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Governance of stakeholder relationships
The German and Dutch experience

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1 Introduction*

This Research Memorandum forms part of a forthcoming comparative study of the Central Planning Bureau which examines the main strengths and weaknesses of the German and Dutch economies. The main purpose of this study is to learn from experiences abroad. Mutual lessons can point out necessary policy adjustments which enhance future competitiveness, with the paramount objective to safeguard national wealth and wellbeing. To this aim, strong and weak elements of the current situation in both countries are analyzed, as well as the main future trends that correspond with potential threats and opportunities for economic growth. Attention is not only focused on the available production factors, but also, and above all, on the role of institutions in relation to economic performance. Institutions are defined as the set of rules that provide a framework for production, exchange and distribution. Consequently, they range from legal rules to informal agreements.

One of the aspects relevant for economic performance is the behaviour and position of the different stakeholders that constitute a firm or are directly related to a firm, and the governance structures that control relationships between stakeholders. Well-known categories of stakeholders are shareholders, creditors, and managers, yet employees, suppliers and consumers are stakeholders as well. The behaviour and position of stakeholders affect national welfare through firm performance, for instance with respect to investment strategies, the structure of finance and the adoption of new technologies. In turn stakeholder behaviour is influenced by various institutional arrangements. Hence, the core questions addressed in this paper are the following. Which institutions influence the position and behaviour of stakeholders in a business enterprise in Germany and the Netherlands? In what way do these institutions and corresponding behaviour affect firm

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performance? What lessons can be drawn from the comparison about options to adjust or strengthen national institutional arrangements?

To address these questions, first of all the main concepts, an analytical framework and a short overview of the booming literature[1] on stakeholder relationships is presented in Section 2. To clarify these issues, the discussion in Section 2 focuses on two main models of stakeholder relationships, the Anglo-American model and the German model.

Concerning Germany and the Netherlands, more detail and nuance is added in the subsequent sections, which delve deeper into the institutional arrangements and the performance of the enterprise sector in the two countries. Section 3 addresses the similarities and differences between Germany and the Netherlands with respect to relationships between managers, shareholders, and creditors. Section 4 focuses on the interaction between management and employees. Section 5 gives an assessment of the mutual lessons that can be learned from the German and Dutch institutions affecting stakeholder relationships.

[1] See Bishop (1994), Blair (1995), Boot (1994), van Damme (1995), Edwards and Fischer (1994), Elston (1994), Guptara (1995), Hart (1995), Jenkinson and Mayer (1992), de Jong (1991), Kaen and Sherman (1993), Kester (1992), Moerland (1995), Monks and Minow (1995), Nickell (1995), OECD (1995a), Pound (1995), Prowse (1994), Shleifer and Vishny (1989), Winter (1994), Yafeh and Yosha (1995).

2 Shareholders or stakeholders: a matter of institutions

For several reasons the words 'shareholder' and 'stakeholder' feature prominently in current public discussions. The (near) demise of a few large companies has put the issue of corporate governance on the public agenda. Deregulation, technological developments and emerging regions in the world economy raised interest in the performance and competitiveness of enterprises and the impact of a nation's institutional characteristics on the internal organisation of companies and the relations between companies. In particular in the United Kingdom, the introduction of the concept of a stakeholder society by the Labour Party brought the subject higher on the political agenda.

At times a heated debate takes place between proponents of the 'shareholder view' and the 'stakeholder view' on the perceived objectives of a company's management. According to the shareholder view companies 'should' be run in the interest of their shareholders, whereas the stakeholder view emphasizes that managers 'should' promote the interests of all stakeholders in the company. Opponents of the shareholder view state that '... We doubt whether shareholders have either incentive or capacity to provide such monitoring. We doubt whether shareholder priority is an appropriate rule for the large corporation in any event. ...' (Kay and Silberston, 1995: 94). Proponents of the shareholder view criticize the stakeholder position: '... The stakeholder approach is simply to dissolve this problem in a general mushiness. Everyone is supposed to promote the interests of everyone else and no-one is really accountable for anything. ...' (Brittan, 1996).

The aims of this section are to analyze this controversy from the perspective of economic theory and meanwhile to develop a framework to compare governance structures among countries. Governance structures can be defined as institutional arrangements which are designed to control relationships between stakeholders and affect the actions of different stakeholders. Section 2.1 argues that the effectivity of national institutions differs with respect to the promotion of relationship-specific investments in stakeholder relationships. Differences in national institutional characteristics imply that the behaviour of managers, who aim at maximization of the equity value of the company, diverges regarding the incorporation of the interests of stakeholders in their decisions. The crucial argument is that certain institutions to a larger extent support the commitment of managers and other stakeholders to invest in relationship-specific assets. In countries typified by these institutions, management behaviour at first sight seems to be governed by adherence to the objectives of the stakeholder view. However, the analysis argues that under these circumstances it is rational for managers who strive for maximization of the value of the company, to take the interests of stakeholders into account and to invest in long-term relationships. In contrast, in countries where management adheres to the same objective but the institutional arrangements are strongly different, a perspective emerges in which investments in long-term relationships with stakeholders are less important. Under these institutions management seems to act according to the shareholder view in the sense that only shareholder interests seem to matter. Therefore, both views do not follow from different behaviourial objectives, but indicate that the emphasis of management shifts under different institutional arrangements.

The existence of different institutional arrangements does not necessarily imply that one group of institutions is superior to the other. In contrast, it is much more probable that each has its distinct strengths and weaknesses, since different systems already co-exist for a long period of time.

The organization of the remainder of this section is as follows. Section 2.2, 2.3 and 2.4 address three types of relationships in more detail, *viz.* relationships between managers and financiers, relationships between two companies, and relationships between management and employees, respectively. Each of these three sections is organized in a similar way. Reviewed are: the relevant economic agents, their goals and motivations, and the institutions which govern the relationships between these agents.

Subsequently, Section 2.5 presents two stylized models of relationships between economic agents, the Anglo-American model and the German model. For both models the main institutions which characterize the three types of governance are presented. Section 2.6 assesses the strengths and weaknesses of the two models. In conclusion, Section 2.7 explains the use of the analytical framework in subsequent sections for the comparison of institutions in the field of stakeholder relationships between Germany and The Netherlands.

2.1 The impact of institutions on stakeholder relationships

This section provides a theoretical frame of reference to analyze the impact of institutions on stakeholder relationships. It starts by delineating the main features of a stakeholder relationship. Subsequently, it addresses the reasons why contracts can never be comprehensive. Incomplete contracts and opportunism of economic agents give rise to the hold-up problem, which states that if agents cannot be committed to keep to an agreement, relationship-specific investments are curbed. Ownership and governance institutions constitute two alternatives to reduce the hold-up problem. Hence, solving the hold-up problem through governance institutions provides a rationale for investments in stakeholder relationships. By consequence, different sets of national institutions may promote a ‘stakeholder society’ or a ‘shareholder society’.

This section ends with a taxonomy of governance institutions, which sets the stage for the analysis of Anglo-American, German and Dutch governance institutions in following sections.

Relationship-specific investments characterize stakeholders

Providing services to a firm and receiving part of the firm's revenues in return does not make an economic agent a stakeholder. A construction worker hires out his working abilities to a specific firm, gets paid the amount mutually agreed upon and moves to another firm after the job has been done. In this case the agreement between the worker and the firm constitutes a market exchange of working ability for money. Analogously, a market transaction in which a down-stream enterprise purchases a product from a supplier, as such involves no stakeholder relationship. Rather, a distinctive feature of a stakeholder relationship concerns investment in assets that are specific to the relationship with the firm[2]. In other words, a stakeholder has invested in relationship-specific assets that are at risk in the enterprise (Blair, 1995).

If substantial relationship-specific investments have been made by contracting parties, asset specificity is considerable. The degree of asset specificity is defined as the fraction of the value of the asset which is lost if the asset is excluded from its major use (Milgrom and Roberts, 1992: 307). If two parties both make relationship-specific investments their assets are co-specialized, *i.e.* the two assets are most productive when used together and are of little value separately. In this way, stakeholder relationships cause a mutual dependency between the participants in a business enterprise. The return on the relationship-specific investment of a particular stakeholder depends on the actions of other participants in the firm.

Reviewing a company's diverse types of investments shows that, although being a legal contracting entity by itself, a company is composed of different stakeholders and on top of that is related to several external groups of stakeholders. The main types of possible stakeholders are managers, as the main decision-making unit within the firm; employees, as the providers of human capital; shareholders, as the owners of the firm's equity; creditors as the suppliers of debt finance; up-stream firms as suppliers of intermediate goods; competing firms for instance in case of a research joint venture; and consumers who may have a long-term purchasing relationship with a specific firm.

[2] Note that the subsequent analysis uses 'stakeholder relationship' as a central concept. In certain circumstances relationship-specific investments will turn out to be negligible or completely absent. In the latter cases no stakeholder relationship exists. Yet, it would be needlessly tedious to systematically speak of 'potential stakeholder relationships' or 'possible stakeholders'. Therefore economic agents that potentially can invest in relationship-specific assets will be defined as 'stakeholders' and their mutual relationship is called a 'stakeholder relationship'.

Bounded rationality and uncertainty imply that contracts are incomplete

Because they have invested in relationship-specific assets, stakeholders are interested in the continuity of the operations of the firm and the prosperity of its activities. However, continuity and prosperity can mean different things to different stakeholders, who may have conflicting interests. For instance, if a firm gets into financial trouble and continuation of the operations of the firm will further increase the probability of default on a loan, creditors will prefer quick liquidation (Blair, 1995: 25). In contrast, if share prices already plummeted because of the initial financial difficulties, shareholders will have little to lose by pursuing some very risky strategies that have some probability of strong recovery. In this case the interests of creditors and shareholders are antagonistic. In general, departing from different goals and different types of investments, stakeholders can have partly conflicting and partly corresponding interests in the company.

Transaction Cost Economics[3] explains why bounded rationality makes it infeasible to align diverging interests and avoid conflicts by designing comprehensive contracts between the various stakeholders, *i.e.* contracts that specify all parties' obligations in all possible future states of the world to the full (Hart, 1995: 22-23; Milgrom and Roberts, 1992: Ch. 5; MacLeod, 1995: 20). Because people are boundedly rational designing a contract is costly and therefore contracts are always incomplete. Bounded rationality manifests itself in several ways: foresight is imperfect and contracting parties face difficulties to develop a common language to unambiguously define the terms of the contract and to write a contract that is interpretable and perfectly enforceable in court.

Contracts are always incomplete, because bounded rationality generates contracting costs. Depending on the degree of incompleteness three types of contracts are relevant, *viz.* formal contracts, relational contracts and implicit contracts. Formal contracts are most appropriate for situations where property rights are secure, bargaining and enforcement costs are relatively low and future contingencies easy to oversee. According to the Coase theorem, in these cases ownership rights will be traded until the emerging pattern of ownership is efficient, *i.e.* until all costs, including transaction costs, are minimized (Milgrom and Roberts, 1992: 38). In more complex situations where formal contracts are too costly, relational contracting is a functional alternative. Instead of specifying many details of the relationship, parties formulate more incomplete written contracts in which they agree on general objectives, bounds on actions to be taken, division of power to act, dispute-

[3] On Transaction Costs Economics see Williamson (1985). Lazonick (1991: 206-227) provides a brief overview of the main concepts of Transaction Costs Economics and a discussion of its strengths and weaknesses.

resolution mechanisms, etc. Research joint ventures are frequently governed by relational contracts (Milgrom and Roberts, 1992: 131). An even less formal type of contracts are implicit contracts. Implicit contracts pertain to unarticulated shared expectations of partners concerning their relationship. Values and norms embedded in corporate culture can be considered as being governed by implicit contracts.

Incomplete contracts and opportunism may create the hold-up problem

Incomplete contracts cannot be fully enforced. Therefore, openings remain for opportunistic behaviour of contracting parties. Williamson (1985) defines opportunism as ‘self-interest seeking with guile’. According to Williamson, opportunism refers to the ‘incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate or otherwise confuse’.

Investment in relationship-specific assets is vulnerable to opportunistic behaviour. This may create the hold-up problem. Once the relationship-specific investment has been made, the investing party can be forced to accept a worsening in the terms of the relationship, because the fact that the investment cannot be put to an alternative use without substantial losses reduces the investing party’s ex-post bargaining power. By consequence, the investing party has been held up (Milgrom and Roberts, 1992: 136, 307). If the party that benefits from the investment cannot convince the investing party of its commitment to the initial agreement, the fear of becoming vulnerable to ex-post reneging on initial agreements can induce the investing party to abstain from profitable investments. Hence, welfare improving value creation has been curbed.

An example of the hold-up problem concerns investment in relationship-specific equipment by a supplier and a procuring firm (Hart, 1995: 27). Ex ante, the parties agree on a division of costs and revenues of an investment to be made by the supplier in machinery and technology, which is tailored to the requirements of the procuring firm. The supplier runs the risk that after it has made the investment, the procuring firm uses its ex-post higher bargaining power to force down the price of products delivered by the supplier. Therefore, it will be less inclined to engage in relationship-specific investment. Depending on the division of costs and revenues in the initial agreement, ex-post the balance may also turn out to the disadvantage of the procuring firm, for instance if it becomes highly dependent on the products delivered by the supplier. This example illustrates the crucial features of the hold-up problem: assets are relationship-specific or co-specialized, ex-ante bargaining power differs from ex-post bargaining power and no credible commitment can be given that parties will stick to the initial agreement, because contracts are incomplete and parties may act opportunistically.

Ownership solves the hold-up problem but eliminates market incentives

Two main types of solutions exist that reduce the hold-up problem. The first is the ownership solution, which implies that the relationship-specific assets fall under common ownership. From an economic point of view, two crucial aspects of ownership are the right on residual returns and the right of residual control (Milgrom and Roberts, 1992: 289-293). Both these aspects follow from the incompleteness of contracts, since in a world of comprehensive contracts the complete allocation of revenues and the full division of control rights would be specified contractually.

The right on residual returns specifies that in general owners exert a residual claim on the operating revenues of a firm. From its operating revenues the firm has to pay rents to other stakeholders, *i.e.* wages for its workers, interest on loans and payments to suppliers. The remaining profits can be used to pay dividends to owners or to finance investments, which raise future revenues of the firm and in that way indirectly benefit owners as well. However, if revenues fall short of wages, interest payments and costs of supplies, the company will not pay any dividends and losses will reduce the owners' wealth.

The right of residual control of an asset entails the right to make any decisions concerning the asset's use after all legal and contractual obligations have been fulfilled. Hence, residual control of a firm's assets is permitted only in so far as control is not restricted by law or other contracts. Consolidating the right of residual control is the reason why ownership solves the hold-up problem: if the user controls the relationship-specific asset the incentive to renege on the initial arrangement vanishes.

In terms of the supplier-user example the ownership solution implies vertical integration, i.e. the procuring firm acquires the supplier (Hart, 1995: 33). Vertical integration increases the incentives of the procuring firm to invest in technological know-how and product development with the acquired firm (the former supplier), since there is no risk that these will be expropriated after the investment has been completed. These investments are fully under the procuring firm's control.

A disadvantage of the ownership solution to the hold-up problem is that market incentives are eliminated. Because of vertical integration, incentives of the acquired firm's management to invest in relationship-specific assets decrease because the procuring firm receives the revenues of these investments. The absence of market incentives may also raise X-inefficiencies and lower productivity of the acquired firm.

Finally, the ownership solution is not always feasible. In particular, potential hold-up problems in relationships between management and employees have to be solved in a different way. The right of residual control on work effort can never be acquired, simply because a firm cannot own a worker.

Institutions may support commitment and reduce the hold-up problem

To preserve market incentives or in the case that the ownership solution is not feasible, the hold-up problem can also be tackled by a second solution that consists of governance institutions designed to commit parties to keep to initial agreements. Institutions may enhance monitoring capabilities of parties, reallocate revenues so as to align incentives between parties, increase co-decision powers of parties, and support long-term relationships between agents. For instance, representation of block shareholders on the board of directors improves the effectivity of direct shareholder monitoring of management and reduces the scope for managerial opportunism. Management share ownership closer aligns management and shareholder incentives. Employee co-determination rights enable employees to monitor management and to partly control managerial decisions that might hamper relationship-specific investment by employees.

Long-term relational or implicit contracts also partly resolve the hold-up problem because they strengthen long-term relationships, which makes reputation more important as a control mechanism. For instance, if a procuring firm reneges on an initial agreement with a supplier, the supplier can threat not to invest in future relationship-specific assets any more. Reneging by the procuring firm is a signal to other suppliers as well not to engage in a future consultative-cooperative arrangement with that firm. Hence, the reputation of the user is harmed and it forgoes the benefits of dedicated supplier relationships.

A ‘shareholder society’ and a ‘stakeholder society’

The following line of reasoning shows how institutional characteristics may lead to the emergence of a ‘shareholder society’ or a ‘stakeholder society’. It starts from four assumptions. Firstly, managers maximize the equity value of the company, which equals the discounted sum of future dividends. Secondly, future revenues from relationship-specific investments increase future dividends and thus raise the equity value of the company. Thirdly, managers are risk-averse in the sense that they aim at hedging against unexpected shocks. Fourthly, investments in stakeholder relationships reduce short-term external flexibility, which relatively strongly lowers the value of the company in case of unexpected shocks.

Now take two countries, A and B, in which two different sets of institutions have evolved. The set of institutions of country A differs from that of country B in its adequacy to solve the hold-up problem. As a consequence of the above assumptions management and other stakeholders in country A to a larger extent invest in relationship-specific assets compared to country B. Since stakeholder relationships feature more prominently in country A than in country B, country A gets the characteristics of a 'stakeholder society', whereas country B becomes a 'shareholder society'.

Note that in country A management incorporates the interests of other stakeholders in its decisions because the country's institutional characteristics encourage stakeholder relations, not because management adheres to some general and probably irrational objective like 'everyone is supposed to promote the interests of everyone else'. Thus, management's objectives are identical to those of managers in country B. Country A's management to the best of its knowledge controls the value creating features of relationship-specific investments and the benefits of these investments for the company. In that respect relationship-specific investment decisions do not differ from decisions to invest in physical capital or technology research and development.

In country B it is equally rational for management to largely disregard relationship-specific investments as it is for country A's managers to take stakeholder interests into account. The larger stock of relationship-specific assets may be welfare improving for country A. However, the associated long-term characteristics may reduce short-term external flexibility and adaptability to new challenges in country A compared to country B. Therefore, a priori none of the institutional systems is superior.

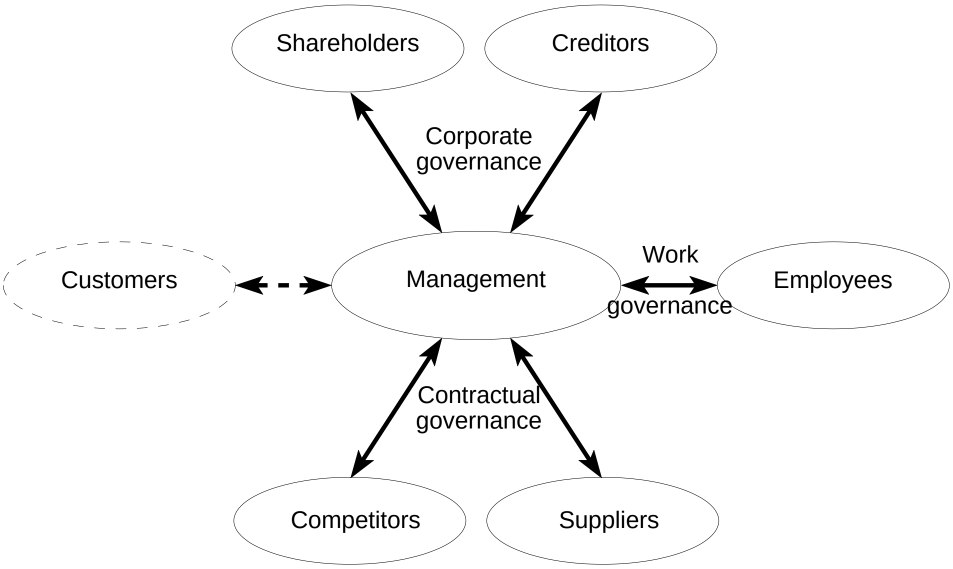
The arguments presented here provide a theoretical frame of reference. In real-world situations a variety of different institutions as well as various imperfections blur the sharp distinction given here. For instance, imperfections may lead to rigidities in country A and to overly short-sighted behaviour in country B. However, the theoretical framework is a useful point of reference to compare specific institutions that are used to govern stakeholder relationships. To set the stage for the more detailed description of specific institutions in Section 2.2, 2.3 and 2.4, this section finishes by further classifying relevant subgroups of institutions.

