, it is blamed for giving rise to insider collusion at the expense of effective monitoring of enterprise managers. Some observers have concluded from the ongoing debate that "perhaps the differences (between bank-oriented and market-oriented systems of finance and control) are apparent rather than real" [Hellwig 1995, p. 196].¹ Others maintain that different forms of corporate governance are suited to different types of corporate activity [Franks and Mayer

* Thanks are due to Frank Bickenbach, Ralph Heinrich and Rolf Langhammer for critical comments and helpful suggestions. An earlier version of this paper was presented at the "International Conference on Chinese Corporate Governance" in Shanghai, 27-28 October 1995.

¹ Text in brackets added.

1995]. Moreover, the appropriateness of existing models for transition economies may depend on country-specific circumstances and the objectives to be achieved during the process of transformation.

Before returning to these issues, the paper briefly sketches the major characteristics of prototype models of dealing with principal-agent problems (Section II). Section III describes the German system of corporate governance, and evaluates to which extent it fits into the widely used classification of bank-based versus market-based models. Subsequently, some of the much debated critical issues of the German system are addressed, namely the role of banks in corporate governance, and the contribution of co-determination and cross-shareholdings to insider collusion (Section IV). This discussion leads to an evaluation of the German model's strengths and weaknesses in ensuring effective corporate control. Section V concludes by discussing the system's applicability under conditions prevailing in transition economies.

II. Alternative Models of Corporate Governance

The effectiveness of corporate governance is a relevant issue since the separation of ownership and control of enterprises has become commonplace in advanced economies. Principal-agent relations involve moral hazard problems when ownership is dispersed and monitoring costs are non-negligible [Berle and Means 1932]. This is basically due to an informational asymmetry once capital owners (principals) have invested in enterprise shares. Unlike enterprise managers (agents), principals do not know whether the capital they own is used most productively in the firm. All they observe is the future stream of dividends, which is not only a function of how capital is used, but also stochastic to some degree. That provides room for the management to pursue other goals than profit maximization. For example, the self-interest of managers to acquire influence and reputation by expanding the operations of the firm may well run counter to the profit motive of owners.

Principal-agent relations of this kind are common to economies in which firms are no longer managed by their owners. Yet, significant differences have evolved as concerns the mechanisms by which to reduce moral hazard and strengthen corporate control. A major distinction in this respect relates to bank-based versus market-based systems of corporate financing and control [e.g., Edwards and Fischer 1994]. The characteristic features of the two systems have been aptly summarized by Berglöf [1990]; the most relevant differences are reproduced in Table 1. In the stylized description of bank-based systems, companies raise most of their external finance from banks which maintain close and long-term relations with their corporate customers [Franks and Mayer 1995, p. 171]. The house-bank tradition in Germany is frequently considered to be a typical example. By contrast, arm's-length and short-term relations with various investors are stressed as the dominant feature of market-based systems, e.g. in the United Kingdom and the United States.

The financial system influences the design of financial contracts and the way they are aggregated into the capital structure of firms. Hence, different financial systems may have important implications for the structure and effectiveness of corporate control. The degree of ownership concentration appears to be most relevant in this regard:

- On the one hand, concentrated ownership in a bank-based system may help to reduce principal-agent problems [Grundfest 1990]. Shareholders with significant stakes in an enterprise have stronger incentives to incur the costs of engaging in effective monitoring of managers. The potential for exercising control and capturing private benefits is large as compared to a situation with many small shareholders. The latter will prefer free-riding given that monitoring involves private costs of collecting and evaluating the relevant information, while the benefits in terms of better management are

marginal for the individual shareholder and largely accrue to other shareholders which remain passive.

Table 1 — Major Characteristics of Bank-based and Market-based Financial Systems

	Bank-based	Market-based
Financial markets		
– sophistication and opportunities for diversification	low	high
Overall capital structure		
– degree of internal finance	low	high
– debt/equity ratio	high	low
Creditor structure		
– ratio of bank credits to total liabilities	high	low
– importance of bond financing	low	high
– degree of concentration	high	low
Shareholder structure		
– degree of concentration	high	low
– commercial bank shareholdings	significant	insignificant
– inter-firm shareholdings	widespread	less common
– turnover of controlling blocs	slow	faster

Source: Berglöf [1990].

- On the other hand, the ownership characteristics of bank-based systems are supposed to give rise to insider collusion between managers, employees and banks (as creditors, shareholders and custodians of shares) at the expense of outsiders, notably shareholders with relatively small stakes [Wenger 1992; Baums 1993, pp. 46ff.]. According to this view, collusion may result in the maximization of (output and employment) growth, rather

than profits.² Moreover, the above reasoning on insufficient monitoring when ownership is widely dispersed ignores that discipline may be imposed on managers by other means in market-based systems, notably by the threat of takeovers [Scharfstein 1988; Franks and Mayer 1990]. Informed raiders may launch bids against firms whose market valuation is considered low due to managerial slack. Principal-agent problems are reduced to the extent that managers facing the risk of being replaced after a takeover, take shareholder interests into account.

This short discussion provides first indications that, on analytical grounds, a clearly superior model of corporate governance does not exist. It may also be open to question whether the systems observed in practice fit well into the above classification. The next sections thus turn to a closer examination of main features of the German system and its strengths and weaknesses.

III. Major Characteristics of the German System of Corporate Governance

1. Basic Institutional Features

The subsequent discussion of governance structures in Germany applies specifically to stock corporations (Aktiengesellschaften).³ Stock corporations represent the largest firms in Germany. However, they account for a very small fraction of the total population of firms: only 1700 out of about 2 million firms

² Blinder [1991] argues along similar lines with respect to Japanese managers. Milgrom and Roberts [1992, p. 443] conclude that "Japanese firms are not run in the interests of their shareholders". For a critical assessment of this proposition, see Kaplan [1994a].

