Corporate Governance Reform and the German Party Paradox

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(published in: Comparative Politics, 39: 4, 401-420. Page numbers of the original text are marked with ***(here starts p. xxx)***)

This version: October 2006.

Abstract

This article discusses an empirical puzzle that seems to contradict insights from comparative political economy and the "varieties of capitalism" approach in particular: Why do German Social Democrats opt for more corporate governance liberalization than the Christian Democrats although, in terms of the distributional outcomes of such reforms, one would expect the situation to be reversed? I show that Social Democrats and trade unions adopted their liberal attitude to company regulation after World War II. In the 1970s, competition policy was introduced to make Keynesian macroeconomic policy work; since the 1990s, labor favored shareholder-oriented reforms because they helped employee representatives in "conflicts over managerial control." I conclude with a discussion of the implications for partisan theory, institutional complementarity, and conflict models in comparative political economy.

1. Introduction

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This article is a contribution to the comparative discussion of the impact of political variables on strategic coordination in political economies. I focus on Germany as the paradigmatic case of a coordinated market economy (CME), on the subfield of corporate governance and on the impact of political parties. This selection, I argue, reveals an empirical puzzle with remarkable consequences for partisan theory, comparative political economy, and the concept of institutional complementarity in particular: Why does the German Social Democratic Party, the SPD, opt for more corporate governance liberalization than its neighbor to the right of the political spectrum, the Christian Democratic Party (CDU)?

Partisan theory has shown that parties are likely to matter if policies have distributional consequences. According to this literature, political parties have different socio-economic voter clienteles, which affects party ideologies,[1] preferred policies[2] and, as a result, economic outcomes.[3] As it is a long way from party ideologies to outcomes,[4] differences in party ideology are greater than differences in implemented policies, which in turn are greater than differences in outcomes. Marked party differences have been described by welfare state research. Here, social democratic parties stands for "politics against markets".[5] Does this also hold true for the distinction between coordinated market economies (CMEs) – production regimes with strategically coordinated corporate governance and industrial relations spheres – and liberal market economies (LMEs)? "In coordinated market economies, working hours tend to be shorter for more of the population and incomes more equal. With regard to the distribution of well-being, of course, these differences are important," Hall and Soskice write.[6] Rhenish capitalism, as Albert puts it, looks like "a modernized and updated version of Social Democracy."[7]

Accordingly, we should expect Social Democracy to support the reproduction of institutions that facilitate firms' coordination with employees, suppliers, customers, owners and other firms. With regard to industrial relations, this expectation holds true. Historically and at present, in comparison to the CDU, the SPD stands for more codetermination at the company level, more inclusion of trade unions, central collective agreements, and employment protection. But why is this constellation inverted when we turn to coordination in the corporate governance sphere? Why does the SPD chose a liberal attitude in corporate governance issues that may not only undermine distributional patterns but also, according to complementarity theory, destabilize features in neighboring spheres such as industrial relations? ***(here starts p. 402)***

The explanation, so I argue, lies in the specific historical experience that the German labor movement gained during the Nazi dictatorship, in constellations of the 1970s and – above all – in the significance of a conflict line that neither class theory nor principal agent theory consider and that I will call "conflict over managerial control." However, for everyone who accepts the keynotes of the varieties of capitalism approach (which I do), even after having understood the reasons for the Social Democratic policy profile in corporate governance issues, the discussed constellation still remains paradoxical (in the sense of, although intentionally achieved, systematically counterproductive): the party with the voter clientele that benefits from the distributional patterns of coordinated capitalism stands for its disintegration, not in all spheres, but in the corporate governance sphere as one of the distinctive subspheres of production regimes.

Beyond partisan theory, my discussion of the "German party paradox" contributes to two lines of comparative political-economic discussion. The first one will be of importance when I formulate the expectations of the interaction of corporate governance reforms and political parties (see below): the varieties of capitalism approach and its use of complementarity theory in particular.[8] Institutional complementarity means that the functioning of an institution A is conditioned by the design of another institution B (and vice versa). According to the varieties of capitalism approach, coordination in the sphere of industrial relations should work better if corporate governance is strategically coordinated, too. This should affect actors' preferences towards coordination and, ultimately, institutional change. However, my analysis will conclude that institutional complementarity and actors' preferences towards institutional change are rather loosely coupled phenomena. The functionality of institutional configurations is only one source of institutional change (and functionality, in fact, is partly conditioned by complementarity). Another source is the expected effect that institutional change has on the distribution of power. And this effect may run contrary to the one that derives from complementarity.

My findings also contribute to the discussion initiated by Roe's book *Political Determinants of Corporate Governance*.[9] What is of interest here is the way Roe connects principal–agent theory (the theory of the conflict line between shareholders and insiders) with class theory (the theory of the conflict line between employees and both managers and shareholders). Roe argues that, due to its preferences in class conflict, Social Democracy strengthens agents vis-à-vis principals. Why is that? By introducing codetermination and high levels of employment protection, social democratic parties press managers to side with employees rather than shareholders. In Roe's words, "social democracies widen the natural gap between managers and distant shareholders, and impede firms from developing the tools that would close up the gap."[10] Shareholders react by not diffusing their investments. Concentrated ownership – one of the decisive features of coordinated corporate governance – allows owners to retain direct control in the firm in order to make effective claims for rents that would otherwise be distributed among employees and managers. The analysis of conflict constellations in the German case will reveal whether or not this view is sustainable. ***(here starts p. 403)***

2. Corporate Governance Reform and Party Behavior: Expectations

Corporate governance deals with the regulation of power over corporations and differs from country to country as well as over time. Two models of corporate governance can be distinguished at the national level. Both rely on different sets of institutions.[11] The first model is governance by markets and is typical of liberal production regimes. Institutional preconditions for market governance are a strong competition and anti-trust regime, liquid capital markets, high degrees of minority shareholder protection, transparency and – above all – takeover regulation that permits hostile takeovers. The second model, governance by company cooperation or "network governance," is to be found in the coordinated production regimes. This way of regulating corporate governance requires the existence of personal ties and capital links between companies, financial companies that are both willing and institutionally able to coordinate the economic behavior of industrial companies, and protection against hostile takeovers. The paradigmatic case for a market system is the US economy, while cooperative links between companies and coordination by banks have been – at least, until the early 1990s – typical of the German and Japanese economies.