Governance structures

Governance structures are defined as institutional arrangements that are designed to control relationships between stakeholders and affect the actions of different stakeholders. Hence, governance structures range from detailed formal contracts to market transactions. An example of an institution that is part of a governance structure is the annual statement of accounts of a company. To overcome information asymmetries these accounts give shareholders and creditors access to financial data of the company.

The specific design of institutional arrangements is influenced by the institutional environment in which they operate (Williamson, 1985). The institutional environment of governance structures consists of the regulatory framework set by the national or supranational government, which influences the existence and

Figure 1 *Stakeholder relationships and governance structures*



efficacy of different types of governance structures. To illustrate the effect of the institutional environment (national legislation) on the strengths and weaknesses of the institutional arrangements (governance structures) in the previous example: requirements concerning the contents of the financial statement laid down in national legislation, strongly influence this instrument's effectiveness from the perspective of the shareholder. For instance, the effectiveness is reduced if national legislation allows a company not to disclose all reserves in its financial statement, because then the precise value of the company is difficult to establish by shareholders.

In the following sections the analysis of stakeholder relationships and associated governance structures is subdivided into three categories, *viz.* corporate governance, contractual governance, and work governance (see Figure 1)[4]. These governance

[4] Customers may also have a stakeholder relationship with a firm if they value the quality of the firm's products high, invest to be kept informed about the firm and prefer to buy a replacement set or related products from the same company. Moreover, firms can invest to intensify their customer relations, for instance through after sales services. However, in order not to broaden the subject too much, this type of stakeholder relationship is not taken into consideration here, which explains the dashed lines in Figure 1.

structures are two-sided because relationship-specific investments of both parties are at stake and both parties influence each others behaviour.

Corporate governance focuses on the relationships between financiers and managers. Two groups of financiers, shareholders and creditors, can act on the basis of partly different views on the purpose of the company and can apply different governance institutions to have management comply to these goals. *Contractual* governance concerns the associations between different companies[5]. Examples are cooperative agreements between suppliers and procuring companies in industrial groups or research joint ventures among competitors. *Work* governance concentrates on the relationships between management and employees. Monitoring among management and employees is also a two-sided matter. Not only do managers monitor the work effort of employees, but their relationship-specific investments give employees an interest in monitoring the performance of management as well. Therefore, with respect to work governance the focus will be on co-determination arrangements and remuneration practices, and the way these institutions stimulate work effort, worker motivation and worker quality.

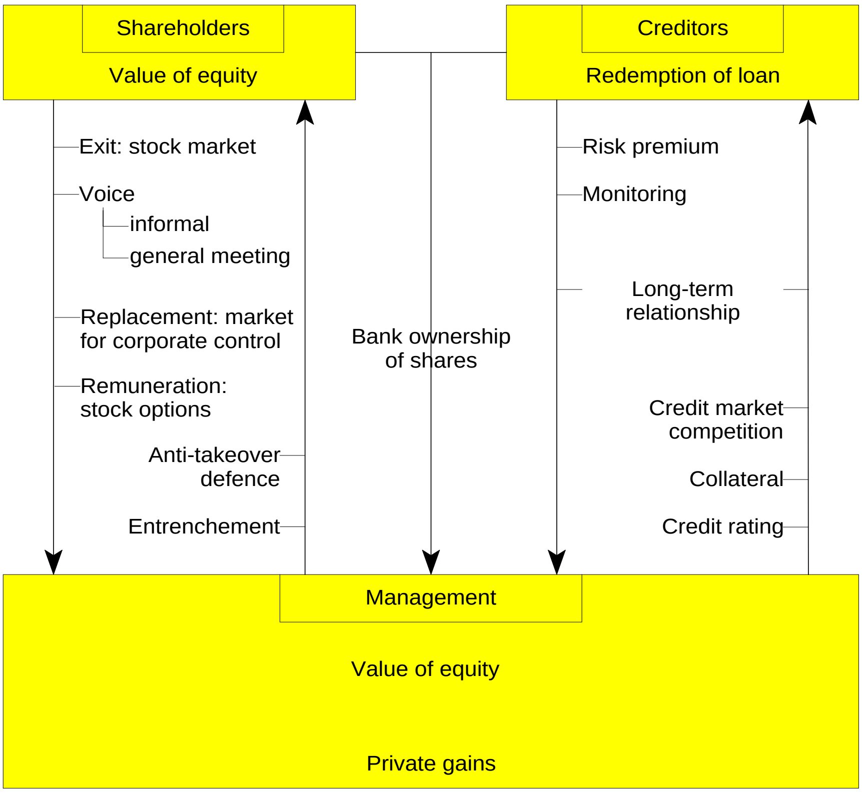
As will be illustrated in Section 2.6 and 2.7, governance institutions balance the interests of stakeholders. Moreover, these sections make clear that the three types of governance structures are partly interrelated.

2.2 Corporate governance: financiers and managers

In the literature the concept of corporate governance ranges from the influence of shareholders on board decisions on the one hand to all institutions that pertain to stakeholder relationships in the enterprise sector on the other hand (see for instance Blair, 1995). As indicated in Section 2.1 and Figure 1, here corporate governance is confined to stakeholder relationships between providers of capital to the firm and the management of firms. Corporate governance institutions affect the intensity of relationship-specific investments of managers and financiers. From this perspective the purpose of corporate governance institutions is to make management accountable to financiers and to give them proper incentives to take the goals set by the providers of capital into account, while preserving managerial autonomy to formulate strategies that enhance the performance of the company. To clarify the discussion, Figure 2 acts as a point of reference. In Figure 2 rectangles contain the relevant agents and their goals and the arrows represent corporate governance institutions among these agents.

[5] The concept of contractual governance in relation to corporate governance has been introduced by Kester (1992).

Figure 2 Corporate governance: agents, goals and governance structures



Note: boxes represent agents and their goals, arrows represent governance structures

Objectives of shareholders, creditors and managers

What are the objectives of capital providers and in what way do these relate to the objectives of managers? An important factor in this respect is that, from a risk-taking perspective, the interests of the two categories of providers of outside financial capital, shareholders and creditors, are divergent (Prowse, 1994). In an efficient stock market, which discounts all information, shareholders receive the highest return on their investment if the value of the firm's equity is maximized. Creditors aim at maximizing the probability to be repaid in full and to receive the amount of interest agreed upon. Hence, creditors are best off if the firm pursues a strategy which minimizes the probability for bankruptcy. Shareholders have a residual claim on the profits of the firm. They benefit from successful high-risk strategies by receiving higher dividends or rising share prices, while the costs of bankruptcy in case of total failure of a high-risk strategy are divided between shareholders and creditors. Therefore, shareholders will be more inclined to engage into risk-taking activities than creditors.

Managers, are hired to run the company. The objective of managers is to maximize shareholder returns, in other words to maximize the value of equity (Monks and Minow, 1995: 41). To properly carry out their task, managers need a considerable degree of autonomy. They have to take risks and take advantage of opportunities when they arise (Blair 1995: 32). However, too high a degree of managerial discretion can provide opportunities to managers to perform activities which are not aimed at value maximization, but which raise their salaries, their power or their status. Activities with a potential for managerial empire building are investment in large offices, in staff departments or in R&D activities, launching of over-extensive advertising campaigns or acquisitions (Prowse, 1994; Yafeh and Yosha, 1995). According to Jensen (1988) managers often waste free cash flow on these activities. Free cash flow concerns earnings of the company that exceed the funds needed for investments by the company in projects with a positive net present value. Instead of spending it on empire-building activities, free cash flow should be returned to shareholders by paying out dividends.

As another way to pursue their own goals, managers can entrench themselves in the company by writing contracts or making investments specific to their ability and presence. These investments makes it costly to replace them (Shleifer and Vishny, 1989). Examples are golden parachute contracts, binding of valuable employees to managers instead of to the company, or excessive expansion of current lines-of-business and aversion to new activities if current operations correspond best to the management abilities of the incumbent management.

Managers may perform myopic behaviour by aiming at a high current share price to reduce the threat of a takeover and subsequent replacement (Nickell, 1995). Finally, apart from promoting their own interests, managers may be biased towards survival of the company, while from a broader economic perspective it can be more useful to shift resources towards other industries (Kaen and Sherman, 1993).

Corporate governance: shareholders and managers

In a single owner firm both the right of residual control and the right on residual returns[6] are in the hands of the entrepreneur who fully owns the firm. The separ-

[6] See the subsection on ownership in Section 2.1: 8 for a definition of these two crucial ownership rights.

ation between equity ownership and management control changes the ownership structure of a firm. Shareholders are only entitled to those ownership rights which are associated with the ownership of equity, like receiving dividends. Hence they have the right on residual returns. Moreover, shareholders have limited liability, which reduces their residual risks because losses can never exceed the amount invested in the company. However, by law the right of residual control and use of the property of the enterprise has been delegated to management.

Although the advantages of the separation between the right of residual control and the right on residual returns are well known[7], it does create a hold-up problem (Hart, 1995: 64). If the manager controls the use of a company's assets, while shareholders receive most of the returns from operating these assets, less incentives exist for the manager to substantially improve operations. The manager might invest shareholders' capital in projects that require little managerial effort or in projects that increase the power or status of managers instead of the performance of the company. In contrast, shareholders' incentives to invest in detailed knowledge of a company's strategies and to directly communicate strategic recommendations to management are low in companies with widely dispersed equity capital.

Three options exist for shareholders who disagree with the way a company is managed: exit, voice and replacement (see also Figure 2). Exit simply comes down to selling the company's shares on the stock market. Exit by the owners of a substantial part of the firm's equity initiates a fall in the share price, which acts as a signal to managers to improve performance. The exit option is useful if the stock market functions effectively. Therefore, liquidity of the market has to be sufficient, market prices have to adequately reveal the value of equity and insider trading must be countered. Liquidity and importance of the stock market are higher if little restrictive regulation on the issuance of shares exists, if information disclosure is sufficient to establish market transparency, and if taxation does not discourage share holdings or share trading (Prowse, 1994: 24-28). Adequate representation of equity value by stock market prices can be raised by accounting rules which require a company's financial information to properly reflect shareholder value. Insider dealing can be curbed by strong legislation combined with effective control.

Using voice, the second option, means that shareholders approach managers directly and inform managers about their opinions on the appropriate way to run the company either informally or at the general meeting of shareholders. Influencing management by voice is relatively easy for a single shareholder or a small group of shareholders who own a considerable part of the firm's equity capital.

[7] Separation between ownership and management enables a company to hire professional managers who are more knowledgable on management issues than an owner-manager. Moreover, it facilitates attracting equity capital by spreading risks over a large group of shareholders.

Their limited number makes it simple to contact management directly, to learn about its plans and policies and to supervise the performance of the company. Moreover, the size of their concentrated shareholdings provides a strong incentive to devote time and resources to monitoring activities, to monitor management effectively and is also a strong incentive for management to take the opinions of shareholders seriously. In general, governance by shareholders who own large equity stocks is primarily exercised by informal procedures and informal meetings between shareholders and managers.

If a firm's equity capital is highly dispersed, formalized contacts between shareholders and managers are more relevant. The general meeting of shareholders votes on a number of issues regarding the condition of the company, like the financial decisions and proposals for merger or substantial investments. In addition, the general meeting usually elects the board of directors or the supervisory board, which act as an intermediary between shareholders and management. Yet for individual shareholders the influence on management through these institutions is small and therefore the cost of exercising voice may outweigh the revenues. Moreover, each shareholder is subject to the free-rider behaviour of leaving monitoring activities to others. The relatively minor significance of direct individual voice in companies with dispersed shareholdings is illustrated by the fact that attendance of shareholders at general meetings is usually low.

The third and most radical option is to replace a management team through the market for corporate control. If the share price of a company is low because current management is incompetent or wastes too much resources on managerial empire building, competing management teams can obtain a majority stake in the company at a relatively low cost, replace the current management team, improve the company's performance and benefit from the rise in share price. Current management can use a number of anti-takeover defences to protect itself against hostile takeovers. On the one hand these defences entrench current management, leave scope for pursuing private goals and drive down share prices. On the other hand defences may protect managerial discretion to strive for long-term goals from raiders who are only interested in the short-term benefits from stripping the company. The efficacy of the market for corporate control depends on the institutions which affect the functioning of the stock market and which have been discussed above. Furthermore, regulations which require disclosure of concentrated shareholdings above a certain percentage of a firm's equity capital, prevent a secret build-up of a large stock of shares in a company and provide information on a possible takeover attempt to current management and to other shareholders.

An institution, which can be used to align the interests of shareholders and managers is to relate remuneration of managers to the performance of the company (see Figure 2). In particular, management stock ownership could generate an incentive for management to act according to shareholder preferences. Stock ownership is stimulated by paying part of management compensation in the form of stock options (Blair, 1995: 87-92). Stock options entail a right to buy a company's shares at a given exercise price at some date in the future. At that date the person possessing stock options faces three possible courses of action. If the stock price of the company has fallen below the exercise price, the manager can refrain from exercising the option. By consequence, the stock option can never incur a loss to managers. It provides a skewed incentive in the sense that it generates benefits if the share price has risen but does not penalize behaviour which affects stock prices negatively. If the stock price exceeds the exercise price, exercising the option provides a gain to the manager. The second action is to cash that gain immediately by selling the company shares on the stock market. The third alternative, not to sell the shares, can be advantageous if the share price is expected to increase above alternative returns.

Corporate governance: creditors and managers

By definition, corporate governance institutions do not only pertain to relationships between shareholders and managers but also govern relationships between creditors and managers (see Figure 2). Before turning to the governance of lending relationships, note that according to Hart (1995: Ch. 6) the existence of debt is part of the shareholders' governance structure in companies with dispersed equity capital. If part of the company's assets are debt financed, management is forced to use part of the revenues from the existing assets to make repayments. Repayment obligations constrain management in using these revenues as a source of finance that is completely under management control and that might be used to finance managerial empire building. Management has to apply to the stock market or creditors to finance new investment projects, which enables financiers to screen future projects before granting additional finance.

A lending relationship itself may give rise to a hold-up problem as well (Van Damme, 1994). For instance, management may not use a loan for the purpose referred to by application, but instead ex-post finance more risky projects or projects that yield high private gains. This problem may result in credit rationing by lenders. Monitoring of management by lenders resolves this problem (Diamond, 1984). However, monitoring of firms by a large number of small lenders causes private incentive problems like high private costs of monitoring and free-rider behaviour. Bank intermediation in debt finance is efficient since it resolves some of these private incentive problems. Moreover, because the bank diversifies its risk by lending to a large number of firms it can offer its depositors a fixed interest on their savings.

However, it can be argued that the efficacy and the need of bank monitoring mainly applies to lending to relatively small firms (Van Damme, 1994: 21).

Usually large firms are less susceptible to the hold-up problem. They either can put up collateral and in that way reduce the risk to lenders or they possess a number of additional means to signal their creditworthiness to potential creditors, like credit ratings or building up a reputation in credit markets. By consequence, large firms also directly apply to the credit market by issuing securities.

If a bank has invested a considerable amount of capital in a specific firm for a long period of time, a stable long-term relationship may develop. An important issue is whether the long-term relationship encourages a less risk-averse attitude of the bank, which raises financing options for management towards projects that carry a higher risk but also a higher expected return. Monitoring options associated with the long-term relationship provide the bank with an informational advantage over non-monitoring competitors. Hence, informational rents motivate banks to perform monitoring activities and substantiate the relationship. Management benefits from the long-term relationship because it raises long-term financing possibilities and it may offer protection against hostile takeovers (Van Damme, 1994: 28).

Mutual advantages can turn into disadvantages if power becomes too concentrated. The long-term relationship entails the risk that the bank exercises monopoly power over the firm. Monopoly power can even lead to a process of adverse selection in which strong firms that are good risks do not need the security of the long-term relationship and are not prepared to allow the bank to have an informational monopoly. Exactly firms that are bad risks are inclined to seek shelter by a bank and pay a somewhat higher rate of interest on the loans (Edward and Fischer, 1994: 145). Another undesirable feature of the long-term relationship is that occasionally unprofitable projects may not be terminated quickly enough. Therefore, long-term relationships between banks and enterprises are expected to attract a range of investment projects with a relatively high variance but also a relatively higher average return compared to arm's length debt financing.

Combination of bank lending relationships and ownership of equity by banks can have a number of advantages. Firstly, economies of scale and scope can arise in information collection and monitoring of management because the monitoring role of creditors and shareholders are concentrated in one bank (Edwards and Fischer, 1994). In a competitive market economies of scale would lower the costs of finance for enterprises. Secondly, according to Stiglitz (1985) the interests of creditors and providers of equity are aligned, which reduces the possibility of an attitude towards risk which is too heavily skewed in favour of the preferences of one of the two types of financiers (Prowse, 1994: 12). The incentive to take large risks with borrowed money to benefit shareholders is reduced if shareholders also have debt at risk in the firm. Moreover, in times of financial problems conflicts between lenders and shareholders are more easily resolved (Kester, 1992: 36).

In contrast, some arguments do not favour a combined shareholder-creditor position by the same agent. For example, if banks have an equity stake in a company, the credibility of a threat to withdraw a loan is reduced since withdrawal would harm the bank as well. Hence, the disciplining effect of the lending position of the bank is weakened by its participations (Boot, 1994). Moreover, the availability of detailed information about the financial situation of the firm in several departments of the bank raises the risk of insider trading of the firm's equity.

2.3 Contractual governance: inter-firm relationships

The purpose of contractual governance institutions is to enable firms to invest in bilateral relationships, which are beneficial to both parties, and thus to prevent expropriation of relationship-specific investments from one company by another company. Analogously to Figure 2, Figure 3 presents the actors, their objectives and the relevant contractual governance structures.

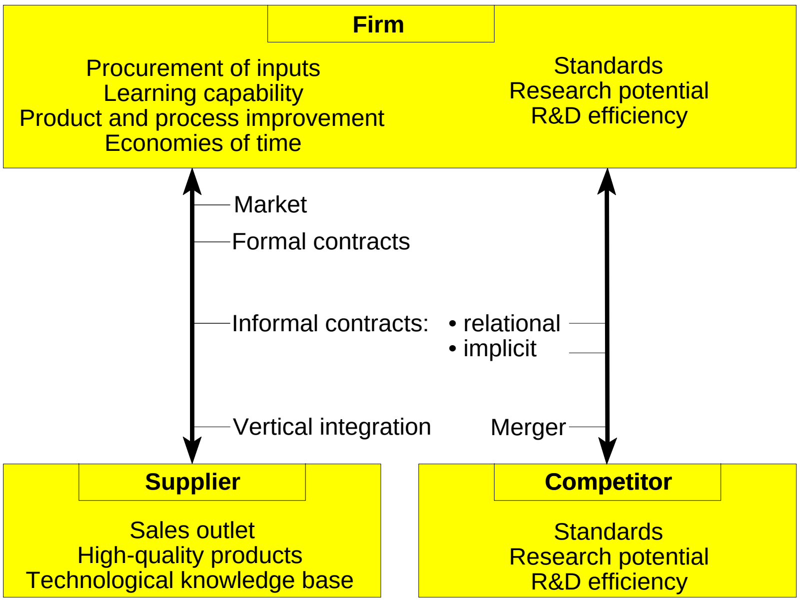
The nature of inter-firm relationships

Two main types of inter-firm relationships can be distinguished: vertical relationships between suppliers and procuring firms and horizontal relationships between product market competitors. Up-stream suppliers of intermediary goods have a market relationship to the procuring firm and from that point of view are interested in the continuation of the firm's operations to uphold their sales outlets. The market relationship raises overall efficiency of production in the supplying and procuring firms because of positive incentive effects.

This relationship can be extended substantially if a supplier and a procuring corporation enter into a consultative-cooperative arrangement (Best, 1990). In contrast to a market relationship, which concentrates on detailed specifications of standardized components and processes in the production chain, a consultative-cooperative arrangement focuses on design and interaction between suppliers and procuring firms. A procuring firm does not confront suppliers with detailed specifications of the products required and subsequently asks for tenders, but submits the functions a product should serve to a supplier together with a considerable amount of technological information on the production process in which the product of the supplier has to be incorporated. The supplier offers a prototype design and the two firms enter in several rounds of consultations until the required product has been developed.

Consultation and cooperation with a limited number of suppliers serve several purposes for the procuring firm. It enhances learning processes and improves the problem-solving capabilities of the firm by exploiting detailed technological knowledge of suppliers, which improves product quality and raises efficiency in

Figure 3 *Contractual governance: agents, goals and governance structures*



Note: boxes represent agents and their goals, arrows represent governance structures

production. Furthermore, the procuring firm in a consultative-cooperative arrangement benefits of economies of time. Suppliers who have considerable knowledge about the firm's production technology are in a strong position to optimize just-in-time deliveries, which raises productivity. A strong problem-solving capability of the related companies also decreases product development times, which is a crucial strategic factor in times of rapid technological change or fast shifts in consumer tastes.