³ The laws applying to limited liability companies (Gesellschaft mit beschränkter Haftung, GmbH) are technically different, but qualitatively similar [Kaplan 1994b]. Note, however, that principal-agent problems tend to be less significant in these companies than in large stock corporations. For a detailed presentation of corporate governance structures in Germany, see Baums [1993], on which this sub-section draws extensively, and Roe [1993].

were stock corporations in 1990.⁴ Stock corporations are required by law to have a two-tier board system, consisting of a management board (Vorstand) and a supervisory board (Aufsichtsrat). The former is appointed by and reports to the latter. Managers run the day-to-day business, typically on a five-year contract basis, and can only be dismissed for cause by the supervisory board.

The supervisory board, whose members may not include current firm managers, operates subject to the co-determination system. Co-determination implies that a certain share of the members of supervisory boards are neither elected nor appointed by the company's shareholders. Rather, one third of board members are elected by employees or appointed by trade unions in companies with more than 500 employees. This share goes up to one half of board members in companies with more than 2000 employees. In addition, workers' councils have considerable rights relating to terms of employment and dismissal. By implication, the interests of different stakeholders in the firm, rather than just the shareholders, are involved when the supervisory board appoints managers and reviews their performance. However, shareholders appoint the chairman of the supervisory board who may break ties with his vote in companies with more than 2000 employees.

Shareholder meetings may not interfere with day-to-day business, i.e., competencies are confined to basic decisions. Apart from electing representatives for the supervisory board, the latter include: changes in company statutes, approval of annual company accounts, profit distribution, and company strategies with regard to mergers, new equity issues, etc. Given that small shareholders have weak incentives to participate in annual meetings, custodians, notably large German banks, are usually given proxies to vote those shares. Banks often have control of a large percentage of shareholder votes. As a result,

⁴ 665 stock corporations were quoted on the stock market, and 80 were widely held and traded [Baums 1994].

bank representatives are members of most supervisory boards. As a matter of fact, the leverage the proxy system provides for banks is one of the most hotly debated issues of corporate governance in Germany (Section IV.1).

2. *The Structure of Finance and Ownership*

Before discussing possible implications on corporate governance, the subsequent paragraphs provide some empirical information on corporate financing and ownership patterns. In various respects, the differences between prototype financial systems are less pronounced than suggested by Table 1, and the evidence for Germany is rather difficult to reconcile with the typical features of a bank-based system.⁵

The label "bank-based" is clearly a misnomer, if one considers the structure of financing of the German (non-financial) enterprise sector as a whole. True, if international comparisons were restricted to stock data on liabilities from balance sheets, i.e., the structure of *external* financing, some of the features listed in Table 1 are brought out. An earlier study by the Bank of England [1984] revealed that debt accounted for about 80 per cent of total liabilities of German non-financial businesses in the early 1980s. The share of equity capital (about 20 per cent) was substantially below the figure for the United Kingdom, where equity capital and debt each accounted for about half of total liabilities. However, such a comparison obscures the overriding role of *internally* generated funds in both financial systems.

A more appropriate way to compare the financing of investment by companies across countries is to refer to flow-of-funds data, rather than balance-sheet data [Edwards and Fischer 1994, pp. 49ff.]. This avoids the complications involved

⁵ For detailed analyses of finance and ownership structures in Germany and other industrialized countries, see Mayer [1990], Baums [1993; 1994], Edwards and Fischer [1994], and Franks and Mayer [1995].

in using balance-sheet data, which arise from different accounting and valuation conventions. Flow-of-funds statements reveal the sources of funds in a particular year, as well as the uses to which these funds were put in that year. To identify the financial sources of investment in *physical* assets, Table 2 contrasts the net financing⁶ of German and UK companies by using flow-of-funds data.⁷ In contrast to widespread beliefs, the contribution of internally generated funds was only somewhat higher in the UK than in Germany.⁸ In both countries, loans from financial institutions rank second, though by a great margin. In other words, loans represent the most important external source of finance, but are very much less important than internal financing. It is again contrary to conventional wisdom that loans accounted for a smaller share of total enterprise financing in Germany, as compared to the UK. Other sources of finance remained insignificant in both Germany and the UK. All in all, the structure of financing was remarkably similar in these two countries, which are typically considered to represent opposite systems of corporate finance and governance.

This picture would not change significantly, if financing structures were analyzed for the rather small group of stock corporations only. The available evidence indeed suggests that the dominance of internal financing over bank loans was even more pronounced for German stock corporations than for the overall enterprise population [see Baums 1993, pp. 22f., and the references given there]. Furthermore, German stock corporations with bank representation on their supervisory boards relied less on bank financing than UK corporations without such a representation on their boards.

⁶ Alternatively, gross financing relates to the acquisition of both physical and financial assets [Edwards and Fischer 1994, pp. 49ff.].

⁷ For a comparison of net sources of finance in Germany, Japan, the UK and the US, see Corbett and Jenkinson [1994].

⁸ The difference becomes marginal when statistical adjustments in the case of the UK are completely attributed to this financial item.

Table 2.— Net Sources of Finance for Investment by the Non-financial Enterprise Sector in Germany and the UK, 1970-1989 (per cent)

	Germany	UK ^a
Internally generated funds ^b	76.0	87.9
Provisions for pensions	4.6	n.a.
Capital transfers	8.5	8.3
Bank loans ^c	11.0	15.4
Bonds	-0.6	0.1
Shares	0.9	-1.3
Trade credit	-1.9	-2.1
Other	1.5	2.4
Statistical adjustment ^d	n.a.	-10.7

a 1970-1987. – b Sum of retained profits and depreciation. – c All financial institutions in the case of UK. Loans from insurance companies (0.01 per cent of total financing) included in the case of Germany. – d Balancing items included implicitly in several financing categories in the case of Germany.

Source: Edwards and Fischer [1994, p. 66].