The internationalization of product and financial markets as well as structural change have put European production regimes under pressure to liberalize. In the 1980s, European integration led to competition-oriented reforms of national business locations. Beginning in the mid-1990s, reforms were extended to the corporate governance spheres of production systems, resulting in the reform of company supervision, disclosure practices, minority shareholder protection, regulation of management compensation, and takeover regulation.[12] In the last years, a series of takeover attempts and hostile stockholdings initiated by financially oriented funds demonstrated the extent to which political reforms have changed the German financial system.[13]

What all the reform acts discussed here have in common is that they have an impact on the likelihood of hostile takeovers. Takeover regulation is a strategically decisive characteristic of production regimes. Agency theorists argue that share prices will fall when managers lack shareholder orientation. Low share prices create incentives for takeovers, as the new owners may increase shareholder orientation, raise profits and, as a consequence, boost share prices. Therefore, hostile takeovers are governance mechanisms to force managers to act in a shareholder-oriented way.[14] Consequently, the emergence of markets for hostile takeovers in Europe is likely to push the "Rhenish" models of capitalism in more market-driven, liberal directions.

Why should there be an underlying left–right dimension to such reforms? First, the procedure for company decision-making is likely to change when hostile takeovers occur. Where codetermination rights allow works councils and trade unions to discuss investment decisions, hostile takeovers might thwart the results of negotiation, as hostile takeovers replace the managements that have been the former bargaining partners. In contrast to "normal" changes in company strategies, hostile takeovers are exclusively decided by capital market participants and cannot be codetermined. ***(here starts p. 404)***

Second, the rule of thumb that the design of economic institutions has distributional outcomes also holds true for corporate governance institutions. A crucial insight of the literature into different models of capitalism is that they tend to distribute welfare in dissimilar ways.[15] De Jong has pointed out that the distribution of the net value added of firms among shareholders, employees, the state, banks and retained earnings varies with respect to the likelihood of hostile takeovers.[16] In systems that include hostile takeovers as governance mechanisms, firms distribute more value added to shareholders, while the percentage of value added that employees receive as wages, as well as retained earnings, are relatively low. The mechanism behind this distributional pattern is the conflict of goals between company growth and profitability. Continental European companies have more scope to invest in company growth even if this does not increase profitability. As a consequence, German corporations tend to be bigger, but less profitable and less valued by capital market participants compared to UK companies. This is in the interest of managers and employees, but thwarts the interests of shareholders, who would gain an extra profit if "their" companies switched from the "high growth – low valuation" equilibrium to a "low growth – high valuation" point.[17] Beyer and Hassel have shown that this mechanism redistributed net value added in shareholder-oriented German companies in the 1990s.[18] Further evidence comes from the "breach of trust" literature, which shows that shareholders' gains from hostile takeovers tend to result not from increased efficiency, but from the breach of implicit contracts with other stakeholders.[19]

The third reason why takeover regulation and corporate governance regulation as a whole should be affected by the political left–right dimension is rather theoretical. In the debate on different national models of capitalism, political economists have highlighted the existence of institutional complementarity between different spheres of production regimes, such as the corporate governance sphere, the industrial relations sphere, the education and training system, and even the welfare state. The idea is that these institutions are in a balanced relationship to each other, which should make major changes in only one of these spheres unlikely, although radical shifts in one sphere ought to affect institutional stability in other spheres also. Since centralized wage bargaining, codetermination, trade union participation and a welfare regime that protects employees against the loss of specific investments are integral parts of coordinated market economies – and since these institutions represent typical goals of leftist movements and parties –, there should be general support among leftist parties for the main institutions of coordinated market economies.

These three considerations lead to the main subject matter of this article, which is the expectation that leftist parties, including the left parties of the center, should favor market-restricting corporate governance institutions and, in particular, that they should oppose regulations that promote hostile takeovers. ***(here starts p. 405)***

3. The German Party Paradox

In the following section, I will show that the German SPD supported more corporate governance liberalization than its rightist neighbor in the German party system, the CDU. The mid-1980s saw the start of a set of reforms in German stock market and company regulation,[20] initiated by a discussion on the quality of Germany as a location of production. In the first phase, the aim of these reforms was not to radically alter the German corporate governance system, but to add a more active capital market to the unchanged attributes of the economic system. By contrast, the reforms since the late 1990s were not harmless, minor reforms, like the introduction of electronic stock trading in 1989, but went straight to the heart of the German corporate governance system.

I distinguish three reform complexes. The first complex concerns transparency, management accountability and minority shareholder protection and was affected by the 1998 Corporate Sector Supervision and Transparency Act *(KonTraG, Gesetz zur Kontrolle und Transparenz im Unternehmensbereich)*, by the 1998 Raising of Capital Act *(KapAEG, Kapitalaufnahmeerleichterungsgesetz)*, by the work of the "Cromme Commission" that developed the Corporate Governance Codex published in 2001, and by the 2002 Corporate Sector Transparency and Publicity Act (*TransPuG, Gesetz zur Transparenz und Publizität im Unternehmensbereich*). The second reform complex concerns the dismantling of interlocking capital, which was advanced and accelerated by the 2000 change to the Corporate Income Tax Law *(Körperschaftssteuergesetz)* that abolished the tax on profits from the sales of large share blocks. The third complex is takeover regulation, which concerns the discussion on the abandoned EU directive and the 2001 Takeover Law *(Gesetz zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und Unternehmensübernahmen)*. All the three corporate governance reform complexes were connected with the creation of a market for corporate control, because the implementation of the "one share, one vote" rule, the disentanglement process and reliable takeover regulation are all preconditions for company control through takeover markets.

The KonTraG Reform of 1998 and Related Reform Acts The KonTraG was passed in by the Christian Democratic/Liberal (CDU/FDP) coalition in 1998 and represented the first significant change of direction in German corporate governance regulation. Beside some limited modifications to supervisory board regulation, risk management and bank ownership of industrial capital, this capital-market-oriented law legalized share buybacks, facilitated the introduction of stock options and, above all, abolished unequal voting rights. As a result, Germany was one of the precursors of the "one share, one vote" rule in Europe, which figured prominently in the 2000 takeover battle between Vodafone and Mannesmann. Another significant development in 1998 was the passage of a controversial law that allowed stock corporations to adopt capital-market-oriented accounting standards (IAS or US-GAAP) instead of the rules of the German Commercial Code *(HGB, Handelsgesetzbuch)*. Corporate governance reform ***(here starts p. 406)*** continued with the 2002 Transparency and Disclosure Act (*TransPuG, Transparenz- und Publizitätsgesetz*), which obliged stock corporations to publish a yearly statement in order to explain whether or not – and, if not, why – they accepted the Corporate Governance Codex of the Cromme Commission, in addition to some further provisions to strengthen the rights of supervisory boards in their interaction with management boards.