The supplier can benefit as well from a consultative-cooperative arrangement. Since these arrangements generally are of a long-term nature, the supplier can be more confident about its future sales potential. Moreover, the supplier can improve its technological knowledge base and raise the quality of its products because it learns from the technological know-how of the procuring company and from the feedback on its prototypes and design given by the procuring company. Improving product quality not only is advantageous to the relationship with the procuring firm, but also strengthens the competitive position of the supplier on the market.

The second type of relationships between companies concerns horizontal cooperation between companies[8]. For instance, sometimes consultation and negotiation between competitors are needed to establish standards for new products. A stronger form of cooperation pertains to coordinated research activity in technology joint ventures, which enable companies to share the often large R&D costs required to design new products and to benefit from their combined research potential. Firms in technology joint ventures become highly dependent on each others' research effort and in that sense become mutual stakeholders.

Governance of inter-firm relationships

In consultative-cooperative arrangements suppliers substantially invest in relationship-specific assets and technologies which are tailored to the needs and specifications of the procuring company. By consequence, the supplier raises its stake in the relationship since termination of the arrangement will make most of the relationship-specific assets unprofitable. Not only the supplier but also the procuring firm becomes dependent on the relationship, because it transfers technological know-how about its products and its production processes to the supplier and becomes dependent on the technological capabilities of the supplier. Investing in the knowledge of the supplier is also costly and renders switching between suppliers more difficult. Moreover, in so far as technological know-how is confidential, the procuring firm has to rely on the trustworthiness of its suppliers.

Obviously, the existence of co-specialized assets in the user-supplier relationship raises the hold-up problem. In Section 2.1: 7, this case has been used as an example to explain the features of the hold-up problem. Section 2.1: 8, also shows that a possible solution to the hold-up problem is vertical integration, but that vertical integration eliminates some of the high-powered market incentives of a relationship between an procuring firm and an independent supplier. Therefore, long-term relationships between companies, supported by relational contracts or implicit contracts and partly enforced by reputation, may be a viable alternative (compare Figure 3).

An analogous argument applies to horizontal relationships between companies. The ownership solution to the hold-up problem is a merger of the two partners in the relationship, whereas governance of an R&D joint-venture or agreements on product standards by relational contracts or implicit contracts support market incentives.

[8] A third type of cooperation are long-term financing relationships between banks and non-financial companies. These type of inter-firm relationships have been discussed in the previous section.

2.4 Work governance: management and employees

Work governance structures serve a purpose both from the side of management and from the side of employees. Managers are interested in monitoring work effort and enhancing flexibility and productivity of employees. Employees monitor the way management handles their investments in relationship-specific human capital. Again the main objectives of these agents and the relevant governance structures are analyzed. The characteristics of work governance structures are depicted in Figure 4.

Objectives of employees and management

If workers perceive labour relationships as the market exchange of labour effort against wages, they will strive for high wages and low effort. From that perspective, management aims at maximum productivity of employees compared to their wage costs.

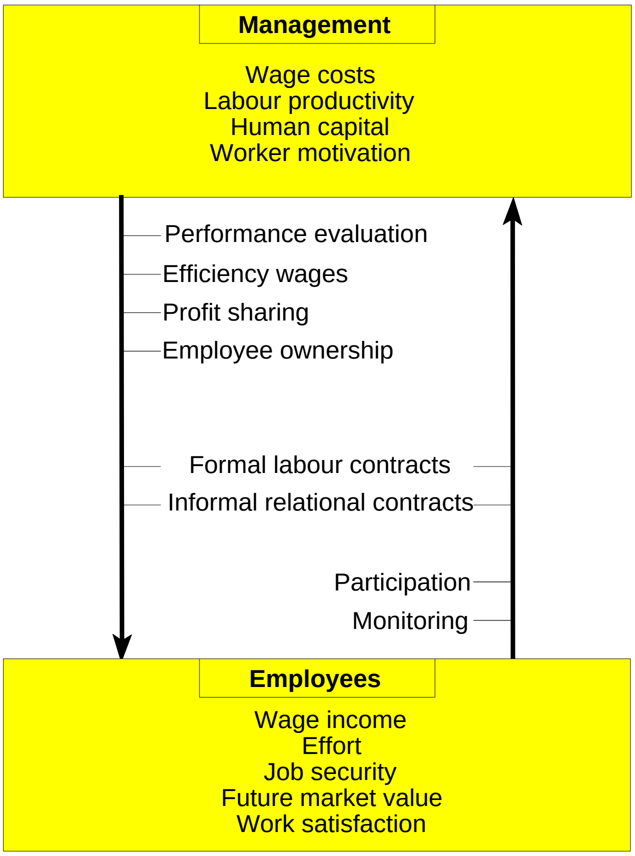
However, the labour relationship between an employee and a firm consists of more than merely a market exchange of labour effort against wages. Workers are motivated to invest in human capital so as to raise their future market value. Moreover, work experience, employee training and worker influence are valuable assets not only for a worker but also for the company. A positive impact on firm productivity arises from the ability of workers to handle more complex tasks and from shop-floor suggestions that improve production processes or product quality, which surpass the day-to-day work responsibilities as incorporated in the labour contract.

Work governance: effort

Assessing work effort of individual workers through monitoring creates a number of difficulties (Milgrom and Roberts, 1992: 403). The contributions of individual members to a team can be hard to measure. Furthermore, monitoring can be a costly activity. If performance is related to some specific measure, workers can be inclined to devote too much of their time to activities related to that measure. For instance, workers may put too heavy a weight on quantity compared to quality or devote too little time to maintenance. Performance evaluations which are not related to specific measures by definition are subjective. Managers often dislike subjective individual performance evaluations and may be reluctant to give low ratings to avoid costly disputes.

If individual performance evaluation and associated performance pay is difficult and costly, more general incentive structures are needed. Prevention of shirking behaviour of workers may induce firms to raise the level of wages above the

Figure 4 *Work governance: agents, goals and governance structures*



Note: boxes represent agents and their goals, arrows represent governance structures

market clearing level[9]. A direct way to increase worker engagement with the company is to link compensation to the performance of the company by means of profit-sharing arrangements. Theory predicts that in a single worker firm profit sharing will optimize work effort (Weitzman and Kruse, 1990; Weitzman, 1995). This effect becomes less strong in a firm which employs many workers. If part of the income of a group of workers is linked to profits, each individual worker faces

[9]This argument is based on the efficiency wage theory of Shapiro and Stiglitz (1984). The mark-up over market-clearing wages is higher the lower the level of unemployment. See also Blanchard and Fischer (1989).

the option of shirking at the expense of other members of the group. Because the contribution of each individual to the profits of the company is small, shirking becomes a relatively appealing alternative. This free-rider problem may lead to a suboptimal situation in which the work effort of all workers is low. However, a long-term relationship between workers reduces the free-rider problem. Besides the possibility of some sort of collective shirking equilibrium, mutual monitoring of workers by their colleagues can generate an equilibrium in which individual shirking is effectively countered and profit sharing raises productivity. In particular, a long-term relationship characterized by teamwork, trust and cooperation will raise the likeliness of a positive impact of profit sharing on performance of the company through increased work effort (FritzRoy, 1995).

The use of profit-sharing arrangements is limited by risk aversion of employees (Weitzman, 1995: 57). In a period of economic downturn or a drop in sales the fall in profits might generate a considerable loss of income, which can be individually and socially unacceptable. Hence the optimal profit-sharing contract consists of a mix of base wage and profit share. Empirical evidence on the effects of these types of profit-sharing contracts is diverse and mixed. Yet, on balance it shows that introduction of profit sharing raises the productivity level in a company but does not result in an increase in the rate of productivity growth (Weitzman and Kruse, 1990: 138; OECD, 1995b: 160).

A specific type of profit-sharing arrangements are employee-ownership arrangements. Because the share price of a company is influenced by its profit performance and employees who own shares receive dividends, employee ownership is related to profit-sharing arrangements. Yet the link is less close since many other factors affect share prices. Furthermore, the contributions of companies to employee-ownership arrangements need not be strictly tied to profits. Although employee ownership loosens the link between current income and profits, it generates incentives for employees, which are comparable to those of other shareholders[10].

Employee share-ownership arrangements, in particular if combined with the condition that shares can only be sold after a period of several years, may also contribute to the solution of a hold-up problem between management and employees related to investment in equipment capital (OECD, 1995b: 157). Investment in equipment raises labour productivity, which will increase future wage demands. Before management has made the investment it can negotiate a division of rents between suppliers of financial capital and employees. However, once the equipment has been installed the bargaining position of workers is stronger. Workers can demand higher wages for operating the new equipment and appropri-

[10] See the discussion in Blair (1995: 302) and the references cited there.

ate a larger part of the rent of the investment. Since management ex ante realizes this danger, it underinvests in equipment capital. Employee share ownership makes employees benefit from increased future productivity through a higher return on financial capital, which aligns their bargaining position closer to that of financiers and reduces the extent of the hold-up problem.

Work governance: human capital investments

Monitoring of managers by workers primarily pertains to the attitude of managers towards investments in human capital by workers. Investments in human capital are either of a general or a relationship-specific nature. Since workers can easily deploy investments in general human capital in other companies, they normally are willing to incur the costs of these investments themselves and expect a higher wage rate in return.

Investments in relationship-specific human capital are often co-specialized with physical capital invested by the firm. Hence, investment in relationship-specific human capital makes employees and management vulnerable to the hold-up problem (Blair, 1995: 252). Consider the case of a training of workers in firm-specific knowledge. Ex-ante bargaining between workers and management leads to an agreement in which the costs and revenues of the training are shared depending on reciprocal bargaining strengths. Workers will pay some of the costs of the investment and will receive some of the revenues in terms of wages that exceed market wages, often by means of a rising wage-tenure profile. If the bargaining strength changes after the workers have completed the training, either workers can threat to move to another firm unless they are paid more, or the firm could ex post effectively renege on the promise for higher wages[11].

Investment in relationship-specific human capital and bargaining over its costs and benefits have two main consequences. Firstly, the labour contract, which results from the bargain, has many features of a relational contract (Milgrom and Roberts, 1992: 131). It explicitly specifies a number of distinct agreements, like working hours, wage scales, etc. However, often the tasks of the employee are specified in general terms only and it is mutually understood that the employer will tell the employee what specific acts are required. More importantly, not all the costs and benefits of relationship-specific human capital investments can be explicitly included in the contract. For instance, it is not feasible to specify in all possible contingencies to what extent an individual worker shares the productivity

[11] An example is the hostile takeover activity in a number of declining industries in the 1980s. Corporate raiders are said to have reneged on implicit contracts with workers to pay high wages in return for firm-specific investments that had been made by workers (Schleifer and Summers, 1988).

gains from additional work effort or on-the-job learning activities in the form of promotion or an extra rise in pay.

A second consequence of investment in relationship-specific human capital is that bankruptcy of the firm or dismissals because of reorganizations generate a loss to employees, which consists of the expected mark-up on future wages. Hence, the return to workers on their relationship-specific investments depends on the performance of the company. In other words, employees who have invested in relationship-specific human capital have a residual claim on the company (Blair, 1995: 238). For an individual worker the residual character of this claim can be more important than the residual claim of the individual shareholder, because the worker's discounted loss of expected revenues on relationship-specific human capital might exceed the loss born by a shareholder. First of all shareholders have limited liability, which reduces their residual risks. Secondly, shareholders are able to diversify their risks by investing in a portfolio of shares. Thirdly, shareholders can easily depart from a company by selling their shares. These options are hardly available for a worker who has invested in relationship-specific human capital. The worker has all human capital invested in a single firm and looses a substantial part of her or his income if the firm is shut down. By consequence, the worker has a strong incentive to monitor the management of the company.

Worker participation in decision making is an institutional arrangement which supports investments in relationship-specific human capital by workers by providing workers with a tool to monitor management. It tackles the hold-up problem by addressing its two main consequences: the relational character of the bargain and workers' residual claim on the revenues of the company. Worker participation precludes unilateral decisions by managers to renege on implicit agreements in relational contracts, organizes the flow of information from management to workers and strengthens the bargaining position of workers. As such it provides a way to enforce implicit agreements in relational contracts and guards the way management handles workers' residual claim on the company.

In addition, worker participation in decision making can improve managerial productivity because it restricts managerial opportunism. Smith (1991), in a transaction cost analysis of co-determination arrangements, mentions curbing of opportunistic behaviour like: arrogating innovative ideas of employees, emphasizing short-term results as a productivity signal to enhance managers' upward career mobility, hoarding and misuse of information, and authoritarianism. Productivity increases because the quality of decision making rises due to the fact that managers constantly have to motivate their decisions, because managers plan and organize more effectively, and because information flows between management and workers improve (Streeck, 1984).

The efficacy of work governance institutions rises if they are combined. Levine and Tyson (1990) conclude that four institutional arrangements enhance the effectiveness of worker participation, *viz.* profit sharing, long-term job security, group cohesiveness, and guaranteed employee rights. Profit sharing and worker participation interact in two directions. On the one hand profit sharing rewards employees for their effort in participation, on the other hand participation provides an opportunity to monitor management decisions which affect the part of income of employees obtained from profit-sharing arrangements. Together with worker participation, long-term job security strengthens incentives for workers to invest in relationship-specific human capital, because it raises the probability that employees actually obtain future revenues from human capital investments. Group cohesiveness manifests itself in small pay and status differentials between employees, which supports trust and confidence between workers and managers and spurs effective participation. Guaranteed individual employee rights strengthen the effects of co-determination because they prevent that employees are dismissed at will and reduce the risk of reprisals from management on employee opinions that counter the views of management. In particular, a legal obligation on universally guaranteed individual employee rights increases the efficacy of worker participation. If, in the absence of collective dismissal protection, a single firm applies a policy of justifying each dismissal, it might attract a relatively large proportion of shirking-prone workers. The firm can only prevent such a process of adverse selection by a high-cost screening policy. Legal employee rights prevent this process of adverse selection.

2.5 The Anglo-American and German models

The previous sections presented the main concepts used to analyze corporate governance, contractual governance and work governance relationships, respectively. The various agents, their goals and the governance structures between the agents came to the fore. This section takes a first step towards the analysis of stakeholder relationships from a national perspective by addressing the characteristics of main types of national models of stakeholder relationships using the framework presented in the previous sections. Three main categories of models of stakeholder relationships can be distinguished, the Anglo-American model, the German model[12] and the Latinist model[13] (De Jong, 1991; Bishop, 1994; Moerland,

[12] On its main characteristics the Japanese model resembles the German model of stakeholder relations, although specific institutions can differ considerably between Japan and Germany. In this section occasionally a few institutional properties of the Japanese model are mentioned, if a broader view on possible governance institutions is needed.

1995; Nickell, 1995). Stylized versions of the Anglo-American and German models are used here to set the stage for a more detailed analysis of the German and Dutch national characteristics in Sections 3 and 4 of the paper.

In this section the emphasis is on the distinctive characteristics of the two models. To a certain degree, this implies abstracting from real-world realities. Not all US or UK enterprises are organized according to the Anglo-American model. In Germany some companies may be more close to the German model than others. However, analyzing the two archetype models makes it easier to link theories on stakeholder relationships to institutions and to assess their impact on enterprise performance. Table 1 summarizes the main features of the models.

The Anglo-American model

Market control and competition characterize the Anglo-American model. In the United States and the United Kingdom the Chief Executive Officer (CEO) runs the company as highest manager in charge. Shareholders have the right to elect the board of directors. Main functions of the board are to select, evaluate and dismiss the CEO and senior executives, to review financial objectives and strategies of the company, and to counsel top management (Monks and Minow, 1995: 183).

Governance of managers by shareholders is a central characteristic of the Anglo-American model of *corporate governance*, which has been referred to as the model of ‘shareholder democracy’ or ‘corporate democracy’ (Blair, 1995; 68). However, possibilities for direct influence are limited. Opportunities for individual shareholders to influence management by voice through active participation at the general meeting are small and relatively costly in large publicly traded corporations with a highly dispersed stock of shares (Blair, 1995: 76). Furthermore, the task of the board of directors as a monitor on behalf of shareholders is limited because strong linkages exist between board and management, either because the CEO is also chairman of the board or because a considerable number of board member are company managers. In 76% of the largest companies in the United States and one third of the largest companies in the United Kingdom the CEO holds the influential position of chairman of the board of directors (Monks and Minow, 1995: 189). The board generally consists of a number of executive directors, who are employed by the company, and a number of independent non-executive directors. In the United States the number of insiders is relatively small and declining, currently executive

[13] Characteristics of the Latinist model of stakeholder relationships are widespread family control, state ownership of corporations, large stocks of shares owned by financial holdings, weak disclosure regulation and government interference with mergers and acquisitions. To simplify the discussion, the Latinist model is not taken into consideration any further.

Table 1 Characteristics of two stylized models of stakeholder relationships

	Anglo-American model	*German model*
General characteristics	*market orientation, short-term relationships, competition*	*inside orientation, long-term relationships, cooperation*
Corporate governance		
Important shareholders	*individuals*	*non-financial enterprises, banks*
Shareholder control	*exit, replacement (takeover)*	*voice, long-term relationships*
Managerial share-ownership	*significant for listed companies*	*not significant, except for firms majority owned by individuals*
Creditor control	*(threat of) loan withdrawal*	*share-ownership, monitoring*
Regulation	*supports stock market*	*obstacles to equity finance*
	prohibits bank share-ownership, restricts cross holding of shares	*bank share-ownership allowed, intercorporate shareholding allowed*
Contractual governance		
Relationships	*market, vertical integration*	*networks*
Contracts	*formal*	*relational*
Contract enforcement	*court*	*personal reputation*
Work governance		
Labour market	*competitive*	*sizable protection*
Contracts	*formal*	*relational*
Work incentives	*wages, profit sharing*	*wages, job security*
Monitoring management	*low*	*co-determination*

directors occupy 25% of the seats of boards of directors (Monks and Minow, 1995: 203). In contrast, in the United Kingdom a substantial percentage, 58%, of the members of the board are executives and accordingly part of the company's management (Monks and Minow, 1995: 303).

Because of the limited opportunities for shareholders to influence management directly or through the board of directors, changes in share prices and takeover threats are the main instruments to discipline management. Shareholders use their exit options if they do not agree with management strategies or if they are disappointed by the performance of the company. Falling share prices signal the necessity for managers to improve firm performance. Hostile takeover bids are the ultimate means to replace managers. Protective measures against hostile bids are relatively difficult to implement, for instance the repurchase of shares by management is tightly regulated and shares with limited voting rights are less common.

Management stock ownership is a significant element of the Anglo-American model of corporate governance. In particular in the United States the recent decade has been characterized by increasing use of stock option compensation (Blair, 1995: 92). In the United States management ownership of shares in the firms they manage exceeds that in other countries (Prowse, 1994: 45). In the United Kingdom management ownership of shares is also considerable (OECD, 1995b: 149). Evidence from an international comparison of managerial compensation among twelve countries shows that remuneration in the United States is highest and relatively strongly related to performance indicators[14].

The regulatory framework in the Anglo-American countries supports the dominant position of shareholders in corporate governance (Prowse, 1994: 15-29). For companies hardly any legal restriction exists on access to securities markets, which encourages equity finance. Moreover, legislation dictates extensive disclosure of accounting information to shareholders and puts large fines on the use of insider information in stock market transactions. Legislation also prevents the formation of concentrated shareholdings, which would reduce the efficacy of the stock market. In particular in the United States regulations significantly constrain financial institutions from holding large blocks of shares. Banks face the strongest restrictions, because by the Glass-Steagall Act of 1933 banks are prohibited to own any shares on their own account (see also OECD 1995c: 75). Antitrust law is hostile to cross holdings of shares between large companies, dividend tax rules discourage these holdings, and securities laws contain a number of regulations which restrict investors with concentrated share holdings from active involvement in firm policies.

The market-oriented character of the Anglo-American model is also manifest in *contractual governance* institutions which pertain to relationships between companies. The United States model of contractual governance is characterized by relatively extensive vertical integration and formal contracts which can be enforced by law. For instance, in the United States automobile industry complex components and subassemblies are produced by the main automobile manufactures themselves. A large number of suppliers produce parts on a short-term, arm's-length contracting basis. Contracts specify in detail the price, quantity and quality of the products purchased and the responsibilities of the contract partners (Milgrom and Roberts, 1992: 131; Kester, 1992: 28).

The United States model is often contrasted as being radically different from the Japanese contractual governance institutions. Contracts in Japanese *keiretsu* are highly informal, implicit and long-term. The number of suppliers is smaller than in the United States, but supplier-user relationships are of a long-term character and

[14] See the results from Abowd and Bognanno (1993), cited in OECD (1995a: 107).

pertain to relatively complex components with a high content of technological knowledge and design by suppliers. Yet, in particular with respect to contractual governance the stylized representation of the national models should be stressed. During the 1980s and the 1990s many companies in the United States reorganized their supplier relationships and adopted many features of the Japanese model (McMillan, 1995: 203, 204, 215).