The differences between Germany and countries such as the UK and the US are much more pronounced when it comes to market capitalization and ownership characteristics of stock corporations [Franks and Mayer 1995, pp. 174ff.]. First of all, the number of domestic companies listed on stock markets was below 700 in Germany in the early 1990s, as compared to about 2000 and 6300 firms in the UK and US, respectively. The value of companies quoted on stock markets exceeded 80 per cent of GDP in the UK and was still high in the US (57 per cent), whereas the value of quoted companies accounted for less than one quarter of GDP in Germany. Second, ownership of stock corporations is typically dispersed among a large number of institutions or individuals in the UK and the US. Among the larger quoted companies in the UK, for example, more than four fifths were widely held (i.e., there was no shareholder who

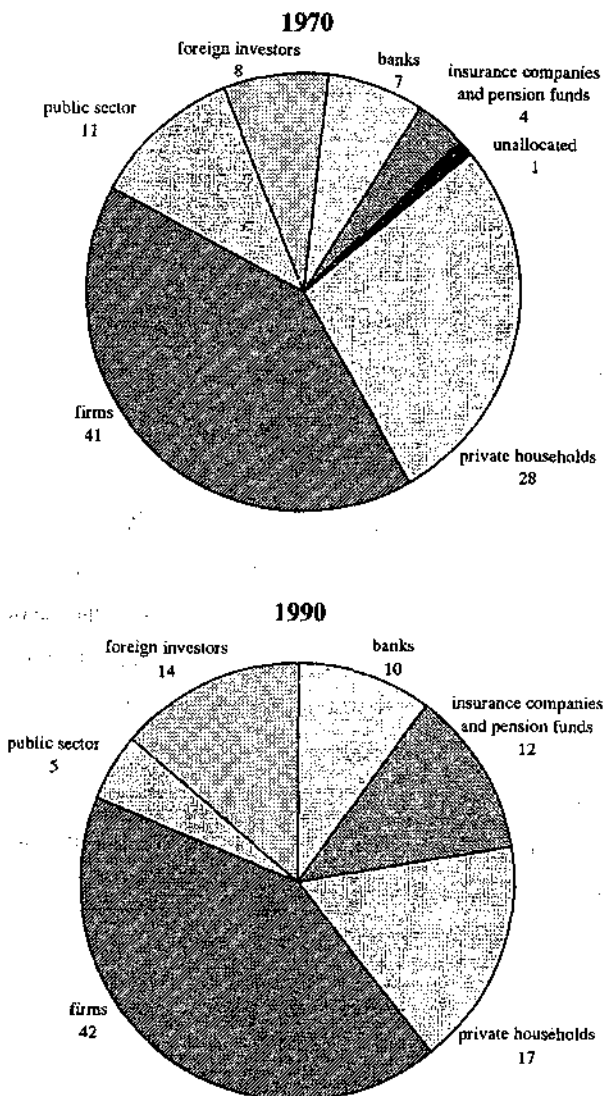
owned more than 25 per cent of the equity of a firm). By contrast, ownership is concentrated in Germany. In nearly 85 per cent of the larger stock corporations, there was at least one shareholder owning more than 25 per cent of all shares.

Nevertheless, as far as stock corporations are concerned, the characterization of the German system as bank-based appears to be misleading, if ownership patterns are evaluated in some more detail. Major insights from Figure 1, which portrays the distribution of shares of all German stock corporations, may be summarized as follows:

- Firms clearly emerge as the most important group of shareholders. Their dominant role has remained fairly stable over the last decades.⁹
- Shareholdings by private households still rank second in importance, but have been declining steadily (relative to other shareholders) since the 1960s. Germany's elaborated social security system on the one hand, and less developed securities markets on the other hand may be reasons for this.
- Foreign investors, as well as insurance companies and pension funds have increased the percentage of their shareholdings. In 1990, they ranked third and fourth among the various groups of shareholders.
- Banks, too, accounted for a larger percentage of shareholdings in 1990 than two decades earlier. However, their role as direct shareholders remained considerably below what might be expected in a so-called bank-based system.

⁹ For the implications of cross-shareholdings on corporate governance, see Section IV.2 below.

Figure 1 — Distribution of Ownership in Domestic Shareholdings in Germany, 1970 and 1990 (per cent)



Source: Baums [1994, p. 4].

Further evidence on the limited role of German banks as direct shareholders of stock corporations is provided by breaking down share stakes in excess of 25 per cent by different types of shareholders [Franks and Mayer 1995, pp. 176f.]. About 28 per cent of such stakes are held by other German companies. Family groups rank next with slightly more than 20 per cent. Trusts and institutional investors as well as foreign companies follow by a great margin, and banks figure even less prominently as large shareholders (banks accounted for less than 6 per cent of share stakes in excess of 25 per cent of the firm's equity capital). Moreover, banks have in common with trusts and institutional investors that their share stakes are rarely majority holdings. This contrasts with family groups and companies, which both appear to be majority holders of German firms rather frequently.

To summarize, large-scale family ownership is a particular feature of the largest enterprises in Germany, which is in stark contrast to the stylized description of bank-based systems in Table 1. Other companies represent the second group of large shareholders which clearly dominates banks. Arguably, this has two major implications with regard to corporate governance: First, if banks have an important say in corporate governance of stock corporations, it must be through exercising proxy votes on behalf of dispersed shareholders in the first place. Second, "the significance of outside shareholders is even smaller than the small number of quoted companies in ... Germany would suggest" [Franks and Mayer 1995, p. 184]. The German system of corporate governance may, therefore, be appropriately described as an insider (or relational) system, rather than a bank-based system. This does not preclude banks from being part of the insider system. The subsequent section examines these propositions in some more detail.

IV. The Effectiveness of Corporate Governance in Germany: Some Critical Issues

1. *Bank Leverage through Proxy Votes*

Bank power continues to be a hotly debated issue in Germany [e.g., Esser 1990; Wenger 1992; Edwards and Fischer 1994]. Four mechanisms through which banks may exercise corporate control figure prominently in the discussion [Baums 1994, pp. 15ff.]:

- creditor-borrower relations,
- direct shareholdings by banks,
- bank control of proxies, and
- bank representation on supervisory boards.