How did the political parties behave in the debates on the KonTraG? The main driving force behind this corporate governance reform was the smaller CDU coalition partner, the

FDP, the German Liberal Party. When the KonTraG was debated in the Bundestag, the FDP speaker said that the law was only a partial success for the FDP, and he regretted that the FDP was not able to push the CDU toward further liberalization. Germany, the FDP argued, is a rent-seeking society, and German companies need more pressure exerted from capital markets.[21] By contrast, the CDU speaker argued that it was pure ideology to say one should restrict the power of German banks, as it was politics that pleased banks to intervene in industrial crises.[22] He insisted that the notion of a “Germany Inc.” built upon quasi-cartels had no equivalence in reality.

So far, this is consistent with the partisan hypothesis. The consistency ends, however, when we turn to the SPD that introduced its own corporate governance reform blueprint. The SPD speaker called the KonTraG a placebo law to appease the demands of the public without introducing any substantial change, a law to protect managers and banks. He spoke about the “sovietization of the German economy” and demanded a prohibition of industrial stock ownership of banks and more company control by capital markets.[23] The expert from the Green Party concurred, criticized the power of banks and said that the share market had to be transformed into a market for corporate control.[24] And even a speaker of the post-communist PDS made the criticism that interlocking capital turns the economic order upside down. More corporate control by the capital market, he said, would accommodate the ideas of the PDS on economic democracy, and it would revitalize the economy.[25]

The behavior of the parliamentary left was supported by trade unions. They welcomed the KonTraG, including the abolition of unequal voting rights, followed by the Corporate Governance Codex of the Cromme Commission (in which trade union representatives were incorporated) and the TransPuG. They also supported the KapAEG that allowed companies to publish the more shareholder-oriented IAS and US-GAAP balance sheets instead of using the HGB accounting rules. Trade unions demand a European directive to make the IAS (now

IFRS) standards incumbent on all German companies, not just stock-listed corporations, and also call for laws to enforce the provisions of the Corporate Governance Codex juristically.[26]

A manifest explanation for this constellation might be that there was simply a government–opposition dynamic in force that made the opposition criticize the (feigned) impotence shown by the government over introducing far-reaching reforms. It should be highlighted that the other two important corporate governance reform complexes were passed after the change in government in late 1998, when CDU and FDP were in opposition and SPD ***(here starts p. 407)*** and Green Party were in government. Still, the CDU – not the SPD – was the party of "Rhenish capitalism."

Corporate Tax Reform In the late 1980s, an extensive restructuring of the German corporate network began, picking up speed in the mid-1990s. A mixture of push and pull factors made disentanglement a conceivable option for banks – among them the reorientation to investment bank strategies, declining benefits from ties with industrial corporations, and the decreasing ability to regulate competition among industrial firms due to internationalization. Between 1996 and 2004, the number of capital ties between the 100 biggest corporations declined from 169 to 44, and the large financial companies of *Deutsche Bank* and *Dresdner Bank* in particular moved from the network center to a more peripheral network position. Reasonable amounts of share blocks were broken up and sold at the stock exchange.[27]

It had long been discussed how politics could force the dismantling of interlocking capital, especially industrial capital held by banks. There were two possible options to choose from. The first was to forbid banks from owning more than five percent of industrial companies. Critics of this view – though they shared the view that interlocking capital should be dismantled – insisted that this was only possible in combination with lower taxes on profits from the sale of share blocks, which was the second possible course of action. Otherwise, it was argued, a law against industrial ownership of financial companies would be an expropriation act.[28]

It was a political surprise for all observers, including capital market participants, that the Schröder government opted for the total abolition of the corporate income tax *(Körperschaftssteuer)* raised on the profits from the sale of share blocks in the context of the 2000 Tax Reduction Act *(Steuersenkungsgesetz)* without hurting banks with any prohibition act.[29] The motivation for this reform was explicitly to abolish interlocking capital and, as a consequence, to create a more active market for corporate control. For example, when the insurance company *Allianz* sold its 13.6 percentage equity stake in *Hypovereinsbank* in 2002 and earned 2 billions of euros as a result, there was no profit tax raised for this. This "tax gift" led to a massive conflict between political parties, in which the SPD and the Greens were opposed by the CDU and the PDS, with the FDP caught between the ideological positions.

In the Bundestag debate over the Tax Reduction Act in May 2000, the opposition parties criticized the fact that SPD and Greens had redistributed in favor of large stock companies, while not assisting the small corporations *(Mittelstand)*. CDU, FDP and PDS members of parliament applauded the CDU speaker when he said that he could not believe it when he heard that finance minister Hans Eichel planned to abolish this tax totally, pointing out that the SPD and trade union protest would have been enormous if the former CDU–FDP coalition had introduced this reform.[30] In this debate, SPD speakers were on the defensive when they explained their political goal to reform the corporate governance system by speeding up network dissolution.[31] Edmund Stoiber, ***(here starts p. 408)*** who was the conservative candidate for chancellor in the 2002 election, used this issue in his election campaign and announced his intention of reintroducing the tax as chancellor.

Takeover Regulation The third important reform issue is takeover regulation. In July 2001, the European Parliament rejected a conciliation compromise on the European Commission's takeover directive, which had aimed to introduce a pan-European takeover market. After the failure of the European takeover directive, the Schröder government introduced a national takeover law in October 2001. This act was less liberal than the Commission's proposal because it allowed the target company's board to take defensive action in the case of hostile takeover attempts if it had sought the shareholders' authorization no earlier than 18 months before the bid and if, in addition, the defensive measures were authorized by the supervisory board. However, this law was definitely no "anti-takeover law" as liberal critics claimed it to be. The law provides a regular playground for (friendly or hostile) takeovers, and it should be mentioned that several other European countries provide more privatized companies with "golden shares" than Germany does. After decades of a virtual absence of hostile takeover attempts, the unfriendly trade of large share blocks is now accepted in Germany, which includes acceptance by the legislator.