Work governance institutions deal in different ways with the relational character of labour contracts and the existence of residual claims of workers on the company. In the archetype Anglo-American model of work governance, workers are promised a fixed return on their investment in human capital through wages that exceed market wage levels. Shareholders have all control rights (Blair, 1995: 269). Labour contracts are relatively extended and detailed in the United States (Hashimoto, 1990). The use of profit sharing and employee share-ownership arrangements have increased in the recent decade.

In the Anglo-American model workers bear the risk of the loss of human capital in the long run. If the performance of the firm weakens and share prices fall, managers have an incentive cut costs and lay off employees. Employees have little formal means to counter the tendency for dismissal and to monitor the way management handles their relationship-specific human capital. In the Anglo-American model worker participation institutions are absent (Hepple, 1993; Biagi, 1993). Moreover, long-term job security is low and strong labour market competition affects group cohesiveness in a negative way. Strong protection of employee rights is lacking (Den Broeder, 1995). Hence, not only worker participation institutions are missing in the Anglo-American model of work governance, but also institutions that would enhance the positive effects of worker participation are largely absent.

The German model

The German model can be characterized by cooperation and long-term relationships between stakeholders in the firm. According to Schneider-Lenné (1992) interest in the firm as a whole is a key concept of the German corporate culture. Charkham (1994: 10) alludes to the values of cooperation and consensus as the cornerstones of the German model of corporate governance.

The German model is based on a two-tier principle by distinguishing a management board (Vorstand) and a supervisory board (Aufsichtsrat). Both shareholders and employees are represented on the supervisory board.

The stock market plays a relatively unimportant role in the German model of *corporate governance*. The number of listed firms in Germany is about one third of the number of firms listed in the United Kingdom and stock market capitalization in Germany is low (for more details see Table 6 in Section 3.1). Banks, other financial enterprises and non-financial companies own large blocks of shares of companies listed at the stock exchange. Shareholdings are concentrated and block shareholders monitor firms through their representation on supervisory boards. Cross holdings of shares, bank control of voting rights at general meetings and regulations with respect to the number of votes required to replace management at general meetings, make the market for corporate control virtually non-existent in Germany. Instead, representatives of the relatively small group of shareholders who own large equity stocks influence management by voice, to a considerable extent through informal procedures and informal meetings.

An important aspect of the German model is that creditors, in particular banks, have a prominent role in corporate governance. German universal banks both grant loans to a firm and own part of its equity. As a ratio to total assets gross debt of non-financial enterprises is not extremely high compared to other countries. However, in Germany debt mostly consists of bank finance, and in contrast to the United States and the United Kingdom securitised debt is hardly used (OECD, 1995a: 92; Prowse, 1994: 31). Moreover, some evidence can be found that concentration of debt claims is higher in Germany compared to the United States and the United Kingdom (Prowse, 1994: 39).

Germany contains a considerable number of firms where a majority of the stock of equity is owned by one or a few individuals (Prowse, 1994: 45). This can be explained by the fact that in the 1980s and early 1990s a number of family-owned companies went public, while the founder or the founding family kept a majority holding of shares in these companies. For these companies stock ownership by managers is substantial. Corporate governance institutions are not needed because the interest of shareholders and managers is embodied in the same persons. However, in firms not majority owned by individuals, management ownership of shares is low. Moreover, compared to the United States and the United Kingdom management compensation is more concentrated on basic remuneration (OECD, 1995a: 107). Hence, in particular for large listed companies management stock ownership is not a substantial element in the German model of corporate governance.

While in the United States regulation restricts creditors from holding blocks of shares and being active investors, German laws do not impose such constraints. In particular the large universal banks are almost completely free to own equity, although specialized banks face more restrictive regulation. Germany is characterized by strong anti-cartel legislation, but in contrast to the United States competition policy has not been used to discourage intercorporate shareholdings. However, German legislation did contain and to some extent still contains a number of obstacles which restrict access to non-bank sources of finance for enterprises. Until their removal at the end of 1991 authorization requirements on issuance of shares and taxation of securities raised the costs of equity compared to debt financing

(Prowse, 1994: 27). Disclosure requirements are less strict and legal requirements make accounting information more relevant to tax policy than to the purpose of obtaining a proper insight in the equity value of a company. Legislation prohibiting insider trading has only recently been established. Finally, according to some authors (Borio, 1990, Prowse, 1994), legal requirements on employee representation on the supervisory board strongly discriminate against the organisational form of public companies, because management opposes worker influence on decision making and fears the risk of loss of confidential information[15]. These objections put up a barrier to equity financing in Germany.

As to *contractual governance*, relationships in German industrial groups are in between those in the United States and Japan[16]. Compared to Japan they are based more heavily on formal contracts, compared to the United States they are much less formal. Hence, where Anglo-American contractual governance institutions can be characterized as being largely based on formal contracts and Japanese institutions as being based on implicit contracts, German contractual governance is characterized by relational contracts (compare Figure 3 and the definitions of types of contracts in Section 2.1: 6).

In Germany personal reputation forms an important element of contractual governance in industrial groups. The group of people who have a seat on the supervisory boards of German firms is relatively small and partly consists of members of the management board of other companies. This network can be effective to disseminate information and impair a reputation in case of opportunistic behaviour (Kester, 1992: 31). Besides personal reputation, cross holdings of large blocks of equity in German industrial groups are instruments to substantiate long-term relationships between companies since they provide means to monitor actions by associated enterprises, which makes it difficult to renege on relational contracts. Cross holdings of shares also foster long-term relationships by preventing hostile takeovers. By consequence, the composition of management teams is relatively stable through time and disruptions in trust relationships among management teams of different companies are less likely, since there need not be any suspicion that a current partner in secret aims at a takeover.

The German model of *work governance* regards employees as one group of stakeholders in the firm. Co-determination is an essential characteristic of the

[15] For more information see the subsection on the performance of the supervisory board in Section 3.1: 59, and Box 2 on the 1994 German Law on Small Public Companies and Deregulation of Equity Legislation, which aims at increasing stock market access for small and medium-sized companies.

[16] For a description of the main characteristics of the Japanese model of contractual governance see the subsection on the Anglo-American model above.

model. In limited liability companies employee representatives hold one third or one half of the seats of the supervisory board. The other seats are held by shareholder representatives. Thus, employee representatives are in a position to monitor management. Another way to monitor management, which is also viable for unlimited liability companies without supervisory boards, is through works councils, which have to be consulted on important decisions concerning the corporation. Monitoring through co-determination supports labour contracts with a larger number of informal elements compared to the United States. Hence, analogously to contractual governance institutions, German labour contracts can be characterized as being relational contracts. In particular long-term job security and institutions concerning protection of employee rights[17] enhance effectiveness of worker participation through co-determination in Germany[18].

2.6 Assessment: strengths and weaknesses of models

After reviewing the main features of the Anglo-American and German models of stakeholder relationships in the previous section, this section concentrates on an assessment of the strengths and weaknesses of the two stylized models. Two main assessment criteria are short-term flexibility and long-term orientation. The former pertains to the adjustment of factors of production and technology to changing circumstances. The latter manifests itself in investment in financial, physical and human capital and firm-specific technologies. The discussion is organized along the three categories of stakeholder relationships distinguished above: corporate governance, contractual governance and work governance. Table 2 summarizes the main findings.

Corporate governance

It has already been noticed in Section 2.2: 18 that in a system characterized by long-term relationships between banks and companies unprofitable investment projects may not be terminated quickly enough. Moreover the disposition towards long-term relationships in the German model of corporate governance implies that financial capital is retained in specific projects for a longer period of time. By consequence, capital reallocation in the German model is less flexible compared to

[17] See Den Broeder (1995) for a detailed analysis of labour market regulation in Germany and The Netherlands. In this paper the United States is frequently used as a reference case.

[18] See the end of Section 2.4: 26, for a description of the mechanisms through which various institutions enhance the effectiveness of worker participation.

the Anglo-American model (OECD, 1995c: 82). Therefore, the market-based Anglo-American model performs better in moving capital out of declining sectors into promising new sectors.

With respect to the Anglo-American model the effectiveness of the market for corporate control as a disciplining device for management by shareholders is often questioned. Firstly, empirical evidence indicates that in particular shareholders of target firms gain from hostile takeovers and that gains to bidding managers are less certain, which would reduce incentives to apply takeovers as an disciplining instrument. Nickell (1995) cites evidence that rewards to bidding managers are substantial only if the total gains of the takeover are at least 30% of the value of the target firm. Hence, mismanagement which hampers the value of the firm by less is not disciplined by the takeover instrument. Franks and Mayer (1996) empirically investigate the performance of target companies in hostile takeovers. Three out of four empirical measures indicate that the pre-bid performance of target companies does not differ significantly from companies engaged in friendly acquisitions or from companies not engaged in mergers. Therefore, Franks and Mayer (1996) conclude that on the basis of their empirical evidence the market for corporate control does not function as disciplinary device.

Secondly, Pound (1995) emphasises the fact that corporate failure frequently is not caused by managerial incompetence or abuse of power but by failures of judgement, stemming from general characteristics of human decision making and the way organisations operate. The market for corporate control might be effective in curbing outright abuses but does not assure effective decision making. The real challenge is to devise a system that reduces the probability of well-intended but flawed managerial strategic decisions. Hence, it is more effective to improve the quality of the board, to shift the focus of the board away from ex-post evaluation towards ex-ante review of major decisions and strategies and to encourage investors relations among companies.

Thirdly, the takeover mechanism is also less effective in a period of economic downturn when funds to finance the takeover are difficult to obtain and by consequence the threat of a hostile takeover may not be credible (Prowse, 1994: 65). Fourthly, besides being only partly effective, hostile takeovers are a costly instrument both in terms of direct costs to launch the takeover and in terms of indirect cost inflicted upon the target company in the form of distraction from normal management tasks and of turmoil among employees (Jenkinson and Mayer, 1992).

Concerning the disciplining effects of using exit options on the stock market, according to Nickell (1995: 32) some empirical evidence indicates that management pays too much attention to the short-term in a system with a well-developed stock market. In particular short-term behaviour can occur if managers face pressure to put a relatively high weight on the current share price by fund-man-

Table 2 *Strengths and weaknesses of two stylized models of stakeholder relationships*

	Anglo-American model	*German model*
Corporate governance		
Resource reallocation	*quick*	*slow*
Monitoring management	*takeovers partly effective, short sightedness*	*concentrated holdings effective, long-term view*
Technical progress in	*start-up firms*	*mature established firms*
Managerial share-ownership	*not very effective*	*not significant*
Contractual governance		
Marketable technologies	*strong*	*weak*
− market incentives	*high*	*low*
− flexibility	*high*	*low*
Relationship-specific technologies	*weak*	*strong*
− cooperation	*weak*	*strong*
− market incentives	*absent (vertical integration)*	*present*
− flexibility	*low (contract renegotiation)*	*high*
− information flows	*intermediate*	*high*
Work governance		
Work incentives	*high*	*moderate*
Labour reallocation	*fast*	*slow*
Incentives to invest in human capital	*weak*	*strong*
− enforce relational contract	*no formal means*	*through co-determination*
− monitor management	*no formal means*	*through co-determination*
− employment stability	*low*	*high*
Information flows between workers and management	*no formal means*	*through co-determination*
Short-term flexibility	*high*	*reduced*
− procedures	*short*	*prolonged*
− conflicts	*solved by market power*	*may result in deadlock*

agers of institutional investors who themselves are judged on short-term performance. Porter (1992) and Blair (1995: 136) reject the argument based on pressure from short-term oriented fund-managers as theoretically hard to defend and as not being corroborated by the empirical evidence. They emphasise the high liquidity of the Anglo-American capital market in general as a reason for low monitoring activities and low commitment of shareholders to the relationship with managers (see also OECD, 1995c: 83). Instead of supporting managers who encounter problems and may need more time, shareholders abandon the firm by selling their shares. Furthermore, investors in liquid capital markets do not efficiently use all available information on the strengths and weaknesses of corporate investment projects. They only act on summary information like dividend pay-out ratios or leverage, but do not take into account the likelihood that strategic investment by firms strengthens the market position of the firm in the long run or opens up new business opportunities.

It should be emphasized that these arguments favouring a short-term orientation of shareholders also imply a certain degree of stock market inefficiency (Nickell, 1995: 23). Investors who take all information into account could make a profit by buying shares of firms which future potential is undervalued by the stock market.

The institutional characteristics of the German model of corporate governance promote a long-term orientation. First of all, the stock market plays a less important role in Germany. Secondly, because of the institutional characteristics mentioned in Section 2.5 hostile takeovers hardly exist. Thirdly, cross holdings of shares and long-term relationships between shareholders and firms provide a way to monitor management and to obtain information on the long-term potential of investment projects. Hence, on the one hand the relationship with shareholders encourages German managers from listed companies to pursue long-term strategies and make relationship-specific long-term investments in R&D and equipment which can improve the performance of the German enterprise sector. On the other hand, the relatively modest importance of the stock market reduces the capacity for risk-taking by German enterprises through attracting equity finance (OECD, 1995a). Moreover, under the German model investment is low in assets for innovation that can be traded on the market, like consulting services, research contracts etc (OECD, 1995c). Compared to the market-based Anglo-American model which favours marketable assets for innovation, this reduces flexibility in directing technological knowledge to new opportunities or shifting consumer preferences.

Edwards and Fischer (1994) conclude that the existence of economies of scale and scope in monitoring by German banks is not supported by available evidence. Concentration of bank representation on supervisory boards is relatively high while concentration in bank lending to firms is hardly significant because the market for bank loans is highly competitive. Representation on supervisory boards does not increase the amount of information which can be used for lending decisions nor does it speed up detection of financial problems or does it reduce the costs of financial distress or bankruptcy. Hence, it cannot be concluded that the German model reduces the cost of capital for German enterprises compared to other countries (see also OECD, 1995a: 101). Moreover, lower managerial empire building activity under the German system does not so much depend on the concentration of the two types of financing in the hands of banks, but on the concentration of share ownership as such, since concentrated holdings motivate shareholders to monitor management (see also Baums, 1994; Prowse, 1994). The empirical results of Gorton and Schmid (1996) corroborate that conclusion. In a 1985 cross section of 57 of the 100 largest German manufacturing companies, firm performance is related to block holdings of all majority shareholders combined, *i.e.* both non-financial enterprises and banks. Neither shareholdings by banks, nor the extent of proxy votes exercised by banks exert a separate influence on performance[19].

Monitoring of management by owners of considerable blocks of shares, consisting of both banks and non-financial enterprises, solves the short-term problems associated with the Anglo-American model of corporate governance. This feature is especially relevant for firms in well-established industries with incremental technological change, consisting of technological innovations that are incorporated in existing production processes. In these companies the risk profile of new investment projects can be assessed relatively easy, consensus exists as to the appropriate way to run the firm and good governance can assure successful outcomes of investment projects. Risks incorporated in these projects are such that firms or banks are willing to put their reputations at stake by providing equity finance to the firm (Jenkinson and Mayer, 1992). Moreover these firms frequently own collateral, which can be used to reduce risks of bank loans. Firms and banks are less willing to provide substantial equity or debt finance for projects of which outcomes are highly uncertain and which therefore carry high risks. Also the house bank relationship offers no solution in this case. To the house bank the opportunity of future lending possibilities at a somewhat higher rate of interest may partly offset the initial default risk (OECD, 1995a: 103). However, at an initial lending arrangement the bank cannot be sure that if the firm is successful it will not renege on its implicit contract with the bank and turn to other financiers for cheaper sources of finance.

For innovative start-up firms with new technologies the risk sharing features of stock market finance are well suited, which provides the Anglo-American model with an advantage above the German model[20]. Yafeh and Yosha (1995: 22)

[19] These results differ from a 1974 sample in which Gorton and Schmid (1996) find bank equity holdings to positively affect performance, but in which they do not find a separate influence of total block holdings or proxy voting. The authors relate the shift between 1974 and 1985 to disintermediation, falling bank equity ownership and increased competition between banks.

[20] Allen (1993) states that the process of debate and exchange of information among a large group of stock market investors leads to efficient dissemination of information, implies a checking mechanism on the actions of managers and results in the emergence of consensus

provide evidence that innovative Japanese pharmaceutical firms tend to rely much less on long-term bank and group finance compared to the average chemical firm, but instead opt for arm's length financing.

Besides stock market finance of innovative new-technology firms, venture capital investment firms in the United States are successful in providing funds to these companies (Blair, 1995: 278)[21]. By investing in a substantial number of high-risk companies at a time, venture capital investment firms both spread risks effectively and are able to closely monitor the management of these companies. In that way they combine the strong points of risk sharing associated with equity finance and the longer-term commitment of financiers to the firm. Both the stock market and the venture capital market in Germany are relatively less developed (OECD, 1995a: 103). Therefore start-up firms often have to turn to debt finance by banks, which risk-averse characteristics and unfamiliarity with new technologies pose a hindrance to the emergence of innovative new-technology firms in Germany.

A number of arguments exist why the corporate governance instrument of managerial stock options, which are used to a significant extent in the United States, is not very effective to discipline management. Frequently stock options do not result in permanent share ownership because managers cash their options at the moment the option expires. This can partly be explained by risk considerations. Managers already depend on the firm for their basic wage income and from a risk perspective it may be wise to allocate their savings and their non-wage income to other sources. To improve its efficacy, the exercise date of stock options can be deferred several years, so that during that period income of managers remains contingent on the performance of the company. Another reason why a strong impact of stock options on managerial behaviour can be disputed, is that the effect of a change in the value of equity that results from expenditure on private aims, on the compensation of managers is generally small. In such a case the personal cost for a manager to engage in empire building activities is small as well (Prowse,

strategies and risk reduction. In these highly uncertain cases monitoring by a limited number of relatively uninformed outsiders, such as bank managers, who lack substantial knowledge of technologies applied by the firm and primarily look at financial indicators, may not be adequate. See also Allen and Gale (1995: 205). However, Bhattacharya (1993) raises a number of critical comments on the theoretical and empirical cogency of this line of reasoning.

[21] OECD (1995c: 82) mentions several other characteristics of the United States 'innovation model' which encourage that exploitation of technological opportunities takes place in start-up firms. Examples are anti-cartel policy which encourages diversification and mobility of scientific staff.

1994: 45; Hart, 1995: 128). Finally, abuses, like re-issuing of stock options when the stock price falls below the option price, also make stock options a less appealing disciplining instrument for shareholders (Monks and Minow, 1995: 243). Tax advantages may be an important reason why executives favour stock ownership plans (Blinder, 1990: 7).

The discussion above indicates that none of the two models of corporate governance performs best in all respects. Risk sharing through the stock market and management monitoring and support by investment capital firms create financing opportunities for innovative start-up firms in the United States that do not exist to such an extent in Germany. When companies mature, the efficacy of the Anglo-American model is reduced compared to that of the German model (Jenkinson and Mayer, 1992). Hostile takeovers are a costly and blunt instrument to discipline management. The high liquidity of the stock market is a reason for low monitoring activity by shareholders and low commitment of shareholders to specific firms. In the German model stable patterns of cross holdings of blocks of shares by both non-financial enterprises and banks motivate monitoring of management and encourage long-term relationships between shareholders and management.

Available evidence does not indicate that German banks obtain considerable economies of scale and scope from their combination of equity and debt finance. Moreover, restricting managerial empire building activity under the German system does not so much depend on the concentration of debt and equity financing in the hands of banks but on the concentration of share ownership as such.

Contractual governance

The Anglo-American model of contractual governance is characterized by market procurement and relatively extensive vertical integration, while the German model is characterized by long-term relationships between companies. To compare these two models it is necessary to differentiate between marketable technologies and more complex relationship-specific technologies (compare Table 2). Because it is strongly market oriented, the Anglo-American model performs well for marketable technologies. By definition, with marketable technologies market incentives and external flexibility to adapt to changing circumstances are high. A disadvantage of the German model is that sometimes long-term relationships between companies take precedence over market opportunities (McMillan, 1995: 231). A supplier may have to forgo profitable market demand to meet demand by a procuring firm with which it maintains a long-term relationship. From the point of view of the procuring firm strong competitiveness between suppliers can be cost-effective if supply characteristics do not require large investment in relationship-specific technologies.

Hence, for marketable technologies gains from a long-term relationship are small and a model based on arm's-length contracting is more efficient.