As concerns the first mechanism, it has been mentioned already that bank loans constitute a rather small percentage of corporate finance, once internal funding is taken into account. Large German stock corporations, in particular, have further reduced their reliance on bank loans [Wenger 1990, p. 163]. Moreover, earlier contentions that the so-called house-bank relationship in Germany enables a particular bank to monopolize the financial arrangements of a particular company are hard to reconcile with empirical evidence.¹⁰ Edwards and Fischer [1994, p. 136ff.], for example, conclude that there was little evidence of exclusive financing relationships with banks even before the increase in

¹⁰ If monopolization were a relevant factor empirically, the implications on corporate control by banks would still be debatable on analytical grounds. The notion of bank power tends to ignore that banks which have monopolized financial relations with a large borrower may be subject to blackmailing. The threat of a highly indebted company to default on outstanding obligations leaves a highly exposed bank with little choice but to continue lending, i.e., to throw good money after the bad. The balance of power between the creditor and the borrower may turn from the former to the latter in the course of debt accumulation. Bank creditors have witnessed this during the debt crisis of developing countries.

competition among banks during the 1980s.¹¹ Even small companies were unlikely to conduct all their banking activities with a single bank.¹² The larger a company is, the larger its number of bank connections.¹³ Likewise, the second mechanism does not provide banks with a great deal of power in corporate governance of stock corporations. As shown before, banks are direct shareholders in German stock corporations to some extent, but they come far down the list of large shareholders (Figure 1). The widely held view that banks have a crucially important say in corporate control thus implies that direct shareholdings are a poor indicator of the banks' significance. As a matter of fact, as holders of bearer shares, banks often have control of a much larger percentage of shareholder votes than direct shareholdings would suggest.

The largest German banks, in particular, typically act as custodians for the shares deposited with them by small shareholders. They are authorized to do so by revocable proxies, which have to be renewed every fifteen months. Banks have to recommend to the owners of deposited shares how to vote at shareholder meetings, and must ask for special instructions. However, banks are typically

¹¹ Likewise, the Japanese pattern of main bank relationships does not involve exclusive financial arrangements. Nevertheless, the behavior of Japanese banks is unique in one important respect. While Japanese banks do not interfere with company operations in normal circumstances, it is in the handling of financial difficulties that bank behavior looks different from other industrialized countries. If a company suffers from a business crisis, the main bank assumes major responsibility for various rescue operations. The main bank is closely involved in restructuring plans and has to coordinate other creditors to accept the plan [for details, see Corbett 1995; Aoki 1990; Sheard 1989]. Failure by the main bank to fulfil its function in these respects "virtually guarantees that it will be punished by others in the banking group of which it is a member" [Williamson 1992, p. 35].

¹² However, German companies with an annual turnover of less than DM 500 million still quite commonly have house banks in the sense of dominant suppliers of financial services [Edwards and Fischer 1994, p. 143].

¹³ For large companies, the house bank is usually the bank which has had the longest standing connection with the particular company. The house bank acts as first among equals in a group of several main banks, rather than as the dominant supplier of financial services.

free to vote according to their own recommendations, as special instructions are extremely rare [Wenger 1992, p. 78; Baums 1994, p. 15].

The latest empirical indication on bank control of proxies refers to the year 1992.¹⁴ The accumulated voting power of banks (due to own shareholdings, proxy votes, and shares held by bank-owned investment companies) accounted for an average of more than 82 per cent of the votes present in the shareholder meetings of 24 stock corporations with widely dispersed ownership.¹⁵ The voting power of banks amounted to a blocking minority in four corporations, a majority in three corporations, and a qualified majority in 17 corporations of this sample. These findings largely resemble the results of an earlier study by Gottschalk [1988]: In 1986, all banks together had a majority of the votes cast in all but one of the 33 shareholder meetings analyzed; all banks controlled more than 75 per cent of the votes cast in 22 cases; the three major German banks alone had a majority in nearly half of all cases.

These findings point to a strikingly strong voting power of banks at shareholder meetings. An important qualification has to be kept in mind, however. The banks' voting power as portrayed for the stock corporations considered in the studies referred to above, cannot be generalized because of a sample selection bias: While all stock corporations whose shareholder meetings were analyzed belonged to the largest 100 German companies, the studies were restricted to stock corporations whose share capital was either widely dispersed or owned directly by banks. Furthermore, Figure 1 suggests that widely held shares became less significant between 1970 and 1990 [see also Wenger 1992, pp. 78f.]. Note that the share of private households in domestic shareholdings

¹⁴ For a summary of recent studies on the banks' voting control in German stock corporations, see Baums and v. Randow [1995, pp. 6ff.]. It should be noted that the subsequent figures are based on proxy votes *plus* votes due to the banks' direct shareholdings and shareholdings by bank subsidiaries.

¹⁵ All stock corporations considered belonged to the "top 100" companies in Germany.

declined from 28 to 17 per cent. As large family holdings remained a typical feature in Germany, this decline is most likely due to a diminishing importance of small shareholdings by private households. This would imply that bank control of proxies, too, has become less significant. Figure 1 also reveals that banks and private households together accounted for 27 per cent of domestic shareholdings in 1990 (1970: 35 per cent). Arguably, this figure represents the maximum of the banks' direct and proxy votes in all German stock corporations taken together.¹⁶ Considering that the shareholdings of private households consist of large family holdings to a significant extent, the banks' actual voting power, on average, should be substantially below 27 per cent.

Obviously, banks may use their voting power to appoint bank representatives as members of the supervisory board, and thereby exercise control over the management. The aforementioned study by Gottschalk [1988] indeed reveals that bank representatives received 27 per cent of the supervisory board seats available to shareholders in the companies where banks had voting control. In 1990, representatives of the Deutsche Bank held at least one seat on the board of 35 out of the largest 100 German companies; the respective figures for the two other major German banks were 19 (Dresdner Bank) and 16 (Commerzbank) [Baums 1994, p. 19].