The crucial point is the difference in party attitudes. Both SPD and CDU opposed the European directive, arguing that German firms would be asymmetrically vulnerable due to under-average market capitalizations and the lack of "golden shares." Therefore, party differences were smaller compared to the conflicts over the 1998 KonTraG and the 2000 Tax Reduction Act, but they nevertheless existed. The FDP criticized the takeover law as being protectionist, and endorsed greater liberalization than the SPD was willing to support,[32] which is not surprising, but consistent with the ideological affiliation hypothesis. Once again, the CDU turned out to be the defender of Germany Inc. The CDU welcomed the failure of the European takeover directive. In fact, much earlier than the SPD, the CDU had criticized the European directive as being too liberal. In addition to this, the CDU argued that the German takeover law failed to allow managers to take enough defensive measures to prevent hostile takeovers. The 18-month period allowed for shareholders' authorization resolutions, according to the CDU, was too short and should be replaced by a 36-month period. The CDU also wanted to decrease the 75 percent threshold provided for the resolutions of the shareholders' meetings.[33] In opposition to this, the SPD speaker stated, "the shareholders own the corporation and should have the final say."[34]

In summary, the attitudes of the German political parties toward the main corporate governance reforms since the late 1990s – the KonTraG, the KapAEG, the TransPuG, the abolition of the corporate income tax on profits from the sales of share blocks, and the Takeover Law – show a distinct pattern that contradicts the expectations of partisan theory. Is there any explanation for this discrepancy? ***(here starts p. 409)***

4. Where Does the Paradox Come From?

Comparative political economy has already done a good job in explaining why corporate governance liberalization happens anyway. The corporate governance reforms of the last ten to 15 years would be unthinkable without a set of interlocked external factors such as technological changes in the financial markets; internationalization of finance, production and sales; demographic pressures; pension reforms; and changes in the ideological sphere. Experts differ with respect to the relative weight of the factors rather than with respect to the fact that such external impulses exist.[35] Below I will focus not on the existence of reforms but solely on the puzzle of why party attitudes – in our case, German party attitudes – towards reforms differ in the theoretically unexpected way described. I argue that the answer to this question cannot lie in the external factors mentioned but in party-specific perceptions of the impact on power relations within and between companies.

My argument consists of three elements. A conversion of labor movement ideology set in after World War II that made Social Democrats and trade unions, in contrast to their positions in the Weimar Republic, adopt a liberal attitude in competition policy and corporate governance issues. Political opportunities in the 1970s and 1990s stabilized this attitude. In the 1970s, being confronted with stagflation and problems of Keynesian policy, the SPD–FDP government hoped that increased competition, especially in the banking sector, would increase the effectiveness of macroeconomic policy. In the 1990s, when corporate governance issues were at the top of the political agenda, it transpired that works councils and trade unions supported capital-market-oriented liberalization measures because increased shareholder power helped employee representatives in an important number of the conflicts inside companies, which I will call "conflicts over managerial control."

Historical Conversion of Ideas Two very different leftist views on interlocking capital as a main feature of coordinated capitalism can be distinguished. The first view was expressed by Lenin and Luxemburg and shared by most German socialists, including the early Hilferding. In his theory on imperialism, Lenin described German capitalism as a mixture between monopoly and competition, mostly driven by interlocking capital and interlocking directorates from the large German banks, which resulted in a concentration of capitalist power to the detriment of labor.[36] Consequently, the centers of interlocking capital were seen as natural points of attack in the revolutionary endeavors of socialists and communists.

In the 1920s, this view lost ground in the discussions of the trade unions and the SPD and was replaced by a view that was expressed by socialist theorists like Naphtali and the later Hilferding. Both, together with other theorists like Sinzheimer, were asked by the board of the German trade union organization, the ADGB (*Allgemeiner Deutscher Arbeiterverband* – German General Workers Association), to develop a conception of the trade union's view on “organized” capitalism and on adequate leftist responses. The outcome was the 1928 book on “economic democracy” that soon dominated the socialist discussion. Naphtali and his commission argued: ***(here starts p. 410)***

> This complete organization of capitalism, this onward development of free competition toward planned production with the aim of a monopolistic market formation is not a democratization process … However, although we do not wish to camouflage the capitalist character of the new form of organization, we believe that this development will result in an impulse for the development of economic democracy, and we believe that this development has already begun.[37]

They stressed the interpenetration of the modern economic and political spheres, rather than the domination of one sphere over the other, and believed that the competition-impeding organization of capital could be used as a tool to oblige corporations to act in accordance with societal goals. Consequently, the Naphtali commission rejected ideas that trade unions should call for the disentanglement of organized capital by the state. This, said the commission, would be a backward, not a forward, move.[38] Such ideas were widely accepted by the late Weimar trade union and SPD movements, and Hilferding presented the new view on organized capitalism at the 1927 SPD party congress in Kiel, akin to Naphtali who gave his famous speech on economic democracy at the 1928 German trade union congress in Hamburg.

It is crucial to conceive that these ideas were driven in new directions at two historical junctures. The Hilferding–Naphtali paradigm did not survive World War II. As to the collaboration of the center of interlocking capital with the Nazi regime and its important role in war preparation, the trade unions stopped their opposition to disentanglement. In their second nation-wide conference with representatives from the different Allied occupied districts in December 1946, the trade unions expressed the view that “both world wars have shown that the war-enforcing pressure came from the concentration of capitalist power in monopolies, cartels, trusts and horizontal economic groups and the malpractice of their power."[39] In his speech at the Munich founding congress of the Federation of German Trade Unions in October 1949, trade union leader Hans Böckler declared, "it must never happen again that economic agglomerations, transformed into political power, destroy a democratic constitution, as happened to the Weimar Republic".[40] Beside the nationalization of main industries, the trade unions called for a consistent disentanglement of capital in their first manifesto[41] and, later, fiercely attacked the toothless competition and anti-cartel policy of the Adenauer government. In this phase, the labor movement was still strictly socialist; but concentrated and interlocked, "organized," capital was no longer a welcome intermediate stage on the way to Socialism.[42]

Of course, the story does not end here. The late 1950s witnessed a second reorientation, clearly articulated in the November 1959 Godesberg manifesto of the SPD, when socialism was finally abandoned as the ultimate aim of the Social Democrats. The nationalization of main industries was no longer a political objective. Trade unions reproduced the same reorientation in their 1963 Düsseldorf manifesto. At this point, the still surviving idea of disentanglement lost its socialist background, and my argument is that this conversion of ideology led to a liberal attitude that was formerly constructed as part of a socialist idea. In the 1963 Düsseldorf manifesto, and in all the manifestos that followed, trade unions called for disentanglement, the abolition of concentration-enforcing tax policies and, above all, the reduction of the power of the ***(here starts p. 411)*** banks. In 1966, a liberal observer concluded, "the manifestos of the SPD and trade unions have made, if I may say so, significant steps toward neo-liberal ideas."[43] Social Democrats and trade unions did not abolish leftist ideas, but a conversion of ideas set in that redefined what it meant to be leftist in the context of a coordinated economy. This attitude survived in the SPD, which claims, in its current Berlin manifesto, "in order to repress the power of banks and insurance companies, we favor the disentanglement of capital ties between companies".[44]