In the field of relationship-specific technologies the German model of contractual governance is stronger. An important reason for the efficacy of the German system is the combination of cooperation between enterprises and high-powered market incentives. Product market competition between domestic industrial groups and foreign competitors is a paramount incentive which prevents cooperative shirking of enterprises that are part of industrial groups. Moreover, market competition within industrial groups has not been eliminated completely because individual companies have not merged or have not completely been taken over. Hence, a strong incentive remains for firms to stay competitive and innovative. Yet a complete market-based interaction between firms would make the hold-up problem to emerge. Supplementation of market incentives by institutions which support relational contracts and implicit contracts, facilitates the existence of long-term relationships and investment in relationship-specific assets. By contrast, in practice large enterprises can be observed to posses some monopsony power vis-à-vis their suppliers, since they sometimes impose substantial price cuts or efficiency improvements on supplier firms (Milgrom and Roberts, 1992: 568, note 14).

Another advantage of solving the hold-up problem by an informal long-term contract is its internal flexibility to quickly adapt to changing circumstances (Kester, 1992: 28). If complex relationship-specific technologies were governed by formal contracts, changes in the external environment would necessitate a complex and expensive renegotiation of the terms of contract. In extreme cases contract revision might only be feasible through very costly lawsuits.

Moreover, informal contracts based on reputation reward innovative behaviour. High-quality products and innovations strengthen a supplier's reputation, which forms a recommendation to other procuring firms (MacLeod, 1995: 21). By consequence, to a large extent the German model is able to exploit innovative and learning capabilities of both the supplier and the procuring firm.

Finally, long-term relationships facilitate the flow of information between the supplier and the procuring firm (McMillan, 1995). In so far as supplier chains have been integrated vertically an efficient flow of information also exists under the Anglo-American model of contractual governance. However, exchange of information is low for those parts of supplier relationships governed by formal contracts on the market.

Work governance

The highly competitive labour market and the relatively extensive use of profit-sharing arrangements in the Anglo-American model of work governance are instruments to raise worker productivity and work effort. These instruments are less developed under the German model, in particular because less use is made of incentive pay.

In the Anglo-American model shareholder pressure to cut costs and lay-off employees in times of weak performance of the firm can be a flexible way to move capital and labour out of declining industries. However, in periods of a temporary drop in activity the pressure for downsizing can destroy relationship-specific human capital. Since employees have no formal means to counter the tendency for downsizing, these features of the Anglo-American model generate a disincentive to invest in relationship-specific human capital. In contrast, German co-determination institutions do provide a way to enforce implicit agreements in relational contracts and to supervise the performance of the firm from the perspective of the residual claims of the employees. Hence the German model of work governance can increase incentives for workers to invest in relationship-specific human capital by restricting managerial opportunism (see also Allen and Gale, 1995: 203).

As the primary objective of worker representatives is to protect the position of workers within the firm (Koene and Slomp, 1991), it is expected that co-determination slackens the adaptation of the employment level to economic conditions. Empirical research (Abraham and Houseman, 1993) confirms that the employment level is relatively stable in Germany, for example compared to the situation in the United States[22]. According to Smith (1994: 308) employment stability is even the main effect of a strong works council. Compared to the US model of work governance higher employment stability is a disadvantage if labour and capital have to move from declining industries to new industries. A positive feature of employment stability is that it strengthens long-term relationships between firms and employees. Long-term relationships are an additional mechanism to enforce relational contracts and to solve the hold-up problem through reputation.

Co-determination stimulates investment in human capital and improves firm performance in the long run. Two further aspects can enhance the positive impacts of co-determination arrangements on performance (Levine and Tyson, 1990; Nickell, 1995: 98). Firstly, co-determination may improve the flow of information and knowledge in a company. It provides an option for management to learn from

[22] It is likely that not only co-determination arrangements but also other types of regulation such as strict firing rules reduce the responsiveness of employment to output fluctuations.

insights of workers and receive valuable suggestions for improvements from workers who are close to the actual production process. Secondly, work effort and productivity may increase because worker participation aligns the goals of workers more strongly with the goals of the firm. Workers can be more committed to the goals of the company and work morale, job satisfaction and trust in management can increase.

Governance of stakeholder relationships concerns the balancing of power of different parties. If too much weight is put on co-determination institutions, they may exert negative effects on firm performance. Strengthening the position of employees through co-determination underscores the need of monitoring worker performance. Reducing managerial discretion can increase opportunism by workers. By consequence work governance institutions in a human-capital intensive firm have to foster mutual monitoring and enhance long-term relationships between management and employees. Moreover, co-determination arrangements may entail a loss of short-term flexibility because relatively lengthy procedures have to be followed before a decision can be taken. Finally, in extreme situations co-determination may have negative consequences if a stalemate results from conflicts between management and works councils or between workers representatives in supervisory boards and shareholder representatives.

2.7 Stakeholder relationships and the stylized models in perspective

In sum, sections 2.1 − 2.6 above contain an analysis of the importance of a nation's institutions regarding the extent to which stakeholders invest in relationship-specific assets; a description of three different types of governance structures; a presentation of the stylized Anglo-American and German model; followed by an assessment of the strengths and weaknesses of the two models[23]. This section completes the analytical framework by, firstly, taking a short overall view of the main results and, secondly, focusing on the use of this framework for the comparison between Germany and The Netherlands in Sections 3 and 4.

The description of the two stylized models of stakeholder relationships shows that the Anglo-American model has many characteristics of a 'shareholder society', whereas the German model corresponds with a 'stakeholder society'. The above analysis argues that these features largely follow from differences in national institutions, which affect the governance of relationship-specific investments, and

[23] A summary overview of types of stakeholder relationships can be obtained from Figure 1. Figure 2, Figure 3 and Figure 4 summarize the main characteristics of corporate governance, contractual governance and work governance respectively. The main features of two stylized models of stakeholder relationships can be found in Table 1, while Table 2 summarizes the strengths and weaknesses of these two models.

not from major differences in managerial objectives. Institutions associated with the German model to a larger extent support the commitment of managers and other stakeholders to invest in relationship-specific assets compared to institutions in the Anglo-American model. Hence, under the German model's institutions it is rational for managers to take the interests of stakeholders into account and to invest in long-term relationships.

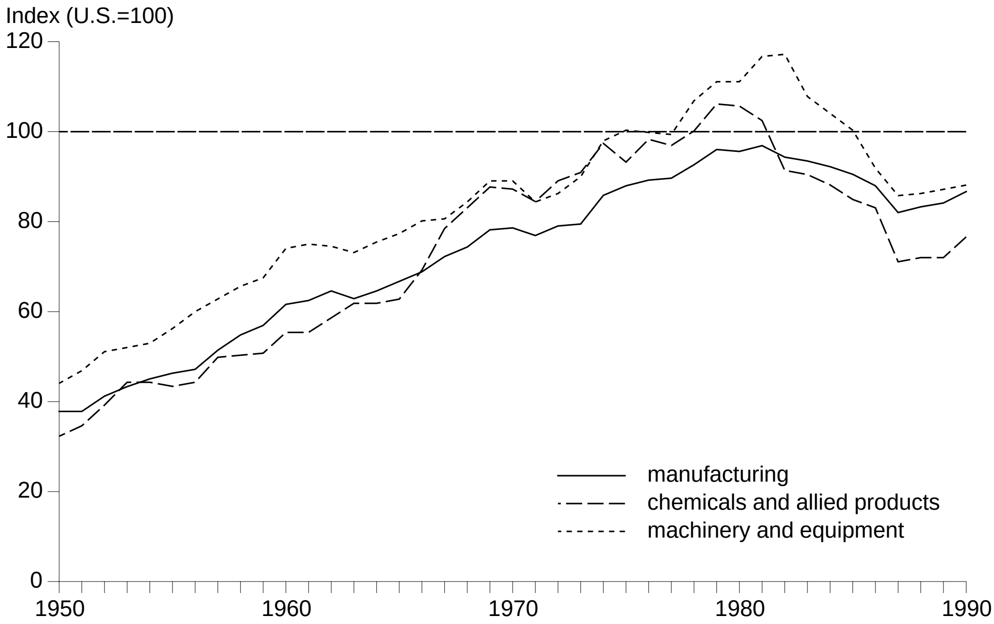
The assessment of the two models in Section 2.6 (summarized in Table 2) presents a mixed picture. Strong elements of the Anglo-American model, characterized by market orientation and competition, are fast reallocation of financial, physical and human capital, short-run flexibility and a focus on innovative emerging technologies in particular in start-up firms. The German model, characterized by long-term relationships and cooperation, is strong on the development of a long-term view, investment in relationship-specific physical and human capital, cooperation between companies, and promotes technological progress in established enterprises. It also turns out that several of the governance institutions are interrelated. For instance German institutions favour long-term investment on the financial market, product market and labour market.

As a result of this mixed picture, superiority of one of the two stylized models of stakeholder relationships cannot be established (see also Jenkinson and Mayer 1992: 9). Empirical evidence is scarce, since it is very difficult to distinguish the impact of stakeholder relationships from a broad spectrum of other factors that affect the performance of companies (internal organisation, management style, national institutions, educational level of the labour force, etc.). De Jong (1996) reviews the performance of large Anglo-American and Germanic companies in the period 1991−1994 and shows Germanic companies to be stronger on growth of nominal value added per worker and employment growth, whereas profitability of Anglo-American companies is higher. Irrespective of some methodological considerations[24], these results confirm the above conclusion that the German model is favourable for large established companies.

Another partial piece of evidence pertains to productivity growth in Germany compared with that in the United States. Figure 5 shows the process of catching-up

[24] Some arguments may question the strength of this evidence. Developments at the national level are not taken into account and no adjustment is made for differences in price and quantity movements. In particular exchange rate movements may blur the results. For instance, Tabel 2 of De Jong (1996) shows that in 1992 nominal value added, measured in ECU, of Anglo-American companies fell by 6%, whereas nominal value added of Germanic companies rose by 9%. In 1992 the appreciation of the German Mark amounted to 6% vis-à-vis both the dollar and the pound. The entire period 1991−1994 is characterized by volatile exchange rate movements (EMS crisis). Hence, exchange rate movements may explain at least part of the results.

Figure 5 Value added per hour worked in German manufacturing



Source: van Ark and Pilat (1993)

of manufacturing productivity in Germany in the period 1950-1980. However, when Germany approaches the technological frontier productivity growth falls behind and the gap with the United States widens. Machinery and equipment, Germany's most productive manufacturing sector compared to the United States, overtakes the United States in the second half of the 1970s (see Figure 5), but after 1980 the productivity ratio falls to levels prevailing around 1970. Van Ark and Pilat (1993) show that the influence of capital intensity, skill intensity and composition of the manufacturing sector only explain a small part of the productivity gap and conclude that factors of a broader nature must cause the difference. The impact of governance institutions on technological innovation may be one of them.

Recent developments do not point towards increasing importance of one of the two models as well. In general, faster transfer of information generated by the spread of information technology reduces the need for relationship-specific technology and skills compared to marketable technology and skills (Blair, 1995: 289; Hart, 1995: 53). From that perspective the Anglo-American model gains relevance compared to the German model. The flexible market-oriented Anglo-American system also is a strong asset in a quickly changing environment of enterprises (Hellwig, 1995). Yet, with respect to the core technologies of a company relationship-specific human capital and organization become ever more crucial to gain a competitive lead. From that perspective management of human capital becomes even more important than management of physical assets. This explains shifts among some enterprises in the United States towards features of the German (and Japanese) models of stakeholder relationships.

Governance institutions balance the interests of stakeholders. The risk has been emphasized that if too much weight is put on the interests of one type of stakeholder, these stakeholders capture returns on firm specific investments by other stakeholders. Too much managerial autonomy involves the risk of managers capturing the rents from financiers and workers, too much emphasis on shareholder value discourages relationship-specific investment in human capital by employees, while giving employees a very large say in the firm can be detrimental to financing opportunities. An example of the balancing role of governance institutions concerns corporate governance and work governance. Levine and Tyson (1990: 219) state that the capital market is inherently biased against participatory institutions in the German model, which encourage long-term work governance relationships. As another example, both share ownership by workers (Blair, 1995: 310) and co-determination arrangements counteract the market for corporate control. Furthermore, in the field of contractual governance, the Anglo-American model emphasizes the reduction of agency costs through formal contracts between companies, while the German model trades these costs against long-term revenues from relational contracts in inter-firm associations (compare Kester, 1992).

Interrelations between governance institutions and the regulatory framework which supports these institutions, imply that it is difficult or even impossible for a country to simply take over institutions from a completely different model. Learning from international comparisons and adjusting of institutions in this field may be more relevant for countries which are relatively close together. That is why comparing stakeholder relationships and governance structures in Germany and The Netherlands is of interest. To properly perform this analysis a closer look at institutional details is needed, which also enables a further step away from the stylized models towards real-life institutions. The framework developed here is meant to serve as a background for that comparison in Sections 3 and 4. These sections concentrate on corporate governance and work governance, because most institutional differences between Germany and the Netherlands pertain to these two governance structures.

3 Corporate governance in Germany and the Netherlands

From a broad international perspective, the Dutch model of corporate governance resembles the German model described in Section 2.5. In both countries the supervisory board monitors management in large limited liability companies. As in Germany, the basic philosophy behind the tasks and responsibilities of the Dutch management and supervisory board emphasizes cooperation and a holistic view on the firm (Charkham, 1994; Iterson and Olie, 1992). Management boards in both countries operate as a team of equals, carry a shared responsibility, and strive for consensus.

However, a closer look reveals that German and the Dutch institutional arrangements differ significantly. To analyze these differences this section is structured along the lines depicted in Figure 2. Section 3.1 explores the specific institutional arrangements that allow shareholders to control management. Section 3.2 analyzes governance structures applied by creditors. Section 3.3 turns to the specific role of Dutch pension funds in corporate governance. Section 3.4 concentrates on the market for corporate control. Section 3.5 deals with two institutions affecting stock market performance: first, regulations on insider dealing and second, accounting rules. Finally, Section 3.6 assesses the strengths and weaknesses of corporate governance institutions in Germany and the Netherlands. As a point of reference, Table 3 surveys the main features of these institutions.

3.1 Relationships between shareholders and management

This section starts by describing institutional arrangements that allow shareholders to govern management in Germany and The Netherlands. Subsequently, it reviews the scant empirical information on the division of the enterprise sector with respect to type of business organization so as to delineate the part of the enterprise sector to which these institutional arrangements apply. Furthermore, it presents empirical information on the ownership structure of shareholdings and briefly reviews managment compensation. The final subsection addresses the performance of the supervisory board in Germany and the Netherlands.

German governance institutions

The German model of corporate governance is based on a two-tier principle by distinguishing a management board (Vorstand) and a supervisory board (Aufsichtsrat) (see Section 2.5). This model applies to all public companies (AG, Aktiengesellschaft) founded before 10 August 1994, to public companies with more than 500 employees founded after 10 August 1994, and to private limited liability companies (GmbH, Gesellschaft mit beschränkte Haftung) with more than 500

Table 3 *Overview of corporate governance in Germany and the Netherlands*

	Germany	The Netherlands
Shareholder control		
Supervisory board		
– criteria	size, type of company (before 1994)	size, works council, international orientation
– appointment	election	cooption
– composition	fixed quota for shareholders' and workers' representatives	not co-determined
Shareholdings		
– important shareholders	non-financial enterprises, banks	foreigners, pension funds
– concentration	concentrated	dispersed
Managerial shareholdings	not significant	recently increasing
Creditor control		
Bank shareholder position		
– extent of shareholdings	considerable	small, but increasing
– representation on supervisory board	substantial, partly linked to share ownership of banks	substantial, not linked to banks' share ownership
– regulation	banks' share ownership allowed	banks's share ownership needs approval
Proxy voting		
– scope	substantial	occasionally
– initiative	banks	foreign companies
– current developments	debate on reform proposals	proposed new system, run by independent organization
Pension funds' control		
Shareholdings	small	moderate, strongly increasing
Activism	negligible	supports shareholder position
Hostile takeovers		
Frequency	minimal	minimal
Anti-takeover defences	concentrated shareholdings, 75% majority at the general meeting required to replace supervisory board	structural model (partly), preference shares, priority shares, depositary receipts, binding nomination
Current developments	no change in regulation	regulation to lower defences
Specific regulations		
Insider dealing	strongly prohibited since 1994	prohibited since 1989
Accounting		
– main objective	comply to tax rules	company's financial position
– international orientation	low	high

employees (see also Box 1). The different position of public companies founded before and after 10 August 1994 is due to the 1994 Law on Small Public Companies and Deregulation of Equity Legislation. This law removed the difference between public and private limited liability companies with less than 500 employees in order to improve the access of small companies to stock-market finance (see also Box 2 below). Private limited liability companies with less than 500 employees generally have a managing director, who is directly responsible to shareholders. Yet private limited liability companies are free to install an advisory board (Beirat). The advisory board can exert shareholder control. However, in practice it tends to provides primarily advisory and supporting services to the manager/owner of the company (Kaen and Sherman, 1993).

The size and composition of the supervisory board depends on the number of workers a company employs (see also Section 4.1 on German co-determination institutions, in particular Table 12). In companies with less than 2000 employees, two thirds of the seats of the supervisory board are assigned to shareholders' representatives and one third of the seats to employees' representatives. In companies employing over 2000 workers[25], seats are divided evenly over shareholders' and workers' representatives. Shareholders' representatives elect the chairman of the supervisory board. In case of a voting deadlock the chairman has a casting vote. Accordingly, the interests of shareholders prevail in the rare case of a severe conflict between shareholders' and workers' representatives[26].

The supervisory board exerts control over management. The tasks of the supervisory board are to monitor the financial conditions of the company, usually on a quarterly basis, to ratify important investment decisions and acquisitions, to approve the annual profit-and-loss statement and balance sheet, and to approve dividend pay-outs. The chairman of the supervisory board is usually informed and consulted by the management at least once a month (Edwards and Fischer, 1994: 210). Moreover, in large public companies, the supervisory board appoints members of the management board (Charkham, 1994: 22) and dismisses them for a major cause, like neglect of duty or loss of confidence (Edwards and Fischer, 1994: 191). In private limited liability companies, in contrast, the general meeting of owners rather than the supervisory board has the right to appoint and dismiss

[25] By law the total number of seats on the supervisory board equals 12 for companies with 2000 − 10,000 employees, 16 for companies with 10,000 − 20,000 employees and 20 for companies with over 20,000 employees (Edwards and Fischer, 1994: 78).

[26] This right is laid down in the 1976 Codetermination Act. The only exception to this rule are companies in the coal and steel sector (Streeck, 1984: 401). The earlier 1951 Codetermination Act obliged supervisory boards of these companies to coopt an additional member to prevent a deadlock of votes.

Box 1 *Types of business organization*

Three main types of business organization are limited liability companies, partnerships and sole proprietorships (Edwards and Fischer, 1994: 72-83). Sole proprietors and members of partnerships face unlimited liability for the debt of the business. Sources of finance for these types of organizations are equity from the owners or from retained earnings of the business and external finance through indebtness. Shareowners of limited liability companies can lose only the amount they invested in the company. Hence, by reducing the individual risk, limited liability companies can access a larger pool of finance.

Limited liability companies can be subdivided into public and private companies. By law, owners of private companies control the transfer of ownership, for instance they may keep it within a family. In contrast, shares of a public company can be transferred freely. However, this does not mean that all public companies are listed at the stock exchange. The law provides only an option for a public company to turn to the stock exchange for equity financing. For several reasons, current shareholders may prefer not to trade shares or to trade shares only in private. Attracting capital through the stock exchange can be too expensive for relatively small companies. Applying for a listing is also of little use for companies that are complete subsidiaries of foreign enterprises.

By definition, only public companies can issue shares that are traded at the stock exchange. Private limited liability companies normally do not issue shares. If share certificates of private limited liability companies exist they are generally not freely tradable. For instance, both in Germany and the Netherlands transfer of registered shares of private limited liability companies requires a notarial act (Edwards and Fischer, 1994: 79; Slagter, 1994: 331). Registration at a notary is obligatory for fiscal reasons and to prevent abuse of the legal rights applying to private limited liability companies.

managers (Edwards and Fischer, 1994: 79).

Despite these rights and duties, management typically does not feel unduly constrained by the supervisory board (see Lane, 1992: 78). The board does not posses a right of initiative:it can not impose alternative strategies on the management board. Moreover, a number of important management decisions are often not presented to the supervisory board. According to Gerum *et al.* (1988), only in less than 20% of the 281 large public companies the supervisory boards must approve the general product or market strategy or investment finance plans. Finally, in 86% of the companies the supervisory board meets only the legal minimum of twice a year.