Surprisingly, however, the relationship between the banks' voting power and their board representation turned out to be ambiguous when subjected to a simple regression analysis [Edwards and Fischer 1994, p. 206]. Votes due to the banks' direct shareholdings had a significantly positive impact on the number of bank representatives on supervisory boards of companies in which the combined

¹⁶ It is assumed here that all shareholders are present at shareholder meetings. By contrast, the aforementioned studies on the banks' voting power in the largest publicly held stock corporations relate the votes cast by banks to the shares actually present at shareholder meetings. The average presence of shares in the samples underlying these studies was around 60 per cent [Baums and v. Randow 1995, p. 7].

votes of all banks exceeded 5 per cent. By contrast, the impact of proxy votes was not significantly different from zero. Two observations cast further doubt on the common belief that bank representation on supervisory boards was determined by voting power in the first place:

- The overall statistical fit of the above regression, in which the banks' own votes and proxy votes were the explaining variables, remained fairly poor ($\bar{R}^2 = 0.12$). This suggests that relevant determinants of bank representation on supervisory boards were omitted, even though the sample was restricted to companies with considerable bank voting power.
- Even more surprisingly perhaps, banks were also represented on the supervisory boards of a significant number of companies in which banks had hardly any voting power (i.e., the combined votes of all banks were less than 5 per cent).

Tentative conclusions which emerge from the discussion so far may be summarized as follows. German banks must indeed be considered major actors as concerns corporate control. It is doubtful, however, that "banks use their proxy voting rights to act as delegated exercizers of equity's control rights" [Edwards and Fischer 1994, p. 206]. Rather, banks may be part of a more complex insider system of corporate governance in Germany.

2. *Insider Relations*

Corporate governance in Germany can be characterized as insider- or relationship-oriented for two major reasons, namely the system of co-determination and extensive cross-shareholdings. The representation of employees and trade unions on supervisory boards may have important implications on corporate governance if one considers the incentives that guide board members. It can safely be assumed that company profits are of considerably less concern to employees and trade unions than to shareholders.

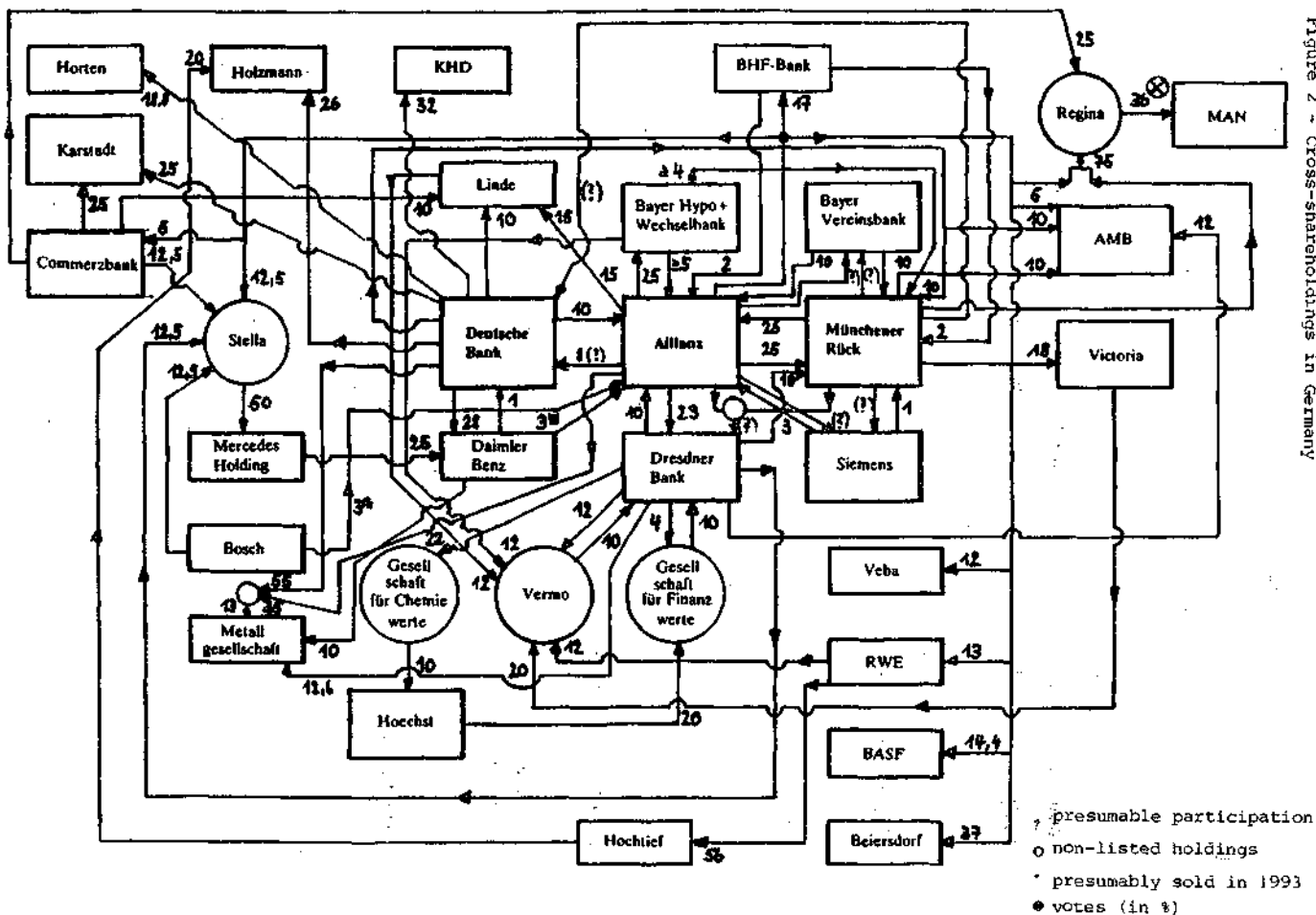
Employees and unions are primarily interested in job security. Output and employment growth may well be in conflict with profit maximization aimed at by shareholders. In this context, it is interesting to note that, according to German law, the management of a company is not obliged to maximize the value of equity shares. This means in practice that management is given considerable leeway to take decisions at its discretion [Baums 1994, p. 11]. Recalling the self-interest of managers to acquire influence and reputation by expanding the operations of the company, their preference structure seems to have much in common with the interests of employees. It may thus be contended that the German system of co-determination encourages insider collusion between the management and employees. This collusion may result in "a bias to excessive retentions" [Baums 1993, p. 24].¹⁷

The second type of insider relations rests on cross-shareholdings. The full extent of cross-shareholdings in Germany is not known. Inter-company linkages are frequently obscured in various ways so that cross-shareholdings remain below threshold levels that would imply mandatory publication. However, recent litigations have forced the revelation of major inter-company linkages [Wenger 1993]. Figure 2 exhibits an intricate maze of cross-shareholdings, even though the picture is still incomplete.