Competition as a Precondition for Keynesian Policy In the years after the first serious economic crisis in Federal Germany in 1966/67, when the number of unemployed persons for the first time exceeded one million, an ongoing debate on the effectiveness of the state's macroeconomic policy stabilized the Social Democratic preference for a liberal form of company regulation. Keynesianism was the economic paradigm of the day. Which kind of industrial organization, it was debated, is most compatible with macroeconomic steering endeavors of the state? Why is Keynesian monetary and fiscal policy sometimes virtually non-effective, and why is it that inflation and unemployment sometimes go together? In accordance with international economists such as Gardiner C. Means and John Kenneth Galbraith,[45] governing Social Democrats identified the lack of competition between companies as diminishing the macroeconomic steering capacity of the central bank and the finance ministry. In principle, expansive monetary policy could help to stimulate growth. But if banks cooperated rather than competed, there was no guarantee that they would pass lower interest rates on to their customers. "Our banking system should be more British," concluded economic ministry member Wilhelm Hankel in 1971.[46] Likewise, in principle, expansive fiscal policy could help to adjust production to its potential. But if the industrial sector lacked competition, companies were free to increase prices, even if production remained below its potential, and therefore to cause stagflation.

Consequently, among the first measures of SPD grand coalition economic minister Karl Schiller in 1967 was the decision to deregulate interest rates fully against the resistance of industrial representatives in order to increase competition among banks.[47] In his government declaration in 1969, the new chancellor Willy Brandt announced the government's intention to introduce a stronger anti-cartel policy. In 1970, he declared, "the economic order that we want requires competition."[48] This resulted in the 1973 anti-cartel amendment that for the first time provided the cartel office with the right to actively intervene in cases of anti-competitive mergers and therefore was the first German anti-cartel act really deserving of its name.

In order to increase competition in the banking sector, the SPD–FDP government encouraged the Land-owned *Landesbanken* to compete with the quasi-cartelized private banks in the field of industrial credits. Furthermore, in 1974, the government used the bankruptcy of the *Herstatt* bank that year to set up a banking commission that published its report in 1979. The commission suggested forbidding banks to own industrial share ***(here starts p. 412)*** blocks larger than 25 percent.[49] After the 1980 federal elections, finance minister Matthöfer announced the government's intention to pass an appropriate act. It was only the coalition change initiated by the FDP in 1982 that saved the financial companies from this measure and ended the discussion on the powerful position of banks in the German corporate governance regime.

As this retrospective view indicates, the liberal attitude of German Social Democrats in issues of company regulation was in evidence long before globalization and structural change put the German corporate governance regime under pressure to liberalize. It shows that specific electoral conditions in 1998 or 2002 offer no sufficient explanation for the observed constellation. It can only be understood with respect to the fundamental, in Mares' terms "prestrategic" preferences of the German labor movement.[50]

Conflicts over Managerial Control The third part of the argument removes the discussion to the company level. I start theoretically by combining two different views on conflicts inside the firm that normally fail to address each other. While the industrial relations literature emphasizes different interests of employers and employees, principal–agent theory points to different interests of shareholders and insiders. By combining these conflict dimensions into one model, we arrive at a triangle, consisting of three interest groups, three conflict lines, and three different coalition lines in which two of the groups distinguished can form a coalition against the third one (see Figure 1).[51] I define the conflict constellation in which shareholders oppose managers and employees as an insider–outsider conflict, the conflict in which shareholders and employees build a coalition against managers as a conflict over managerial control, and the conflict in which employees oppose the two other groups as a class conflict.

The class conflict view is the one that fits with the left–right dimension. If capital-market-oriented reforms strengthen the position of employees' opponents in class conflicts, trade unions should refuse such reforms. The same holds true for insider–outsider conflicts. But, opposed to this, employees and their works councils and trade unions turn out to be on the winning side if increased shareholder power is played out in conflicts over managerial control. I argue that in the perception of employee representatives – for good or ill – the gains from conflicts over managerial control for various reasons are weighted higher than the losses incurred in class conflicts and insider-outsider conflicts. This, in effect, makes trade unions support capital-market-oriented corporate governance reforms more than one might possibly expect.

The center of class conflict is the distributional conflict. As increased shareholder protection and, in particular, the emergence of a market for corporate control strengthen the power of shareholders, one might expect a process of redistribution of net value added in firms that adjust to the new pressures by increasing their shareholder orientation. Beyer and Hassel found evidence that such a development is actually in process: in shareholder-oriented German companies, the share of net value added that employees receive as wages is in decline, while dividend payments toward shareholders are on the rise.[52] I will come back to this, but prefer to examine conflicts over managerial control before doing so. ***(here starts p. 413)***

The share of conflicts inside firms that manifest themselves as conflicts over managerial control is surprisingly high. One of the crucial points in shareholder value is company transparency, and disclosure conflicts are conflicts over managerial control. Trade unionists interpret transparency as a precondition and a tool for codetermination.[53] This also includes, explicitly, segment reporting[54] – from the point of view of shareholders, an instrument used to identify and defend cross-subsidization. Consequently, trade unions oppose German Commercial Code (HGB) accounting. The only works council I know that opposed international accounting is the Volkswagen works council – Volkswagen is codetermined to such an extent that the works council sees no need to pass more information to outsiders.

Both TransPuG and KonTraG concerned management accountability in management board–supervisory board interaction. As the supervisory board and not the management board is the codetermined institution, every increase in supervisory board rights is an increase in the degree of codetermination and is, of course, warmly welcomed by works councils and trade unions.[55] The field of common interests of shareholders and employees turns out to be even larger when we consider that both shareholders and employees prefer variable (and transparent) to constant management payment. In general, German trade unions and works councils distrust managerial behavior.[56] The managers' freedom of action in diversification and company growth also gives them more room to maneuver for prestige investments. "If shareholder value helps to limit this risk potential, this must be in the interest of employees," says one trade union expert.[57]

So far, we have seen that, inside companies, increased shareholder orientation results not only in losses (in class conflicts and insider-outsider conflicts) but also in gains (in conflicts over managerial control) for the employee side. But why, in the context of capital market reforms, did trade unions and Social Democrats weight the gains higher than the losses? I speculate that some mechanisms make the losses, compared to the institutional gains for codetermination, less visible. There are two different ways in which redistribution might occur. The first possible way is downward pressure on wages, which would result in enormous opposition to shareholder value, but which is not the way in which such redistribution does come about. Rather, redistribution results from a reorientation in the conflict of aims between company growth and profitability. This redistribution is "real" redistribution to the disadvantage of employees, too. However, it is institutionally neutral insofar as it leaves central collective agreements (and codetermination) intact.