Table 4 gives an impression of the number and size of the various types of enterprises in Germany. Limited liability companies account for a relatively small share of German companies: 46.6% of total turnover is produced by limited liability companies. In the United Kingdom, by contrast, approximately 75% of private sector GDP is produced by limited liability companies (Edwards and Fischer, 1994: 84). Among the group of limited liability companies the number of

Table 4 Different types of business in Germany and the Netherlands

Type of company	Number of companies[a]	%	Employment[b] percent		Turnover[c] percent		Equity[a] mld DM/f	%
Western Germany								
Unlimited liability	–		46.		53.4		–	
Total limited liability	468 466.	100.	54.	100.	46.6	100.	362.6	100.
− of which private	465 660.	99.4	40.	74.	25.5	55.	208.5	58.
− of which public	2 806.	0.6	14.	26.	21.1	45.	154.1	42.
Listed public companies[d]	486.	0.1	–		10.5	23.	–	
Two-tier system mandatory	–		26.5[e]	49.	30.0[f]	64.	–	
The Netherlands								
Unlimited liability	–		43.[g]		–		–	
Total limited liability	97 577.	100.	57.[g]	100.	–	100.	349.4	100.
− of which private	96 909.	99.3	41.	72.	–	72.	216.8	62.
− of which public	668.	0.7	16.	28.	–	28.	132.6	38.
Listed public companies[h]	140.	0.1	–		–		–	
Upper limit two tier system[i]	806.	0.8	21.	37.	–	48.	250.2	72.
Two tier system present[j]	583.							

a Source: Germany, 1991, Statistisches Bundesamt (1994); Netherlands, 1993, Statistics Netherlands (1995) and additional material supplied by Statistics Netherlands.

b Source: Germany, 1987, Statistisches Bundesamt (1994) Unternehmen und Arbeitsstatten; Netherlands, see note [a].

c Source: Germany, 1986, Edwards and Fischer (1994: 75, Table 4.1). Data for 1992 in Statistisches Bundesamt (1995) largely confirm these figures: 30% (compared with 25.5% in the table) of turnover is produced in private limited liability companies and 20% (21.1% in table) in public limited liability companies.; Netherlands, see note [a].

d Source: Germany, 1986, Edwards and Fischer (1994: 87)

e Source: Germany, 1981, Streeck (1984)

f Source: Germany, 1986, Edwards and Fischer (1994: 83)

g Source: Netherlands, 1993, Rough estimate based on CPB (1995: 217)

h Source: Netherlands, 1993, Statistics Netherlands (1994)

i Companies with subscribed capital at least 25 million guiders and at least 100 employees. Upper limit because companies without works council and companies exempted from structural model also included. Source: Netherlands, 1993, additional material supplied by Statistics Netherlands.

j Structural limited liability companies. Source: 1992, Information from the Netherlands Ministry of Justice.

public companies is relatively small. However, their contribution to turnover and equity capital is relatively large. Also the employment share of public companies is considerable. Companies for which the German two-tier system is mandatory, *i.e.* public and large private limited liability companies, are estimated to produce 30% of total turnover. In 1986 turnover of public companies amounted to 21% of total turnover in Germany, approximately half of it being produced by listed companies.

Dutch governance institutions

Two main types of models can be distinguished in the Netherlands: the structural model and the common model. The structural model is mandatory for large public and private limited liability companies, which are therefore called structural limited liability companies. The 1971 law specifies three criteria to define these companies: a subscribed capital of at least 25 million guilders, at least 100 employees employed in the Netherlands, and the presence of a works council in the company (Honée, 1986; Voogd, 1989; Rietkerk, 1992, Van het Kaar, 1995). Subsidiaries of a holding company that fulfil the three criteria are exempted from the structural model if the holding company itself is governed by the structural model.

Four main features characterize the structural model (compare Table 5). Firstly, the presence of a supervisory board (Raad van Commissarissen) is obligatory. In contrast to the German situation, its members are appointed by cooption, i.e. members of the seated supervisory board elect new members. Both the general meeting of shareholders and the works council can propose or reject new members of the supervisory board. Only a legal procedure can overrule objections by the general meeting or the works council against proposed members of the supervisory board (Koene and Slomp, 1991: 48-50; Honée, 1986: 9). The management board (Raad van Bestuur) merely has a right to propose new members. In practice, however, the influence of management on the composition of the supervisory board is considerable (Van der Knoop, 1991: 150; Van het Kaar, 1995: 16). Secondly, members of the management board are appointed and, for major causes, dismissed by the supervisory board. Yet also with respect to appointments of new members of the management board the influence of current management is substantial (Van der Knoop, 1991: 83). Thirdly, the supervisory board determines the annual statement of accounts, which however requires approval by the general meeting of shareholders (Voogd, 1989: 247). Fourthly, the supervisory board ratifies important managerial decisions, like share issues, major investment projects, mergers and acquisitions or significant restructuring processes.

A mitigated form of the structural model applies to companies that, while fulfilling the three criteria, are majority owned by foreign enterprises. If at least 50% of the shares of a Dutch company is owned by a company where a majority of employees works abroad, the mitigated structural model applies (Voogd,

Table 5 *Responsibilities of the supervisory board and the general meeting of shareholders in the Dutch structural and common model*

	Structural model	*Common model*
Supervisory board		
− appointment	*supervisory board*	*general meeting*
− dismissal	*court*	*general meeting*
− nomination	*general meeting, works council*	*not applicable, unless binding nomination*[a]
− number of members	*at least three*	*company statutes*
− term of membership	*four years*	*company statutes*
Appointment management board	*supervisory board*	*general meeting*
Annual statement of accounts[b]		
− determination	*supervisory board*	*general meeting*
− approval	*general meeting*	*general meeting*
Approval major decisions	*supervisory board*	*company statutes: general meeting or supervisory board*

[a] *For additional information on binding nomination see the description of Dutch anti-takeover defences in Section 3.4.*
[b] *Determination of the annual statement of accounts entails the right to adjust its contents, approval is restricted to integral acceptance or rejection.*
Source: Koot and Wiersma (1994: 47)

1989: 245; Slagter, 1994: 332). These companies must still have a supervisory board. Its members are also appointed through cooption. However, the competencies of the board are more limited. In particular, the general meeting of shareholders rather than the supervisory board appoints and dismisses members of the management board and determines the annual statement of accounts. The mitigated model ensures a sufficient degree of control for foreign companies over their Dutch subsidiaries.

Dutch legislation allows companies that do not meet the legal criteria, to voluntarily adopt the structural model. A company can opt for the full structural model, the mitigated structural model or elements from one of these models.

The common model applies to all other limited liability companies. Here, the presence of a supervisory board is voluntary. If a supervisory board is present, its competencies are confined to ratifying important managerial decisions: the general meeting of shareholders appoints both the members of the supervisory board[27] and the management board and also determines the annual statement of accounts. In 1994, 24% of a sample of 755 private limited liability companies with 50 − 1000 employees had voluntarily installed a supervisory board. The average size of the board was 2.8 seats and the main motive for installing a supervisory board was the need for expert advice (GITP, 1994).

Table 4 shows that the distribution of number of companies, employment and equity capital is largely similar in Germany and the Netherlands. The share of public companies in turnover is higher in Germany. In 1992, the Dutch structural model applied to 583 companies, which consisted of 273 public companies and 308 private limited liability companies. To put this number in perspective, Table 4 presents data on the number of companies with a subscribed capital of at least 25 million guilders and at least 100 employees employed in the Netherlands. These data indicate that companies for which the structural model is potentially relevant are relatively large compared to the total of Dutch public companies: the ratio of turnover shares (48/28) exceeds the ratio of the number of companies (806/668). Yet, their share in employment and turnover falls short of comparable figures for German companies.

In the Netherlands internationalisation causes the mitigated structural model to gain importance as opposed to the structural model. According to Voogd (1989: 249), in the Netherlands the structural model applies to 55% of the public companies listed at the stock exchange. This at first sight low percentage can be explained by the fact that holding companies with the majority of employees working abroad are exempted from the structural ordering. However, for Dutch subsidiaries that fulfil the three criteria the structural model again applies if the holding is Dutch but not a structural company. For instance, the holding company of Philips (NV Gemeenschappelijk Bezit van Aandeelen Philips' Gloeilampen-fabriek) is a common public company that is listed at the stock exchange, while the Dutch subsidiary (Philips Nederland BV) is a structural private (unlisted) limited liability company.

Share ownership

The ownership structure of shares yields further insights about the influence of shareholders. Table 6 presents key indicators on shareholdings in Germany, the Netherlands, and, as countries of reference, the United Kingdom and the United States.

[27] At least 2/3 of all members on the supervisory board but in practice often all members.

Table 6 *Shareholdings in Germany, the Netherlands, the United Kingdom and the United States*

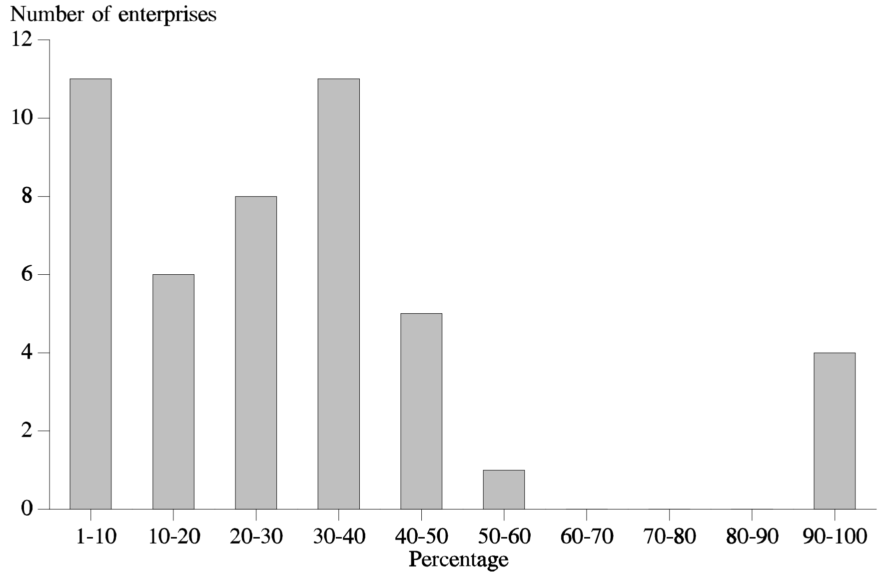
	Germany	*Netherlands*	*United Kingdom*	*United States*
Domestic listed companies, 1993				
−number[a]	*664.*	*140.*	*1927.*	*6098.*
−number per billion $ of GDP	*0.35*	*0.45*	*2.04*	*0.97*
−capitalization, % of GDP[a]	*25.1*	*61.5*	*132.4*	*83.5*
−percent of total turnover[b]	*10.6*	*−*	*30.5*	*−*
Ownership of shares[c]		*percentage*		
−households	*16.6*	*20.0*	*17.7*	*50.2*
−non-financial enterprises	*38.8*	*9.6*	*3.1*	*14.1*
−banks	*14.2*	*0.7*	*0.6*	*0.0*
−investment funds	*7.6*	*1.5*	*9.7*	*5.7*
−pension funds	*1.9*	*7.9*	*34.2*	*20.1*
−insurance companies	*5.2*	*5.5*	*17.2*	*4.6*
−government	*3.4*	*0.0*	*1.3*	*0.0*
−foreign	*12.2*	*54.8*	*16.3*	*5.4*
Share of largest shareholder[d]		*percentage of largest firms*		
> 25%	*85.*	*−*	*13.*	*−*
> 50%	*57.*	*22.*	*6.*	*−*
> 75%	*22.*	*−*	*1.*	*−*

[a] *Source: CEPS (1995: 7).*
[b] *Source: Germany and the United Kingdom 1986, Edwards and Fischer (1994: 86, 87).*
[c] *Source: Germany, 1993, Deutsche Bundesbank (1994: 68, 69) and CEPS (1995: 31, 32); the Netherlands, 1993, CPB extension of Swank et al. (1989); United Kingdom, 1993, CEPS (1995: 13) and OECD (1995c: 88); United States, 1990, Prowse (1994: 21).*
[d] *Source: Germany and the United Kingdom, Franks and Mayer (1993); the Netherlands Cantrijn et al (1993: 47).*

This table reveals that the German stock market is relatively small. The number of listed companies per $ of GDP in the United Kingdom is nearly six times as high as in Germany. The corresponding ratio between the United States and Germany equals about three. Comparison of stock market capitalization as a percentage of GDP yields the same picture. Measured in terms of turnover, listed companies are three times more important in the United Kingdom than in Germany.

Table 6 shows that also the ownership structure of shareholdings differs considerably between the four countries. The United States stands out as the country with the highest percentage of shares owned by households. The percentage of shares owned by insurance companies and pension funds in the United Kingdom exceeds that in the Netherlands and especially that in Germany. Share

Figure 6 German largest 100 enterprises distributed by the percentage of shares owned by other enterprises among the largest 100.



Source: Monopolkommission (1994)

ownership of Dutch pension funds is increasing. Therefore Section 3.3 pays more attention to the corporate governance role of institutional investors. Table 6 shows also the relatively large shareholdings by banks and cross holdings between non-financial enterprises in Germany. Accordingly, companies and banks are represented on each others' supervisory boards.

The relatively high concentration of shareholdings strengthens the influence of banks and non-financial enterprises in Germany: In 57% of the 180 largest German companies the largest shareholder owns more than 50% of the shares. With a corresponding figure of 22%, shareholdings in the Netherlands are less concentrated, while in the United Kingdom shareholdings are widely dispersed. Figure 6 presents additional information on the cross shareholdings among the largest 100 enterprises in Germany in 1992. In 46 out of the largest 100 German companies, part of the stock of shares issued by that company is in the hands of banks or other non-financial companies belonging to the same group of 100 largest companies. In 11 of these 46 companies shareholdings of other large companies are relatively small. They do not exceed 10% of the stock of shares. Yet, for a substantial number of companies (24) the percentage of shares in the hands of other large companies lies in the range of 20% to 50%. Four companies are almost completely owned by other companies from the largest 100.

The performance of the supervisory board

The supervisory board has to be consulted on important decisions like major investments, mergers and acquisitions, it can intervene in times of a financial crisis or a confidence crisis in the management board, and it appoints and, if necessary, dismisses members of the management board. In this respect the German and Dutch models have much in common. However, several substantial differences can be identified as well, which are summarized in Table 7.

Both in Germany and the Netherlands the performance of the supervisory board is under discussion. The discussion in the two countries pertains to weaknesses of different institutional arrangements, such as the co-determined supervisory board in Germany and cooption of members of the supervisory board in the Dutch structural model. Yet, to some extent the discussion suggests comparable remedies. These remedies do not aim at completely abolishing or replacing the institutions, but instead aim at moderate institutional adjustments and at improving the functioning of the board, in particular by enhancing information flows between management and supervisory board.

Some recent developments in Germany have initiated the discussion on the weak points of monitoring management by supervisory boards. The near collapse of Metallgesellschaft in 1994 is the most well-known example (Fisher, 1995), but large financial problems with several other companies have also reduced confidence in the ability of the supervisory board to adequately monitor firm performance. These experiences partly explain proposals to reform the German two-tier system[28]. Yet, proponents of the German model emphasize that these incidents are not appropriate to disqualify the entire system, since no monitoring system is able to deal with outright misleading of supervisors by management.

As a result of the large financial problems in some German companies, members of supervisory boards are becoming more alert at properly executing their task (Goudzwaard, 1994). In the Netherlands, a comparable development is taking place, partly also caused by financial crises. In addition, members of Dutch supervisory boards increasingly run the risk that they personally will be held liable if a company fails because of mismanagement (Tamminga, 1995c). In some recent

[28] At the same time the Anglo-American model features some opposite tendencies. Crises in some Anglo-American companies (for example: abuse of pension fund capital at Maxwell Corporation; the collapse of Barings Bank) have induced reform proposals that advocate a more independent position of non-executive directors in the board to improve monitoring of management (see also Bishop, 1994).

Table 7 Presence, composition and tasks of the supervisory board

	Germany			Netherlands (public, private)		
type of limited liability company	*public large*[a,b]	*private large*[a]	*public, private small*[a]	*structural*	*structural mitigated*	*common*
Presence obligatory	*yes*	*yes*	*no*	*yes*	*yes*	*no*
Composition	*elected*	*elected*	*elected*	*coopted*	*coopted*	*elected*
Tasks						
− appoint management	*yes*	*no*	*no*	*yes*	*no*	*no*
− statement of accounts	*yes*	*yes*	*no*	*yes*	*no*	*no*
− monitor and ratify	*yes*	*yes*	*advisory*	*yes*	*yes*	*yes*

[a] *Large: over 500 employees. Small: less than 500 employees.*
[b] *Founded since 1994; all public limited liability companies founded before 1994.*

bankruptcy cases the Dutch court has convicted former members of the management board and of the supervisory board for mismanagement. The conviction creates opportunities for aggrieved shareholders to submit claims for compensation[29]. In several other cases official receivers decided not to enter a lengthy court procedure, but to agree on a financial settlement with the former management board and the supervisory board.

An institutional difference between Germany and the Netherlands, affecting the efficacy of the board, is that in Germany by law the composition of the supervisory board is divided between a fixed number of seats for representatives of shareholders and for representatives of employees. In the Netherlands the influence of shareholders and workers on management through the supervisory board takes place more indirectly, since members of the supervisory board are not elected by shareholders and workers, although both parties do have a say in its composition[30]. Moreover, Dutch workers cannot become a member of the supervisory board of their company (Van der Knoop, 1991: 51; Van het Kaar, 1995: 9).

[29] Boot (1995) warns against proposals to further increase personal liability of members of the supervisory board, because personal liability encourages risk-averse behaviour of board members.

[30] At the end of the 1970s left-wing political parties proposed the introduction of joint representation of employees and shareholders on Dutch supervisory boards comparable to the German system. In 1984 a majority of the Dutch Social Economic Council opposed these ideas. They have never resulted in an adjustment of legislation (Van der Knoop, 1991: 11).

Advantages of the co-determined German supervisory board are that employee representatives are generally well-informed about developments taking place at the work floor, which enhances information flows to management. Furthermore, management is able to communicate its views, including unpopular measures, to employees more effectively (Schilling, 1994). However, critics also state several disadvantages. Firstly, in their statutes a number of companies have reduced the responsibility of the supervisory board to the legal minimum in order to limit the influence of worker representatives, in particular of union members (Schröder, 1995). Moreover, executives from other companies or from banks, who occupy a seat on a supervisory board as shareholder representative, regard the managers of the companies as their peers. Therefore, they do not like to criticize the management in front of employee representatives and do not raise controversial issues. Instead, some shareholder representatives use informal meetings with managers to discuss controversial issues. Another reason for not raising controversial issues is the risk of dissemination of confidential information. According to answers given by members of supervisory boards, scientists and politicians to a questionnaire about the functioning of supervisory boards, employee representation entails a risk of loss of confidentiality of information presented to the board (Schilling, 1994). These reasons also explain why meetings of the supervisory board in Germany are often characterized by the absence of debate and by consensus; the subjects brought before the board are hardly ever controversial.

A specific feature of the supervisory board in the Netherlands concerns the system of cooption of members of the board. The fact that members of the supervisory board are appointed by cooption and not elected by the general meeting of shareholders limits the powers of shareholders through the general meeting (Rietkerk, 1992). The expression that the efficacy of corporate governance institutions significantly depends on the people that administer these institutions (Schneider-Lenné, 1995), in particular applies to the Dutch model. Cooption largely shields the Dutch supervisory board from influences outside the company. In well-managed companies members of the supervisory board and directors recognize the necessity of a competent supervisory board. Therefore, they look for capable candidates to fulfil a vacancy on the board. Moreover, the quality of the present board constitutes an incentive for capable people to agree to join the board. However, in companies with an incompetent supervisory board, which primarily aims at not disturbing the status-quo with management, members of the board will select congenial candidates[31]. These arguments indicate that as a result of cooption the Dutch supervisory board may be of less uniform quality compared to Germany: both at the lower end and at the upper end the mass of the Dutch distribution may exceed that of the German distribution.

Cooption may, furthermore, increase risk-averse behaviour of companies (Boot, 1995), because the Dutch model puts too much weight on disciplining management by creditors. By selecting relatively unrisky strategies, management will try to reduce the risk of loosing control to creditors in case of financial difficulties. If members of the supervisory board too closely identify themselves with management or are too little involved in the companies' strategies, incentives to oppose risk-averse behaviour are small.

An institutional difference between Germany and The Netherlands that nowadays exists only for companies founded before August 1994, concerns the fact that in Germany the type of company partly determines whether the two-tier system is obligatory. The system applies to all public companies founded before this date, but not to private limited liability companies with less than 500 employees. In the Netherlands, size, the presence of a works council and international orientation of companies are relevant criteria, whereas in this respect the legal form is an irrelevant criterion. The German regulations prior to 1994 have acted as a barrier for small and medium-sized companies to adopt the legal form of a public company, which constrained their access to equity finance (see Box 2).

As a final difference members of the management board in Germany are appointed for a limited period of usually five years (Edwards and Fischer, 1994: 191), while in the Netherlands appointments generally are permanent (Iterson and Olie, 1992: 101). This feature makes it slightly more easy to dismiss German managers.