The complex pattern of cross-shareholdings seriously limits the chances of outsiders, including shareholders, to exercise corporate control. It may even be an euphemism to argue that outsider control has been replaced by insider

¹⁷ The extent to which collusion between the management and employees is at the expense of shareholders remains open to debate, however. Empirically, a relevant question is whether the German stock market has performed worse because of insider collusion, as compared with stock markets in the UK and the US. For empirical investigations of the effects of different corporate governance systems, see Section IV.3.

Figure 2 - Cross-shareholdings in Germany



control. Rather, cross-shareholdings are likely to encourage "insider dealings" [Hellwig 1995, p. 197] and compromise any effective corporate control.¹⁸ Consider the case where, due to cross-shareholdings, the chief executive of company A is sitting on the supervisory board of company B, while the chief executive of company B is sitting on the board of company A. Under such conditions, agency problems are looming large and outside shareholders are largely deprived of control. If the chief executives of the interlinked companies come to terms with each other, they may protect each other from interference by outside shareholders. The chief executive of company A can be expected to influence supervisory board decisions in company B in favor of his colleagues there, once the chief executive of company B is willing to return this favor when acting as a member of the supervisory board of company A.

Overall, it appears that the potential for insider collusion is fairly large in the German system of corporate governance. This raises the question of how this system compares with alternative institutional arrangements in terms of effectiveness of corporate governance.

3. Strengths and Shortcomings of the German Model: A Critical Evaluation of Major Arguments

Strikingly different contentions are made when it comes to the effectiveness of corporate governance in Germany, relative to alternative systems. One view maintains that the German system has considerable advantages. The supposed advantages have led various analysts to call for the US and UK system of corporate governance to imitate aspects of the German system [e.g., Cosh et al. 1990; Porter 1992].¹⁹ By contrast, others argue that "economic systems that have

¹⁸ The subsequent reasoning draws heavily on Hellwig [1995].

¹⁹ It may indeed be argued that major characteristics of different systems of corporate governance are the result of government policies and regulations. For example, the US and German systems might tend to converge, if German-type universal banks were allowed to operate and large shareholdings were no longer restricted in the US.

markets for control are ... superior to economic systems where control is allocated in a nonmarket fashion" [Spremann 1995, p. 166]. This would imply that any successes of German companies were achieved inspite, and not because of their corporate control structure.

The latter view refers to some of the aforementioned characteristics of the German model which are supposed to lead to major deficiencies in corporate governance. The basic argument is that the lack of effective monitoring by outsiders and poorly developed external markets for corporate control induce managerial slack. The insignificance of hostile takeovers in Germany is mentioned most frequently in this context. As a matter of fact, very few hostile takeovers have been recorded in Germany since World War II, which is in sharp contrast to the active market in corporate control, for example, in the UK [Franks and Mayer 1995]. The economic costs involved in takeovers cannot account for such differences across countries. Rather, takeovers are discouraged in several ways in Germany [for a detailed analysis, see Baums 1992]: Agreements among current shareholders with respect to voting right limitations, which restrict the voting rights of any shareholder to a certain percentage of total votes at shareholder meetings, are fairly common and prevent raiders from acquiring controlling interests in German companies. Moreover, it may be difficult for raiders to gain control of a company, even when a majority of the shares are tendered, because employee representatives on the supervisory board "by tradition vote with the incumbent management" [Franks and Mayer 1995, p. 187].

It remains open to question, however, to which extent the extremely low level of takeovers in Germany leads to managerial slack. The German model would be deficient in this respect, if economies with a higher level of takeovers were more successful in correcting for managerial failure. Yet, empirical studies do not

provide a clear-cut picture on the disciplinary role of takeovers.²⁰ Takeovers appear to have given rise to corporate restructuring, including asset disposals and executive dismissals, but there is at best a weak relation between past corporate performance and the risk of being the target of a takeover bid.

According to critics of the German system of corporate governance, the high degree of insider collusion has another major drawback, namely the deprivation of shareholder rights in general, and the discrimination of small shareholders in particular. Obviously, shareholders are interested in realizing the returns to their investments. By contrast, insider groups will prefer profit retention over distributing dividends [Wenger 1992, p. 82]. High retentions provide the easiest way for managers and employees to secure their jobs and expand corporate activities. Creditor banks, too, may have a preference for limiting the distribution of dividends among shareholders, as high retentions reduce the risk that the company will default on its outstanding debt. The dominant role of internally generated funds in corporate financing is, thus, consistent with the perception of an entrenched insider system of corporate governance in Germany.