Another mechanism may, in effect, allow redistribution to be tolerated. At this point, we have to go beyond the conflict triangle (Figure 1) and assume that employees, like shareholders and managers, are a heterogeneous group with differing degrees of vulnerability deriving from increased profitability pressures. Let us further assume that rising job insecurity will be concentrated not at the core but at the periphery of companies, and that works councils primarily represent employees at the core of the companies. It is not necessary to presume that works councils ignore restructurings at the periphery. But, in the context of conflicts of aims, we may speculate that the asymmetry of affectedness ***(here starts p. 414,*** **FIGURE 1 at the beginning of p. 414)** by redistribution may let works councils judge the losses lower than they would do if losses were equally distributed among employees.

The asymmetry of losses from increased shareholder orientation is even larger if variable wages come into play. In fact, industrial relations research has revealed a strong empirical connection between shareholder orientation and the introduction of non-management variable pay. In her study on the rise of contingent pay in Germany, Kurdelbusch found wage components to be linked to company profits in around half of the 114 largest companies. Two company-related variables predict the extent of profit-related pay: internationalization of sales and shareholder value orientation.[58] Consider a shareholder-oriented firm that halts company growth and sells underperforming subunits in order to raise average profitability. When a part of employees' wages is variable according to company profitability, the number of employees at the periphery will decrease, while wages at the core, compared to a scenario without restructuring, may increase – which, perversely, creates an incentive for works councils to tolerate such restructuring.

Of course, the above mechanisms do not turn employees' losses into gains. Therefore, they are definitely not the reasons why trade unions and Social Democrats perceived corporate governance liberalization as an attractive political option in the ***(here starts p. 415)*** 1990s and 2000s. The asymmetry of employees' losses to the disadvantage of employees at the periphery of companies only helps us understand the fact that the institutional gains for codetermination, compared to the losses caused by redistribution, were weighted surprisingly high and stabilized a liberal attitude in company regulation issues that had already been in place before.

Note in addition that not all conflicts over restructuring are insider–outsider conflicts (in which shareholders force insiders to restructure) or class conflicts (in which shareholder pressure helps managers to introduce restructuring that they would have preferred anyway). There are also constellations, as in the Mannesmann case, where both works councils and shareholders preferred to split up the conglomerate, but were opposed by managers who had a preference for a big and powerful company.[59] In such cases, even conflicts over restructuring are conflicts over managerial control.

5. Comparative Lessons

By the 1990s the coordinated German corporate governance regime came under pressure to liberalize. It is not these pressures that are at the center of this article but a puzzle that appears to show that liberalization pressures are politically processed. The politics of German corporate governance reform contradict expectations deriving from a combination of partisan theory and production regime theory (and the varieties of capitalism approach in particular): although coordinated capitalism distributes welfare in favor of employees, the large party on the left of the socio-economic conflict axis, the SPD, has favored more corporate governance liberalization than its political neighbor to the right, the CDU.

My explanation has consisted of three parts. First, I have shown that the liberal Social Democratic (and trade union) attitude towards industrial organization emerged not in the 1990s but as a consequence of the historical experience with the Nazi dictatorship. A conversion of ideas set in that redefined leftist thinking. Second, after the change of government in 1969, a quite different reasoning stabilized the liberal attitude: the government was optimistic about the macroeconomic steering capacity of the state in principal, but believed that this capacity was threatened when capital cooperated rather than competed. Therefore, Social Democrats and trade unions already shared their preference for liberalization when corporate governance became one of the most dynamic policy fields in the 1990s and 2000s. Yet another impulse added to the attitude that had already been in place: the large extent to which Social Democrats and trade unions perceived the conflict over capital market orientation as a conflict over managerial control (as distinguished from insider–outsider conflicts and class conflict). In fact, and irrespective of redistribution to the disadvantage of employees, corporate governance reform strengthened the supervisory board vis-à-vis managers – which resulted in an institutional gain for employees' codetermination.

I perceive it as important to contrast my explanation with other possible answers to the "party political paradox." In fact, the corporate governance sphere is not unique in having surprised the observers of recent Social Democratic reform agendas. However, my explanation is ***(here starts p. 416)***, first, *not* that Social Democrats seek votes by moving to the right, thereby abandoning traditional leftist goals and employee orientation; the paradox discussed in this article exists on the basis of, not despite, different voter clienteles and different orientations on the socio-economic conflict axis. Second, the solution to the puzzle is not opportunism on the part of the political leadership of the day. The age of the liberal attitude in industrial organization issues contradicts this possible explanation. The specific economic constellation of the 1990s, likewise, cannot serve as a solution to the puzzle. Third, the described political dynamic must not be confused with a "Nixon goes to China" constellation, in which two parties are convinced of the necessity of unpopular reforms but, due to political vulnerability, reforms are suitable only for the party that, programmatically, is farther away from their content.[60] In contrast, I interpret the liberal Social Democratic attitude in competition policy and corporate governance issues as part of their "prestrategic"[61] preferences.