German and Dutch participants in discussions on the performance of the supervisory board have suggested various possibilities for reform[32]. Most of these do not entail substantial adjustment in legislation. Instead, proposals for reform require changes in company practice and call for modest institutional adjustments. Although they state that employee representation weakens the control function of

[31] Slagter (1993: 196) states: '...The current system has a contrary effect: a member of the supervisory board who wants to intervene is looked upon as a rebel and forced to resign. The failing members hold their positions whereas they should be dismissed instead of the innovating member.'

[32] See Slagter (1993) for a review of an extensive discussion in 1993 about options for reform of the Dutch structural model and the papers in *De Naamloze Vennootschap* 73, december 1995.

Box 2 *The German Law on Small Public Companies and Deregulation of Equity Legislation*

The German Law on Small Public Companies and Deregulation of Equity Legislation aims at increasing access to stock market finance for small and medium sized enterprises (SMEs) and to ease the transfer of ownership of firms currently owned by the founder or by families to successors and the transfer of management of these firms to professional managers (see Deutscher Bundestag, 1994a and 1994b; Blanke, 1994; Lutter, 1994). In the coming years the latter transfers will have to take place in many German SMEs because the founders or current owners / managers will retire. Separation between ownership and management can be very attractive if no successor with sufficient management capabilities can be found or if successors who inherit ownership rights want to diversify their wealth by selling part of these rights.

To reach these aims, the legal form of a public limited liability company (AG) has been made more attractive to SMEs. The law contains a number of deregulation measures that reduce the regulatory burden on SMEs if they opt for becoming a public company instead of a private limited liability company (GmbH). The number of people needed to found a public company has been reduced from five to one. The right of the general meeting of shareholders to determine the distribution of profits has been enlarged for unlisted public limited liability companies. Formalities associated with convening and administration of the general meeting have been simplified. Increases of equity capital of the company by 10% or less do no longer require extensive procedures to take into account claims of current equity owners.

Besides deregulation of equity legislation, the law has eliminated the difference between public and private limited liability companies with less than 500 employees with respect to co-determination legislation. Public companies with less than 500 employees founded after 10 August 1994 are no longer required to install a supervisory board with a specified number of employee representatives. Because the situation for companies founded before that date does not change, the legal adjustments will only gradually manifest themselves. These adjustments in co-determination requirements are regarded as important measures to remove obstacles for SMEs to opt for the legal form of a public company. In the past frequently the German criteria have been regarded as discriminating against the organisational form of a public company, in particular for small and medium sized enterprises (Borio, 1990; Lutter, 1994; Prowse, 1994).

Because some of its measures concern unlisted public companies, the legislation is not so much directed at fostering a listing at the stock exchange at short notice, but at changing the ownership structure towards a public company. This facilitates the transfer of ownership in case of retirement. Moreover, the change in ownership structure is a necessary condition for an initial public offering, which however can take place at a later stage.

the supervisory board, German critics do not want to abolish the institutional model of employee representation on the supervisory board. After the difficult and lengthy political struggle in the 1970s to introduce the co-determined supervisory board, most participants in the debate consider abolishing it politically infeasible[33].

Boot (1995) proposes to adjust the nomination procedure for members of the supervisory board in the Netherlands, so as to increase stakeholders' influence on the board's composition. According to Boot's proposal a selection committee nominates members for 60% of the seats on the supervisory board, the other 40% of the members is elected by cooption. Shareholders, employees and possibly other stakeholders elect a fixed number of their representatives in the selection committee. The selection committee has to make a unanimous nomination, so that conflicts of interest between stakeholders must be solved in the selection committee. Partial cooption, for 40% of the seats, enables the supervisory board to elect a number of independent outside experts. In addition Boot (1995) puts forward the option to increase the responsibility of the selection committee by making elected members of the supervisory board accountable to that committee[34].

A point of attention relevant to both countries concerns the number of supervisory board seats per person. If individual members do not take up too many appointments and if companies examine the number of appointments upon nomination, a tightening of the legal limit on the number of supervisory board seats a person can occupy is not necessary. Alternatively, instead of increasing the frequency of supervisory board meetings, which most probably will increase absenteeism, improving the quality of information flows from management board to supervisory board is more useful. Some German authors propose to reserve a part of the seats on the supervisory board for independent professionals (Schilling, 1994). Others suggest to abandon the practice in some companies that the chairman

[33] For the same reason a reduction in size of the supervisory board is also difficult to accomplish. In the largest companies the board consist of 20 persons, which is large to reach efficient decision making and to motivate individual members to participate actively. Yet, reduction of its size would require adjustments of the co-determination agreements, which no one advocates in order to avoid the risk that the entire agreement will be called into question. Reducing the size of the supervisory board is also difficult for companies with several shareholders with substantial equity holdings, because these shareholders generally expect all to occupy a seat on the board.

[34] In particular the latter option entails the risk that a complicated and less effective 'three-tier board' will emerge. The enhanced selection committee will closely resemble a German-type supervisory board, including the associated problems of parity representation mentioned above.

of the management board is nominated as chairman of the supervisory board after retirement (Schneider-Lenné, 1995).

In order to improve the effectiveness of the supervisory board's activities, both German and Dutch discussants advise companies to install committees such as an audit committee, a nominating committee or an investment committee. An audit committee enhances monitoring of a company's financial position by raising the quality of financial information to the supervisory board[35]. Generally the audit committee consists of the general director and the financial director, several members of the supervisory board, and the internal and external accountant (Deloitte & Touche, 1995). The audit committee allows specialized members of the supervisory board to increase their contacts with the company's accountants. Compared to German companies, more audit committees feature in Dutch companies. Yet, there is ample room for improvement. Deloitte & Touche (1995) has conducted interviews with 50 members of supervisory boards of Dutch companies. Only about half of the interviewed companies has an audit committee.

In a nominating committee, members of the supervisory board can discuss the quality of the management board on a confidential basis. Subject of discussion in investment committees are strategies of the company and major investment plans. Investment committees can support the supervisory board to develop a view on the strategy and mission of the company. Deloitte & Touch (1995) concludes that Dutch supervisory boards generally discuss the financial position of the company, market developments and major investments. Identification and control of important strategic risks facing the company are less frequently on the agenda.

The presence of an audit, nominating or investment committee may alleviate some of the problems companies perceive with respect to confidentiality of information presented to the co-determined supervisory board. For instance, currently in many German companies members of the supervisory board can only consult the accountant report at the offices of the company. They do not receive a personal copy because management is concerned that employee representatives disclose confidential information to competitors (Goudzwaard, 1994). Confidentiality is more easily secured in a small committee than in a 20 person supervisory board. Yet, to further guarantee confidentiality, Schilling (1994) advocates that a company should be able to install committees without joint representation. A verdict of the German court currently prohibits such committees.

[35] In the United States an audit committee is even required for a company to obtain a listing at the stock exchange.

Management compensation

Data on managerial compensation in Germany and the Netherlands are scarce. Section 2.5: 32, concluded that management stock ownership is low in German companies that are not majority owned by individuals. The results of Abowd and Bognanno (1993) in OECD (1995a: 107) show that in 1992 long-term performance-related compensation was negligible also in the Netherlands. According to this study, management compensation in the Netherlands, together with Sweden, is lowest among twelve countries compared. Compensation of Dutch managers is 15% below the German level and even 50% below the level in the United States[36].

Although differences among remuneration of top-managers in international companies are less extreme and the application of stock options has increased recently in the Netherlands, information from business consultants confirms that the performance-related part of managerial remuneration is still relatively small in Germany and the Netherlands compared to Anglo-American countries (Crooijmans, 1995; Economist, 1995; Tamminga, 1995b). Together with the experience from the United States, discussed in Section 2.6: 39, that stock options are not very effective to discipline management, it can be concluded that managerial share ownership is no significant institution to align interests of shareholders and managers in Germany and the Netherlands[37].

3.2 The corporate governance role of banks

Section 2.2: 17, addressed the creditor position of banks in corporate governance. Banks intermediation in debt finance is effective because it resolves the private incentive problem related to monitoring by small individual lenders. This argument of bank monitoring efficacy mainly applies to small and medium-sized companies. Large companies can put up collateral or can build up credit market ratings as signals of creditworthiness. Long-term relationships between banks and companies reduce banks' risk aversion, but also raise banks' monopoly power and reduce the speed of capital reallocation. Section 2.6: 37, argued that in Germany concentration

[36] Management compensation in the United States is very high compared to other countries. It exceeded the second highest country, France, by 30% and consisted for over 30% of long-term performance related remuneration.

[37] Section 4.4 contains additional information on profit sharing by employees in Germany and the Netherlands and the use of stock options as a specific type of profit sharing.

in bank lending to firms is not very significant, because the German market for banks loans is highly competitive.

From an international perspective, the position of German banks in corporate governance is rather special because they combine a creditor and a shareholder position. The shareholder position is strengthened by the system of proxy voting, which under certain conditions permits a bank to vote at the general meeting of shareholders for shares it holds in custody. Partly as a consequence of their share ownership, banks are represented on supervisory boards of companies. Section 2.6 concludes that the specific role of German banks in corporate governance follows from their shareholdings, which add to the concentrated shareholdings among non-financial enterprises.

The combination of a creditor and a shareholder position constitutes the background for further analyzing the position of Dutch banks in corporate governance and for comparing Dutch banks to German banks. Therefore, share ownership of banks, proxy voting and supervisory board representation constitute the core of this section. The analysis shows that the role and ambitions of Dutch banks in corporate governance differ considerably from their German counterparts. Dutch banks currently increase their historically low equity investments, but do not aim at active shareholder monitoring of companies. Equity is mainly regarded as one of the investment alternatives. In contrast to German banks, Dutch banks emphasize their creditor position.

Share ownership of banks

Shareholdings of German banks are relatively large compared to those in other countries. Table 6 shows that in 1993 German banks owned over 14% of the stock of shares. Comparable figures are negligible in the United Kingdom and the Netherlands and zero in the United States, where the law prohibits universal banks.

For several reasons bank influence on non-financial companies through share holdings is smaller than the figure of 14% might suggest. Not all of the German banks' shareholdings pertain to participations in industrial companies. A substantial part consists of participations in other financial companies such as insurance companies, mortgage banks or other subsidiaries. From the total stock of shares owned by banks, only 40% are shareholdings in German non-financial enterprises (Schröder, 1995). Moreover, public limited liability companies constitute a relatively small part of the enterprise sector in Germany (see Table 4). Including the private limited liability companies, a study of the Bundesverband Deutscher Banken (1995) shows that the ten largest private German banks in 1994 owned 0.4% of the nominal capital of all limited liability German companies. Over time this percentage has fallen from 1.3 in 1976 to 0.7 in 1986 and 0.4 in 1994. These figures illustrate that the creditor position of banks is most important, in particular for the small and medium-sized companies. The relevance of the shareholder position increases for listed public limited liability companies. The ten largest private banks own 4.1% of the equity capital of the 30 largest German listed non-financial companies.

Bundesverband Deutscher Banken (1995) also shows that in the period 1986−1994 banks have reduced the size of their shareholdings in individual companies. Equity capital of domestic non-financial companies owned by banks, associated with participations of over 25%, falls, while equity capital of participations of 10% to 25% rises. Banks reduce large shareholdings in individual companies because they aim at a better diversification of shareholdings over branches of industry and over countries (Schröder, 1995: 12). Reduction of large holdings became interesting after the lowering of the threshold, above which double taxation on corporate income from municipal taxes and wealth tax can be avoided (Schachtelsteuerprivileg) from 25% to 10% in 1977. Since 1977, a shift from participations of 25% or over towards participations of 10% or over has taken place. By consequence, share ownership of banks changed from very large dominating blocks towards blocks which are still substantial but to a larger extent require coalitions with other block shareholders, if influence on firm policy or offering protection against hostile takeovers is desired[38].

In 1993 Dutch banks owned 0.7% of the total stock of shares (see Table 6). Amounting to 14.2%, the percentage owned by German banks is twenty times as high. To some extent Dutch regulation has discouraged share ownership of banks. Firstly, in the past regulation prohibited strong cooperation between banks and insurance companies, including participation of banks in the equity capital of insurance companies. However, in the 1980s these regulations have been liberalized and since then a number of banks and insurance companies have merged. Secondly, a banks' participation of over 10% in the equity capital of a non-financial company requires approval by the Dutch Ministry of Finance, assisted by the central bank[39]. In the decision to grant permission or not, the ministry and the central bank judge whether the participation would lead to excessive power concentration in the hands of banks. The 1980s also witnessed a relaxation of this policy; since then permissions are granted more easily. The focus of Dutch banks on trade finance constitutes another reason why shareholdings are relatively small.

[38] See Zwiebel (1995) for a theoretical analysis of the impact of the size of blocks of equity of a firm and control benefits to shareholders on the resulting shareholder structure within and across firms.

[39] The threshold of 10% applies since 1992, before 1992 participations of over 5% required approval.

This focus differs considerably from German banks, which have a long-standing history of industry finance[40].

Proxy voting

Although the direct influence of German banks as a result of their shareholdings is not strong, the shareholder position of banks in corporate governance is strengthened by the system of proxy voting. Usually, owners of shares deposit their shareholdings with a bank. These shareholders can authorize the bank to exercise votes at general meetings on behalf of them. The purpose of the system is to increase the representation of shareholders at the general meeting so as to ensure that decisions taken comply with the views of the majority of shareholders and to prevent that unstable and random minorities at the general meeting strongly influence company policy (Kümpel, 1995; Schneider-Lenné, 1992; Schröder, 1995).

The scope of these proxy votes can be quite substantial. In 1988 banks themselves owned 8.1% of the total shareholdings, while another 53.5% of the total stock of shares had been deposited with the banks (Edwards and Fischer, 1994: 112). Moreover, 45% of the shares deposited with the banks were held by the three German large banks (Deutsche bank, Dresdner Bank and Commerzbank). Baums and Fraune (1995) show that among the largest firms without a majority owner proxy votes provide banks with a considerable voting majority at the general meeting (see also OECD, 1995a: 96).

Since many private share owners do not instruct banks as to their voting preferences, this voting system seems to justify the conclusion that banks are very powerful by being free to vote according to their own insights and priorities. Yet, three qualifications need to be made in this respect. First of all, proxy voting does not apply to all the shares deposited with the banks. From the 53.5% of shares deposited in 1988, the shares owned by non-financial enterprises amounted to 17.5 %-points and the shares owned by the government to 4.3 %-points. Since it is likely that large companies and the government will instruct the banks as to their voting preferences, the maximum percentage of proxy votes directly under the banks discretion diminishes to 31.7%. According to Table 6, for 1993 the ownership of shares by households provides an estimate of 16.6% of the stock of shares for which proxy voting is relevant. Secondly, concentrated shareholdings, as depicted in Figure 6 above, reduce the scope for proxy voting among the largest companies, because block shareholders dominate the general meeting. The evidence by Baums and Fraune (1995) on large voting majorities of banks refers to only 24

[40] For a detailed analysis of German and Dutch financial intermediation and relevant institutional arrangements see De Jager (forthcoming).

of the largest companies. Thirdly, the bank's discretion is restricted by a formal procedure on proxy voting that has to be followed. In anticipation of the general meeting the bank must inform each depositor on its intended voting behaviour and ask for instructions. In case of no response, the bank has to stick to the voting strategy outlined to the depositor, except when new information becomes available at the general meeting and the bank is convinced that the depositor would have changed her preferences. The depositor must always be informed of a change in voting.

Despite these qualifications, compared to the Netherlands the viability and extent of proxy voting in Germany is remarkable. Proxy voting does hardly exist in the Netherlands, although in both countries no legal impediments to proxy voting exist. Moreover, in both countries nearly all equity capital consists of bearer shares. Since only banks that hold bearer shares in custody are able to contact shareholders, it seems natural that these banks administer the system of proxy voting.

Differences in incentives or behaviourial characteristics of individual shareholders or banks must offer an explanation for the contrast. Section 2.2: 16, states that incentives are small for individual shareholders to monitor firms with a widely dispersed stock of shares. For that reason, an individual shareholder has little incentives to take action to grant the bank a proxy right unless some kind of procedure encourages the shareholder to do so. Indeed deliberate action of shareholders to get in touch with the bank and ask the bank to cast a proxy vote hardly occurs in Germany. The basic procedure is that some months before the general meeting banks approach shareholders, alert them to the possibility to attend the shareholders meeting and already include the relevant documents to grant a proxy vote if attendance is not preferred. Hence, it can be concluded that the initiative to solicit a proxy vote lies with the bank.

The soliciting procedure also reduces the efficacy of both the option for shareholders to select non-bank representatives and of the 15 month duration of proxy rights, which is frequently referred to as a restriction on the discretion of banks (Bundesverband Deutscher Banken, 1995; Schröder, 1995). A shift towards non-bank organizations like shareholders associations will occur only if these organizations employ comparable procedures to obtain proxy votes. However, in general shareholders associations do not posses sufficient resources to organise proxy votes. The share of the votes cast by shareholders associations in widely held public companies is lower than 0.3% in Germany (Baums, 1996). The 15 month limit is not very effective, because an alternative procedure can be used, which consists of granting the proxy right for each specific general meeting separately (Kümpel, 1995).

What are the motives for German banks to spend resources for soliciting proxy votes? Bank representatives argue that they do not adhere to proxy voting at all means, that the system is a reflection of the relationship of trust between banks and their customers, and that banks provide an important service through contributing to a stable majority at the general meeting (Bundesverband Deutscher Banken, 1995; Schneider-Lenné, 1995; Schröder, 1995). Yet, why do not banks charge the substantial services they provide? According to Baums (1996: 13), the most important reasons are the lack of shareholder monitoring incentives and competition on the market for share custody. The absence of shareholder incentives implies that the majority of individual shareholders is not willing to pay for the proxy voting services of banks. Competition prevents banks from imposing a general surcharge on the cost of keeping shares in custody because shareholders can switch to competing banks that do not provide proxy voting services and therefore charge lower costs.

If imposing costs on shareholders is not feasible, banks could abstain from providing these services or they could reduce their proxy voting activities to the bare minimum. Some smaller banks indeed can be observed to act in such a way. In contrast, the larger banks actively perform proxy voting activities, which suggests that the system also contains some advantages for the banks.

Baums (1996) suggests three types of benefits to banks from the system of proxy voting, which explain why banks would actively engage in proxy voting activities without charging costs to shareholders (see also Baums and v. Randow, 1995). Firstly, banks can obtain more easy entry to firms to sell financial services. For instance, empirical evidence shows that banks with large blocks of voting rights at the general meeting to a significantly higher extent are involved in share issue activities of the companies concerned compared with other banks. Secondly, proxy votes may provide a channel to stronger monitor companies in order to reduce the risk on credit or equity supplied by the bank. Thirdly, most of the large banks themselves are public companies with widely dispersed equity capital and proxy voting provides the management of banks with a substantial voting power on their own general meeting of shareholders[41]. For example, voting shares controlled by a bank on its own general meeting were 32% for Deutsche Bank, 44% for Dresdner bank, 18% for Commerzbank, 32% for Bayerische Vereinsbank and 24% for Bayerische Hypothekbank (Baums, 1996: 14). Adding the votes controlled by the other four banks give these five banks a combined majority vote at each of their individual general meetings.

[41] Proxy votes granted to a bank to be used at the bank's own general meeting face stronger legal control compared to proxy votes applying to other companies. Instead of granting the bank a general authorization, a shareholder has to inform the bank how to vote on each separate issue on the agenda. If shareholders do not explicitly specify their preferences their votes are lost. In practice banks ask shareholders to state their voting instructions two or three times if a shareholder does not respond.

The advantages of proxy voting to banks and the alleged influence of banks on enterprises has sparkled a debate in Germany on reform options for the system of proxy voting. Recent reform proposals range from completely abolishing the system to having independent agents administer and execute the voting system[42] (see Baums, 1996; Baums and v. Randow, 1995). It would take too far to thoroughly review that discussion here (see for instance Hammen, 1995; Peltzer, 1996). Some arguments raised against reform of proxy voting are that some proposals will be less effective because they require additional effort by individual shareholders to get informed on company policies or voting proposals by independent agents, that interests of banks and individual shareholders do not differ to such an extent that adjustment of the system is needed, that a considerable risk exists of a concentration of power by authorized agents and that reform proposals are costly.

A reason why proxy voting is rare in the Netherlands concerns the restricted power of the general meeting of shareholders compared to that in other countries (De Vijver, 1980). Under the Dutch structural model the supervisory board is appointed by cooption and opportunities for the general meeting to influence the composition of the supervisory board are restricted to proposing or rejecting future members (see Section 3.1). Moreover, Dutch companies utilize a considerable number of anti-takeover defences that shield managers from shareholders (see Section 3.4). These restrictions on the influence of shareholders on management imply that the revenues of a system of proxy voting would be relatively moderate. For the same reason, the risks are also small that shareholder minorities at the general meeting affect a company's policy to a large extent, which reduces the need for a system of proxy voting.