Nevertheless, it appears premature to blame insider relations for giving rise to a particularly pronounced deprivation of shareholder rights in Germany. It should be recalled from Section III.2 that internal financing dominates external financing in alternative financial systems as well. More importantly, high profit retentions cannot be equated with low returns to shareholders' investments. Rather, any bias to excessive retentions should be reflected in lower share values. In other words, the effect of limiting the distribution of dividends on overall returns may be compensated by the chance to acquire shares at lower prices. As a matter of fact, a recent empirical study has found no evidence in support of the view that the German system entrenches managers and employees

²⁰ For a summary of relevant studies, see Franks and Mayer [1995].

at the expense of shareholders [Kaplan 1994b]. The hypothesis that German managers are insulated from poor performance of companies they were running, had to be rejected. Turnover of the management board was significantly related to stock returns and income losses. Poor stock performance and the inability to generate positive income in the short-term had a consistently negative effect on top management tenures. Large structural differences between governance systems notwithstanding, poor stock returns and income losses increased the likelihood of top management turnover in Germany, Japan and the US to roughly the same extent. These results call into question the view that the relationship-oriented system of corporate governance in Germany tends to ignore current measures of performance.²¹

Accepting that the deficiencies of the German system are less dramatic than perceived by its critics, one might ask whether the proponents of this system have a more valid point in stressing its model character. The reasoning of the latter rests on the assumption that close financial ties and relationships in Germany "reduce agency costs and allow investors to monitor managers more effectively" [Grundfest 1990, p. 98]. Banks and large shareholders are said to have the power to induce needed changes at relatively low costs, if the management performs poorly. Again, however, the available evidence is highly ambiguous.

First, reliable information is scant on whether supervisory boards effectively monitor the management of German stock corporations. Several studies suggest that proponents of the German model tend to overrate the monitoring function of

²¹ The study by Kaplan [1994b] even tends to underrate the sanctions imposed on poorly performing managers in Germany. The empirical investigation focuses on turnover of the management board as the dependent variable. Yet a manager responsible for mismanagement in the respective division or function may remain in office, while the manager's competences may be curtailed. Such sanctions below dismissal are not captured by Kaplan's analysis.

supervisory boards [Esser 1990; Baums 1993; 1994; Edwards and Fischer 1994, p. 236].²² In the two-tier board system, the flow of information to the supervisory board is considered to be much smaller than to the directors in the (US or UK-type) one-board system, especially under German conditions of co-determination.²³ Normally, the supervisory board "acts as an advisory committee rather than as a monitoring panel" [Baums 1994, p. 12].

Second, the claim of an earlier study that banks play an important role in corporate control [Cable 1985] has been subjected to considerable criticism.²⁴ Cable essentially argued that informational asymmetries were removed due to close financial ties between banks and enterprises ("internal capital markets") so that loans could be provided on more favorable terms. Moreover, bank control of voting rights and bank representation on supervisory boards were said to impose profit-maximizing discipline on managers. The significance of the former argument has been declining with bank loans becoming less and less important in corporate financing [Wenger 1990, p. 163].²⁵ The empirical support to the latter argument is rather weak; in most of the estimated equations, the effect of bank control of voting rights on the companies' profitability remained insignificant.

Third, recent empirical findings have called into question the widely held belief that effective monitoring is ensured in companies with concentrated ownership. Kaplan [1994b] has analyzed whether turnover of the management board was

²² Former chief executives of German stock corporations are frequently appointed to chairmen of supervisory boards of the companies they had been running. The incentives to monitor their successors may be limited, considering that a company's current problems may be due to previous mismanagement of former chief executives.

²³ Esser [1990, p. 27] argues that "the supervisory board comes to know what the executive board thinks important enough to merit its attention".

²⁴ For a detailed critique, see Edwards and Fischer [1994, pp. 221ff.].

²⁵ Note that Cable's analysis refers to the period 1968-1972, when German companies were still relying on bank loans to a greater extent.

more strongly related to economic performance in German companies dominated by large shareholders. All tests for differences in turnover-performance relations as a function of ownership and voting concentration turned out to be insignificant. The interpretation offered by Kaplan [1994b, p. 155] is that "the monitoring and entrenchment effects of the shareholdings offset each other".

In the light of the ambiguous effects of bank control and concentrated ownership on effective monitoring, proponents of the German model may be tempted to focus on its supposed ability to overcome the short-termism of the US or UK-type system of corporate governance. In the latter system, which is characterized by a high level of takeovers and frequent changes in ownership, owners are supposed to be unable to commit themselves to the long-term interests of the company [Franks and Mayer 1990; 1995]. This system may thus be associated with inadequate investment in firm-specific assets and an unduly short-term investment horizon.²⁶ Commitment by owners is considered easier to sustain under German conditions of concentrated ownership. Free-riding in providing sufficient funds for investment is less attractive so that the German system may be superior to alternative systems in encouraging long-term investment.²⁷

This line of reasoning can be challenged on various grounds. Empirical support is lacking. Rather, the findings reported above are in conflict with the hypothesized investment effects. Recall that German managers, too, were penalized for poor *current* performance in terms of stock returns, while

²⁶ Short-termism may also prevail if shares are less liquid, however. The only way for shareholders to realize returns is to press for high dividends in the short run, once the tradability of shares is seriously constrained.

²⁷ Franks and Mayer [1995, p. 172] conclude that diversity in corporate governance structures "is a consequence of the fact that different forms of ownership are suited to different types of corporate activity. Some forms of production require the long-term relations that concentrated ownership can sustain, while others benefit from the greater flexibility in adjusting corporate policy that dispersed ownership can achieve".

management turnover was not significantly related to sales growth (which may require higher long-term investment) [Kaplan 1994b]. According to these results, it is unlikely that the German system is superior in encouraging long-term investment. It may even be questioned whether a longer-term commitment by owners is necessarily an advantage. Short-termism may well be appropriate when "managements seem to be demanding ... more time to keep making the same mistakes" [Pickens 1986]. Moreover, sustained investment in firm-specific assets may preserve traditional lines of production when, from a macroeconomic perspective, there is need for structural change [Wenger 1992; Hellwig 1995].

All in all, the discussion of the pros and cons of alternative systems of corporate governance suggests that a clearly superior model does not exist. This conclusion does not only relate to the effectiveness of corporate governance at the microeconomic level. It is also consistent with macroeconomic performance indicators for economies with different systems of corporate governance. Notably per-capita income growth was rather similar in Germany, the UK and the US (around 2 per cent in 1980-1993). Both the critics and the proponents of the German model tend to overrate the impact of its particular features on effective corporate governance, which refers in particular to the role of banks in monitoring. A possible interpretation is that the positive effects, which concentrated ownership might have on monitoring, and the negative entrenchment effects of insider collusion are largely offsetting each other. It follows that differences in corporate governance structures are less important in shaping company behavior than factors which are exogenous to all stakeholders in a particular company. Among exogenous factors, the degree of competition on goods and factor markets is likely to figure prominently. Increased competition, e.g. by eliminating trade barriers, spurs corporate efficiency and disciplines managers, employees and shareholders all alike.