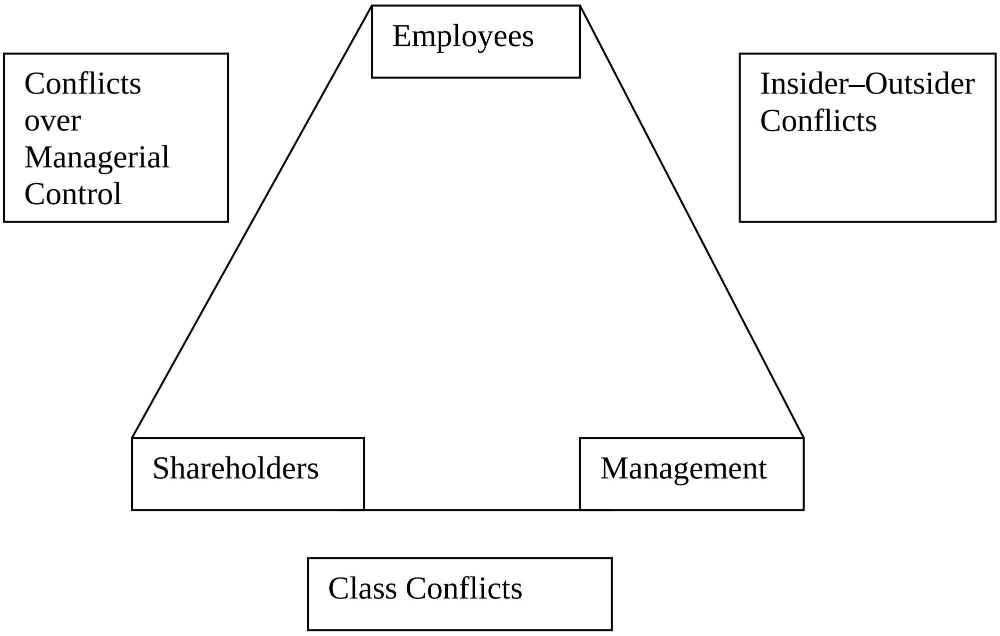
These findings have important implications for the debate on comparative political economy. First, parties do actually matter in corporate governance reform. As corporate governance is one of the main sectors that constitute different models of capitalism, parties have to be taken into account in the discussion on the forces that change production regimes. Second, I have demonstrated that the conventional wisdom on party behavior in welfare state design must not be generalized to corporate governance reform. Here, paradoxically, – and only here, not in the industrial relations sphere, – the SPD is not the party of "politics against markets." The SPD might be the interventionist, market-restricting party in questions of labor market policy. But with respect to the enforcement of share markets and the conflicts between shareholders and managers, the SPD is the market-enforcing party. Advanced capitalist societies have developed five different markets with different commodities, participants and cycles: markets for territorial property, product markets, labor markets, capital markets, and markets for corporate control. Accepted theories of party behavior in a given market like the product market or the labor market need not be generalized to capital markets and markets for corporate control.

Third, the results of my analysis point directly to the problem of institutional complementarity. Do the findings contradict complementarity theory? In a strict sense, complementarity is a functional category and means that the functionality of an institution A is conditioned by the presence of another institution B and vice versa. Hall and Gingerich have shown convincingly that such a complementarity actually existed between industrial relations and corporate governance in OECD countries in the 1971–1997 period.[62] It may seem puzzling that the German left obviously does not believe in this complementarity, since it promotes institutional change that increases coordination in the industrial relations sphere while simultaneously seeking to decrease coordination in the corporate governance sphere. This is no problem for complementarity theory, as complementarity might exist without political actors' knowledge.

The theoretical problem arises when we turn to the implications for institutional change. The findings cast doubt on the assumption that "nations with a particular kind of coordination ***(here starts p. 417)*** in one sphere of the economy should tend to develop complementary practices in other spheres as well."[63] For sure, institutional change is not entirely independent of economic functionality. However, there are other considerations that institution builders have in mind when they promote change. I have shown that one of them is the impact on the distribution of power. In the case discussed above, the force deriving from power distribution runs contrary to the one deriving from institutional complementarity and seems to even dominate the latter. Therefore – at least in the cases discussed – the functionalist assumption that institutional change primarily follows functionality is misleading. I do not doubt that institutional complementarity exists. But it is rather loosely coupled to institutional stability and change insofar as at least two different causes of institutional change must be distinguished: power and (economic) functionality.

Fourth, my findings contribute to the discussion of Roe's *Political Determinants of Corporate Governance*.[64] In a way, the "party paradox" fits nicely with Roe's basic intuition: organized capital is a countermovement to the power of the labor movement. Therefore, he rightly emphasizes the tension between social democracy and organized capital. However, I insist that Roe's model lacks complexity and offers misleading predictions on labor's role in corporate governance reforms. The model consists of class conflict between capital and labor, in which legislation presses managements to side with either shareholders or employees. Strong labor, in Roe's view, will always increase agency costs. Rather than combining agency conflict and class conflict in one model, he identifies one with the other. But, as I have shown, labor has played an active role in enabling shareholders to limit managerial agency costs – a constellation that does not make sense in the light of the one-dimensional conflict model. Therefore, it must be replaced by a more complex, but much more realistic, conflict model that allows every two of the three crucial stakeholder groups (minority shareholders, managements and employees) two build a coalition against the third one (see Figure 1). This model reveals a conflict line – the conflict over managerial control – that neither class theory nor principal–agent theory has considered so far. But this conflict line is crucial for an understanding of the political dynamics behind some of the most important economic reforms in the last one and a half decades.

Figure 1: Three types of coalitions and conflicts inside companies



Example: In conflicts over managerial control, both shareholders and employees oppose managers.

Thanks to Suzanne Berger, John W. Cioffi, Richard Deeg, Bernhard Ebbinghaus, Peter A. Gourevitch, Peter A. Hall, Torben Iversen, Gregory Jackson, Herbert Kitschelt, Andrew Martin, Jean-Philippe Touffut, Wolfgang Streeck, and three anonymous referees for their very helpful hints and comments.

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[13] Examples for target companies are ATU (2004), Celanese (2004), Debitel (2004), Demag (2002), Deutsche Börse (2005), Duales System Deutschland (2004), Dynamit Nobel (2004), Gagfah (2004), Gerresheimer Glas (2004), HDW (2002), Hypovereinsbank (2004), Klöckner (2001), Minimax (2003), MTU (2003), ProSiebenSat.1 (2003), Rodenstock (2003), SGL Carbon (2004), Siemens Nixdorf (1999), Tank & Rast (2004), TUI (2004).

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[21] See Otto Graff Lambsdorff in the debate over the KonTraG, minutes of the Bundestag debate 13/220 from March 5, 1998. The translated quotation that follows below is by the author,

Martin Höpner, as are all other translations in this paper.

[22] See Hartmut Schauerte, ibid.

[23] See Hans-Martin Bury, ibid.

[24] See Margarete Wolf, ibid.

[25] See Uwe-Ernst Heuer, ibid. ***(here starts p. 419)***

[26] Marie Bolt, *Stellungnahme des DGB zum Fragenkatalog der Regierungskommission ‚Corporate Governance – Unternehmensführung – Unternehmenskontrolle – Modernisierung des Aktienrechts'* (Berlin: Deutscher Gewerkschaftsbund, 2000); Roland Köstler and Matthias Müller, *Unternehmensführung – Unternehmenskontrolle – Modernisierung des Aktienrechts, Arbeitshilfe Nr. 15 für Arbeitnehmervertreter in Aufsichtsräten* (Düsseldorf: Hans-Böckler-Stiftung, 2001); Hans-Detlev Küller, "Das Shareholder-Value-Konzept aus Gewerkschaftssicht," *Betriebswirtschaftliche Forschung und Praxis* 49 (1997), 517-31; Heinz Putzhammer and Roland Köstler, "Eckpunkte für ein Übernahmegesetz," *Die Mitbestimmung* 46 (May 2000), 22-3; Ingrid Scheibe-Lange and Arno Prangenberg, "Mehr Mitbestimmung via US-Börsenaufsicht?," in *Die Mitbestimmung* 43 (November 1997), 45-9; Hubertus Schmoldt, "Corporate Governance und Mitbestimmung," *Die Mitbestimmung* 48 (June 2002), 10-6.

[27] Martin Höpner and Lothar Krempel, "The Politics of the German Company Network," Competition and Change 8 (December 2004), 339-56.

[28] Otto Graf Lambsdorff in the debate on the KonTraG, minutes of the Bundestag debate 13/220 from March 5, 1998.

[29] Other elements of the 2000 Tax Reduction Act were a personal income tax reduction (the highest tax rate was reduced to 42 percent) and a corporate income tax cut (25 percent). As a result, the 2000s saw the lowest corporate and personal income tax rates in the history of the Federal Republic of Germany.

[30] Peter Rauen in the debate over the *Steuersenkungsgesetz*, minutes of the Bundestag debate 14/105 from May 18, 2000.

[31] See Lothar Binding, ibid.

[32] Rainer Funke in the debate on the takeover law, minutes of the Bundestag debate 14/192 from October 11, 2001.

[33] Beschlussempfehlung und Bericht des Finanzausschusses, Drucksache 14/7477, November 14, 2001.

[34] Nina Hauer in the debate on the takeover law, minutes of the Bundestag debate 14/201 from November 15, 2001.

[35] See, for example, Margaret M. Blair, *Ownership and Control. Rethinking Corporate Governance for the Twenty-First Century* (Washington: The Brookings Institution, 1995); William Lazonick and Mary O'Sullivan, "Maximizing Shareholder Value: A new Ideology for Corporate Governance," in William Lazonick and Mary O'Sullivan, eds., *Corporate Governance and Sustainable Prosperity* (Houndmills: Palgrave); Cioffi and Cohen; Gourevitch and Shinn.

[36] Rudolf Hilferding, *Das Finanzkapital* (Wien: Verlag der Wiener Volksbuchhandlung, 1910); Wladimir I. Lenin, *Der Imperialismus als höchstes Stadium des Kapitalismus* (Berlin: Dietz, 1985 [1917]), pp. 45-50.

[37] Fritz Naphtali, *Wirtschaftsdemokratie. Ihr Wesen, Weg und Ziel. Dritte, unveränderte Auflage. Mit einem Vorwort von Ludwig Rosenberg und einer Einführung von Otto Brenner* (Frankfurt a.M.: Europäische Verlagsanstalt, 1969 [1928]), pp. 35-36.

[38] Ibid., p. 37.

[39] Quote from Anne Weiss-Hartmann and Wolfgang Hecker, "Die Entwicklung der Gewerkschaftsbewegung 1945–1949," in Frank Deppe, Georg Fülberth and Jürgen Harrer, eds., *Geschichte der deutschen Gewerkschaftsbewegung* (Köln: Pahl-Rugenstein, 1977), p. 291.

[40] Deutscher Gewerkschaftsbund, *Dokumente der Gewerkschaften. Programmatische Dokumente zur Politik des Deutschen Gewerkschaftsbundes* (Frankfurt: Nachrichten-Verlags, 1970), p. 202.

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[44] Sozialdemokratische Partei Deutschlands, *Grundsatzprogramm der Sozialdemokratischen Partei* ***(here starts p. 420)*** *Deutschlands. Beschlossen vom Programm-Parteitag der Sozialdemokratischen Partei Deutschlands am 20. Dezember 1989 in Berlin, geändert auf dem Parteitag in Leipzig am 17. April 1998* (Berlin: SPD, 1998), p. 46.

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[46] *Der Spiegel* (4/1971), p. 20.

[47] Deeg, pp. 49-50.

[48] *Der Spiegel* (19/1970), p. 71.

[49] Studienkommission 'Grundsatzfragen der Kreditwirtschaft', *Bericht der Studienkommission 'Grundsatzfragen der Kreditwirtschaft'* (Bonn: Wilhelm Stollfuss Verlag, 1979), p. 267.

[50] Isabela Mares, *The Politics of Social Risk. Business and Welfare State Development* (Cambridge: Cambridge University Press, 2003), p. 3.

[51] This model applies to corporations in dispersed ownership. If ownership is concentrated, blockholders may be introduced as a fourth party or – which is sufficient to clarify my argument – they may be added to the management side of the triangle. The crucial point is that "shareholders" in this model are minority shareholders: those that benefit from increased transparency and shareholder protection.

[52] Beyer and Hassel. Changes in the relative distribution of net value added may be due to cyclical variations as dividends decline faster than wages when earnings shrink. The crucial point in Beyer and Hassel's comparison of 59 large German companies between 1992 and 1998 is that the shareholder value orientation turns out to be the best predictor for changing distributional patterns.

[53] See, for example, trade union expert Roland Köstler, "Grundsätze der Unternehmensführung und –kontrolle in der Diskussion," in *Die Mitbestimmung* 46, (May 2000), p. 34.

[54] See Bolt, p. 9; Scheibe-Lange and Prangenberg, p. 47.

[55] In addition, trade unionists point out that minority shareholder protection becomes increasingly important for workers because more and more of them hold shares. See, for example, Putzhammer and Köstler, p. 22.

[56] This is why trade unions also explicitly supported the introduction of the "one share, one vote" rule. Similarly, trade unions support extension of shareholders' rights to sue. See, for example, *Deutscher Gewerkschaftsbund, Stellungnahme des DGB zum Entwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts* (Berlin: Deutscher Gewerkschaftsbund 2004), p. 3.

[57] Küller, p. 529.

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[59] Höpner and Jackson.

[60] Fiona Ross, "Beyond Left and Right: The New Partisan Politics of Welfare," *Governance* 13 (2), 155-83.

[61] Mares.

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[63] Hall and Soskice, p. 21.

[64] See Roe.