V. Applicability to Transition Economies

In industrialized countries, the differences between relationship-oriented and market-oriented systems in ensuring effective corporate governance were shown to be less significant than might be expected from large differences in terms of institutional settings and ownership structures. There is no clear-cut experience to which transition economies may refer, when deciding on how to fill the gap created by the withdrawal of the state from the position of corporate control [see also Frydman and Rapaczynski 1992]. Hence, why not choose *any* of the existing systems at the very beginning of economic transformation, in order to prevent persistent institutional void after the regime change?

If it is time, rather than the concrete model applied, which matters most for ensuring corporate control after the retreat of the state, a German-type system may incidentally become widespread in European transition economies. Arguably, such a system lends itself to a quick implementation more easily than market-oriented systems. Note that a viable stock market takes time to develop. Especially reformers attempting to proceed with large-scale privatization early on in the transition may have no real choice but to rely on existing institutions. Notably the banking sector will then have to play an important role in privatization.

As a matter of fact, several transition economies in Central Europe have moved in this direction. In the Czech Republic, banks have emerged as major players in the enterprise sector during the process of voucher privatization, though by spontaneous development rather than deliberate policy design [Raiser and Nunnenkamp 1995, pp. 324ff.].²⁸ It was largely the banks which established investment companies, in order to attract voucher points from the public and invest them in privatized companies. Through their subsidiaries, banks have

²⁸ At the same time, the stock market plays a more prominent role than in Germany, e.g. in terms of the number of quoted companies.

become co-owners of an important part of industry [Grosfeld 1994, pp. 22ff.]. However, effective monitoring and enterprise restructuring may be hampered by the fact that major banks continue to be state-owned (or have the government as the dominant shareholder) in the Czech Republic. Moreover, a typical German feature seems to be emerging in the Czech Republic, namely cross-shareholdings. Especially banks have come to own each other, though somewhat obscured through the intermediation of investment funds. In Poland, the banks' equity involvement in industry was rather limited until recently. However, Polish banks shall actively participate in the so-called mass privatization programme. Among others (notably foreign investment companies), they may establish management funds which will take control of 20-30 enterprises each. Efforts at financial restructuring of enterprises and banks (e.g., through debt-equity swaps), in order to overcome the non-performing debt problem, will eventually add to industrial equity holdings by Polish banks.

Recent developments in those Central European countries where economic transformation is fairly advanced, have led to "a growing concern that through various mechanisms large banks ... are starting to strongly dominate the enterprise sector" [Grosfeld 1994, p. 22]. It remains open to question whether such fears will be substantiated in the future, or rather turn out to be exaggerated as in the case of Germany. In any case, the privatization of still state-owned banks, financial market competition, and an institutional framework of prudential rules and bank supervision seem to be required in transition economies, in order to provide appropriate incentives for effective monitoring of enterprises.

For the latecomers in economic transition, too, there are more questions than definite answers on how to proceed with the implementation of corporate governance structures. On the one hand, various objections may be raised against a quick implementation of whatever type of system prevailing in

industrialized countries, and, in particular, against eagerly copying a German-type model:

- The institutional set-up of any particular market economy has developed over time in the country-specific historical context. The effectiveness of a particular set-up may be path dependent so that the same institutional set-up may be less effective elsewhere [Frydman and Rapaczynski 1992, p. 266].
- Various systems of corporate governance may produce similar results in similarly advanced, industrialized countries. However, the results may be different when these systems are transplanted into transition economies, where starting conditions differ vastly from industrialized countries.
- Given that the risk of failure is higher in transition economies than in industrialized countries, the former may "try to set up an institutional arrangement that contains in itself some mechanisms of self-correction" [Frydman and Rapaczynski 1992, p. 268]. Opportunities for self-correction may be constrained, once a system with entrenched insider relations is implemented.
- From a macroeconomic point of view, the medium-term perspectives in economic restructuring are of utmost importance in transition economies. The legacies of central planning imply a tremendous need for redeploying available resources and for investment in physical as well as human capital. Hence, a model which may be flawed when it comes to managing structural change, would be exactly the opposite of what is needed in transition economies.²⁹

²⁹ One might add to ambiguities concerning the macroeconomic effectiveness of different models of corporate governance by noting that Japan handled structural change more successfully in the past than both Europe and the US [Gundlach and Nunnenkamp 1994]. Despite the rather unique role of Japanese banks under conditions of business crises (see note 11 above), the Japanese system of corporate governance is typically considered to

On the other hand, the latecomers in reform must be aware of the costs involved in further delaying privatization and institutional reforms which may fill the gap after the retreat of the state from corporate control. First of all, expectations are likely to be frustrated that a clearly superior model of corporate governance will emerge as soon as more evidence is available from the frontrunners in economic transformation. In other words, the option value of waiting, in terms of applying a better suited model after having evaluated earlier successes and failures, is probably fairly low. Second, it can safely be assumed that persistent institutional void will have a more adverse impact on enterprise restructuring than any of the models of corporate governance applied in market economies.

Finally, both the frontrunners and latecomers in economic transition should recognize that implementing corporate governance structures must not be seen in isolation. The experience of industrialized countries suggests that company behavior is not only shaped by corporate control structures, but also – and probably even more so – by the degree of competition that companies are facing on goods and factor markets. Hence, institutional reforms in the field of corporate governance may have limited effects unless discipline is imposed on managers, employees and shareholders by reducing the protection of companies from domestic and foreign competitors.

have much more in common with the German system than with the market-based system of the US. Hence, transition economies would not necessarily fare better by adhering to an US-type, market-based model, if the German system were flawed in terms of handling structural change.

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