Three recent developments in the Netherlands have induced representatives of companies and the Stock Exchange to reconsider the usefulness of a proxy voting arrangement. Firstly, Dutch companies, shareholder associations and the government discuss proposals to lower anti-takeover defences (see Section 3.4). This will make a system of proxy voting in the Netherlands more effective. Secondly, institutional investors, which aim at increasing their shareholdings and their involvement in monitoring of companies (see Section 3.3), favour introduction of proxy voting in the Netherlands. Thirdly, some large internationally-oriented Dutch companies, headed by Akzo Nobel and Royal Dutch Shell, advocate proxy voting. Increasingly, large international companies turn to foreign capital as a source of

[42] An alternative suggestion, raised in the United Kingdom and the United States, to oblige institutional investors to vote at the general meeting would not be very effective in Germany because share ownership of pension funds is low (compare Table 6). This alternative would be more viable for the Netherlands, although it may be doubted whether increasingly activist Dutch pension funds really need a voting obligation (see Section 3.3).

finance. Foreign investors demand that they are represented through proxy votes. For instance, occasionally the Dutch Association of Equity Owners already acts as authorized voter for foreign shareholders. Hence, Dutch companies favour proxy voting because it will increase their access to foreign capital markets.

These three developments considerably raise the probability that proxy voting will be introduced in the Netherlands in the near future. However, it is unlikely that Dutch banks will become as active as German banks in administrating the system. Current thoughts involve a system in between the German and the Anglo-American model, in which a company itself contacts its shareholders and solicits proxy authorization[43] (Tamminga, 1996b). An independent organization will administer the system and will act as an intermediary between companies and the banks. Before the general election a company approaches that organization with the request to distribute a document on which the shareholders can give their votes among its shareholders. Upon request, banks will provide the organization with the names and addresses of the owners of the company's stock held in custody by the bank, conditional upon the owners' authorization. Banks will receive a financial compensation for these services. Companies bear the costs of the system. The bank will not act as authorized voter at the general meeting.

Bank representation on supervisory boards

Apart from holding voting rights at the general meeting of shareholders, German bank representatives participate on the supervisory board of companies. Yet, the number of seats on supervisory boards held by bank representatives is lower than might be expected on the basis of the voting power of banks at the general meeting on account of their own shareholdings and the proxy votes under their discretion. From Table 6 an estimate of shareholder votes under direct control of the banks in 1993 is at least the sum of 14.2% from banks own shareholdings and 16.6% through proxy voting on stock owned by households, which yields a total of 30.8%. According to Monopolkommission (1992: 235), in 1988 the number of private bank representatives on supervisory boards of the 100 largest companies equalled 6.4% (see also Table 8). After a rise to 8.3% in 1990, the percentage of private bank representatives has fallen to 7.2% in 1992 (Monopolkommission,

[43] In the United States and the United Kingdom equity capital in general consists of registered stock. This enables companies to be active in proxy solicitation (for more details see De Vijver, 1980; Blair, 1995; Monks and Minow, 1995). The United States stock exchanges even require companies to administer proxy solicitation, but have strongly regulated the soliciting procedures to prevent abuses. Before the general meeting shareholders may authorize a specific member of the board of directors of a company to represent them in voting.

1994: 232) and 6.3% in 1993 (Bundesverband Deutscher Banken, 1995)[44]. Even considering that shareholder representatives occupy half of the seats on the supervisory board (see Section 3.1: 49) these numbers are still relatively low compared to the voting power of the banks.

Despite the fact that because of their expertise bank representatives on supervisory boards may be influential, the data above indicate that their number is too small to completely determine decision making on the board, even if they act in concert. Yet, it is by no means self-evident that bank representatives act in concert. Edwards and Fischer (1994) cite several pieces of evidence showing profound competition between banks on the market for bank loans to enterprises[45]. The representation on supervisory boards is seen to provide no opportunities for banks to supply additional loans to firms. Moreover, data show that companies often invite representatives of competing banks to take a seat on the supervisory board[46] (see also Schneider-Lenné, 1992: 19). For example, besides Deutsche Bank, which owns nearly a quarter of the total stock of shares of Daimler Benz, also Commerzbank and Dresdner Bank are represented on the supervisory board, although the latter banks do not own any Daimler Benz equity (Schröder, 1995: 5).

Finally, to put the influence of private banks in perspective, the power of the supervisory board itself should not be exaggerated. It has been concluded above that the supervisory board is an influential body, but it is not that powerful and

[44] For 1979 Gerum *et al*. (1988) find a comparable figure of 8% among the supervisory boards of all 281 public companies with more than 2000 employees.

[45] Edwards and Fischer (1994: 234) also conclude: ‘This detailed analysis of the evidence provides no support for the claim that institutional features of the German system of finance for investment allow firms greater access to external finance at lower cost than in the UK’. Amongst others, the evidence analyzed by Edwards and Fischer concerns the relatively modest importance of enterprises with the two-tier system for bank lending, the lower share of equity finance compared to loan finance in Germany than in the United Kingdom, and banks’ response when firms are in financial distress.

[46] Bundesverband Deutscher Banken (1995: 28) presents additional quantitative information on bank representatives on supervisory boards. In 1993 supervisory boards existed in 89 of the 100 largest German companies. The other 11 companies had organisational forms that differed from a public or private limited liability company and therefore had no supervisory board. In 52 of the 89 companies private banks were represented on the supervisory board. From a total of 99 bank representatives it follows that on average two bank representatives are seated on a supervisory board, which generally contains 20 members. In 28 out of the 52 companies with bank representation, representatives of at least two competing private banks belong to the supervisory board. The chairman of the supervisory board is a bank representative in 14 companies.

Table 8 *The structure of supervisory boards in large German and Dutch companies*

	Netherlands	Germany	
Year of data	*1984*	*1986*	*1993*
Number of companies	*85.*	*84.*	*89.*
Number of seats	*650.*	*1466.*	*1561.*
Average number of seats	*7.6*	*17.5*	*17.5*
Composition of supervisory board			
Non-financial companies	*36.*	*25.*	*27.*
Block shareholders	*14.*	–[a]	–[a]
Former directors	*7.*	–[a]	–[a]
Banks and insurance companies	*13.*	*11.*[b]	*10.*[b]
Employee representatives	*11.*	*49.*	*49.*
Politicians and civil servants	*11.*	*5.*	*4.*
Lawyers, professors	*8.*	*10.*	*10.*

[a] *Data included in other categories: non-financial companies and banks*
[b] *Of which private banks: 8% in 1986, 6% in 1993.*
Source: Netherlands: Van der Knoop (1991: 164), Table 2, independent Dutch companies
Germany: Bundesverband Deutscher Banken (1995:28)

involved to strongly direct the actions taken by management.

Table 8 shows that the percentage of supervisory board seats occupied by representatives from banks and insurance companies is largely comparable in Germany and the Netherlands. In the table the Dutch figure (13%) is somewhat higher than the German percentage (11% in 1986). Disregarding the number of employee representatives the figures change to 15% (13/(1-.11)) in the Netherlands and 22% (11/(1-.49)) in Germany.

A difference between the two countries is that bank representatives in the Netherlands do not occupy a seat on a company's supervisory board because the bank owns a stake of the company's equity capital. Yet, frequently the bank does have a creditor relationship with the company concerned, also because Dutch managers do not prefer to have representatives from competing banks in the supervisory board (Van der Knoop, 1991: 131). In some companies the creditor relationship was the main reason to offer the bank a seat on the supervisory board. However, most companies value bank representatives because of their financial know-how and because they are knowledgable about specific sectors from their lending relationships with many companies. The latter argument is also a motivation for banks to take seats in supervisory boards, it broadens the view of the bank's directors on the enterprise sector. Another reason is that incidentally in case of large financial distress a bank, who has a large debt claim on a company, claims a seat on the supervisory board to guard its financial interests.

Several non-bank members of Dutch supervisory boards oppose the admission of bank's representatives because financial problems may cause conflicts between the interests of the bank and those of the company. That is one of the main reason why the number of banks representatives on supervisory boards has fallen over time in the Netherlands. Van der Knoop (1991) presents slightly adjusted data from De Boer (1957), which show that in 1955 23% of supervisory board seats were occupied by banks' representatives. According to Table 8 this figure has fallen to 13% in 1984.

Conclusion on bank governance

The above evidence on bank voting power and representation on supervisory board leads to the conclusion that banks play an important role but do not control the German public enterprise sector. Proxy voting strengthens the shareholder position of banks and enhances the monitoring role of banks from a shareholder perspective. Edwards and Fischer (1994) state that the position of banks in corporate governance fits into the general view of extensive cross holdings between enterprises in Germany. Gorton and Schmid (1996) empirically corroborate that conclusion. Firm performance is related to block holdings of majority shareholders in general, including banks, but no additional influence exists of share holdings by banks or through proxy voting (see Section 2.6: 38).

In the Netherlands, the role of banks and non-financial enterprises as shareholders is clearly much more limited. Dutch banks primarily monitor companies from a creditor perspective and in that sense are closer to Anglo-American banks. Consequently, Dutch banks do not face the risk of a weakening of their creditor position due to their shareholder position, as may be the case with German banks (see Section 2.2: 19).

Recent developments indicate that the creditor position of Dutch banks in corporate governance is shifting to some extent (see for instance, Tamminga, 1996a). Because companies expect a liberalization of legislation on anti-takeover protection[47], they pay more attention to investor relations and attempt to raise the interest of large banks in the equity capital of the company. At the same time Dutch banks become more engaged in equity finance. In some cases banks appear willing to take a minority position of 5% to 10% of the stock of shares, yet they

[47] See section 3.4 for a discussion of anti-takeover defences in Germany and the Netherlands.

emphasize that their creditor position is predominant and are reluctant to become strongly involved with the policy of the company. Share ownership is no reason for the banks to require a seat on the supervisory board, to want a say in the appointment of company directors, or to concern themselves with strategies of the firm. Banks consider their shareholdings mainly from a longer-term investment perspective. Dutch banks do not intend to sell their stock of shares if profits temporarily fall, but strive for an adequate rate of return on their equity investment over a longer-term period. Hence, selling shares becomes an definite option if longer-term perspectives of a company worsen.

3.3 Corporate governance by pension funds

Table 6 shows that the percentage of shares owned by Dutch pension funds (7.9%) considerably exceeds the percentage of shares owned by German pension funds (1.9%), while share ownership of insurance companies is largely comparable. The substantial extent of their shareholdings and the role of pension funds in corporate governance need further clarification. To what extent do Dutch pension funds influence decision making in large companies and how does their role compare to that of German banks?

Pension funds' share ownership

Shareholdings of German pension funds are small for three reasons. Firstly, the private pension system is relatively small because of the extensive public pension system. Secondly, the size of private pension funds is even smaller because on average two thirds of pension contributions are retained in companies. Assets of German pension funds and life insurance companies come down to only 5% and 16% of GDP, respectively. Thirdly, pension funds are risk averse to such an extent that they invest less than 10% of their cover stock in shares, despite the fact that the legal room for investment in shares equals 30% of their cover stock (Schneider-Lenné, 1992: 13).

In the Netherlands, a comparatively larger part of total shareholdings is in the hands of pension funds, because of the elaborate private pension system. Total assets invested by Dutch pension funds amount to 73% of GDP in 1992 (CS First Boston, 1993). The civil servant pension fund (ABP) is already worth nearly half of this sum. Adding another 40 %-points assets of life insurance companies yields total assets of institutional investors of 113% of GDP in the Netherlands. The comparable figure for the United Kingdom is 103% of GDP, divided into 59 %-points assets of pension funds and 44 %-points in the hands of life insurance companies.

However, in spite of the elaborate Dutch pension system the part of equity capital owned by pension funds is much smaller compared to that in the United Kingdom (34.2%) and the United States (20.1%). Related to the total cover stock, shareholdings by pension funds in the Netherlands merely comprise 14% of total assets, while the comparable figures for the United Kingdom and the United States are in the order of 65% and 45% respectively (CEPS, 1995). Since the former legal restriction for the civil servant pension fund that no more than 20% of the cover stock of the fund can be invested in shares has not been binding, this is mainly due to a risk-averse investment policy by the funds.

Currently the investment policy of Dutch pension funds is changing. An example is the civil servant pension fund, which has been privatized in 1996. The civil servant pension fund aims at raising the average return on its investments by one percentage point through an increase of its total equity investment from 13% of the cover stock in 1995 to 30% in 2000 (Barentsen, 1995b)[48]. Holdings of equity issued by Dutch companies are planned to increase from 7% to 10% of the cover stock. This implies that a number of the current participations of just below 5% of equity capital in about 40 Dutch companies will increase to some 8 to 10% (Bakker and Schlaghecke, 1995). Another aim of the fund is to participate in smaller securities and in venture capital. However, the main increase in shareholdings of the civil servant pension fund stems from foreign equity which is intended to increase from 6% to 20% of the cover stock.

The target of 30% equity investment does not imply that on a relative basis the civil servant pension will be among the highest equity investors of Dutch pension funds. For long the Shell pension funds has large equity investments. In 1993 57% of its cover stock consisted of equity. The pension fund for health care workers (PGGM), after the civil servant pension fund the second largest in the Netherlands, is increasing its equity investment at a vast rate (Barentsen, 1995a). In 1990 14% of that fund's cover stock consisted of equity. Equity investment has risen to 30% in 1995 and is planned to increase to 50% or 60% in the coming years.

Pension fund activism

The relatively large shareholdings of institutional investors in the Netherlands and the rising investment in equity by Dutch pension funds suggest that Dutch institutional investors might perform a role in corporate governance which is comparable to that of the German banks and non-financial enterprises. Indeed, developments in

[48] Privatization also implies that regulations facing the government pension fund are identical to those of company pension funds. Hence, the 20% restriction on equity investment has been cancelled.

the United Kingdom and the United States indicate that institutional investors become stronger involved in monitoring management performance (Bishop, 1994; Blair, 1995; Crist, 1995). A comparable development can be observed with the Dutch pension funds. Pension funds oppose the cumulation of anti-takeover defences applied by Dutch companies (for more details see Section 3.4), pay more attention to shareholder value of enterprises, and show an increasing interest in corporate policy and nomination of members of supervisory boards (Frijns *et al.*, 1995).

In particular the civil servant pension fund has thoroughly reconsidered its role as shareholder (Barentsen, 1995b). Exit options, i.e. the selling of shares if the performance of the company is disappointing, are not very attractive, because the stake of the fund in a specific company is so large that exit would drive down the share price. Therefore the fund aims at increasing the use of voice as a governance instrument to promote the interests shareholders by exerting influence on the composition of the supervisory board and the management board, on major mergers, takeovers or investments and on a companies' dividend policy. It will not confine itself to financial data to develop an opinion on the performance of the company, but also wants to become knowledgable on corporate strategies and the quality of management.

A comparison with Section 3.2 learns that the pension funds' stance in corporate governance differs markedly from that of Dutch banks. Both aim at long-term relationships with companies but banks emphasize their creditor position and are reluctant to become involved with company policy. In contrast pension funds more actively seek involvement in a company's strategic decisions.

The role in corporate governance of pension funds in the Netherlands also differs from the role of banks and non-financial companies in Germany. Firstly, the link between shareholdings and supervisory board representation in the Dutch structural model is much weaker compared to Germany. By consequence, pension funds have less direct means available to convince management of their views and will therefore frequently seek more informal contacts with management. Secondly, although Dutch pension funds do hold a long-term view and do not easily sell shares for short-term profits only, their interest in a company primarily follows from an investment perspective. This differs from the perspective of German firms, which also have commercial and technological links[49], and from the perspective of German banks, which are also associated to enterprises through their borrowing relations. Hence, increased pension fund activism primarily strengthens shareholder control of management in the Netherlands.

[49] See the discussion on contractual governance in Section 2.3.

Experiences in the United States provide some insight in the effectiveness of the corporate governance role of pension funds. In the second half of the 1980s and the early 1990s increased shareholder activism of pension funds in the United States improved management in some poorly performing companies (Blair, 1995: 170). According to proponents of pension fund activism, two important structural advantages of monitoring by pension funds are the solution of the free-rider problem and returns to scale (Blair, 1995: 173). The pension fund's equity stakes are large enough to make monitoring effective, which solves the free-rider problem that confronts small shareholders (see Section 2.2: 16). Pension funds achieve returns to scale if they are able to spread learning experiences with specific governance instruments over the broad range of companies in which they have invested.

In contrast, opponents raise two objections against active involvement of pension funds in corporate strategies: fund managers are no company directors and monitoring costs are excessive. Generally, fund managers have little entrepreneurial experience and face different incentives from company directors. Their career progress is less related to the performance of a specific company compared with that company's director. Involvement of the pension fund with corporate strategies invokes high monitoring costs because for each individual company the fund has to amass detailed knowledge of strategic variables such as product development, production processes, internal organization, technology, market opportunities, worker motivation, etc. (Blair, 1995: 183). Because these variables differ substantially between companies, returns to scale hardly exist.

Dutch pension funds recognize the boundaries between entrepreneurship and finance. Fund managers do not strive to take the place of company managers. For instance, the aim of the civil servant pension fund is to have a relatively small group of specialists monitor the companies in which the fund participates. These specialists will gather sufficient information on the performance and strategies of the companies to support the position of shareholders vis-à-vis management and other stakeholders, while maintaining the scope for management to control corporate strategies. The civil servant pension fund also does not aim at direct representation of fund managers in supervisory boards of companies (see Bakker and Schlaghecke, 1995).

3.4 The market for corporate control

Section 2.5 showed that hostile takeovers are one of the devices to discipline management in the Anglo-American model, while they are virtually non-existent in Germany. The first part of this section takes a closer look at concentrated shareholdings and institutions that shield German companies from hostile takeovers. The second part analyzes the position of the Netherlands and shows that intensive use of anti-takeover devices explains the absence of a market for corporate control. However, in the Netherlands parties involved have reached an agreement on measures to lower anti-takeover defences.

Germany's concentrated shareholdings discourage hostile takeovers

Hostile takeovers, in the sense of a stock market bid on the shares of an enterprise without the consent of its management, are rare in Germany (Charkham: 34). One obvious reason is that the stock market is relatively unimportant in German corporate governance (see Section 2.5: 31). Yet, also for listed companies hostile takeovers are difficult to effectuate in Germany. Large concentrations of shareholdings are in the hands of founding families, other enterprises or banks which, because of their long-term attachment to the company, choose the side of management and refuse to sell to a hostile bidder. In addition, the proxy-voting rights of banks imply that banks control a substantial number of votes on the annual general meeting, which also functions as a defence against a raider.

Moreover, various types of regulation thwart hostile take-overs. The most important of those is that 75% of the votes at a shareholders' meeting is required to replace shareholders' representatives on the supervisory board before their term of appointment ends (Edwards and Fischer, 1994: 191). The requirement of a 75% majority at the general meeting is the most important barrier to the control of the management of a firm. If all shareholders' representatives on the supervisory board favour the take-over, either voluntary or after being replaced by a raider owing 75% of the shares, replacement of the management board is no significant obstacle, since it can be effectuated by majority decision. Because shareholders' representatives constitute at least half of the supervisory board and because the chairman is a shareholders' representative and has a casting vote, shareholders can always effectuate a majority vote.

As an additional barrier to hostile take-overs, some public companies have a cap on voting rights at a shareholders' meeting, which means that the number of votes cast by a single share owner is restricted, regardless of the size of the stock of shareholdings. According to Baums (1990) 23 of the large public companies had limited voting rights, eleven of these were companies with a large dispersion of shares. However, voting caps offer no absolute protection because they can be circumvented by share owners acting in concert.

In the past a cap on voting rights has been justified as a protective measure against the gradual secret build-up of a large stock of shares in a company. In the second Financial Markets Promotion Act (Finanzmarktförderungsgesetz) of August 1994, German legislation on the disclosure of significant stocks of shares has been adjusted. Heretofore, disclosure was only required if stakes exceeded 25% of the total stock of shares. Under the revised legislation holdings above 5% have to be made public[50]. The change in German disclosure regulation is likely to increase pressure on firms to abandon caps on voting rights (Bishop, 1994). In that case, protection against hostile take-overs will weaken, but information on hostile take-over threats will improve.

The structural model and anti-takeover defences in the Netherlands

Hostile takeovers are uncommon in the Netherlands as well. The Dutch structural model of corporate governance acts as one of the defensive devices. Powers attributed to the supervisory board and the appointment of its members by cooption instead of by shareholders at the general meeting shield management from shareholders (Rietkerk, 1992). However, under certain conditions the structural model can be overruled in case of a hostile takeover or pressure can be exerted on the supervisory board to give in to the raider, for instance by objecting to the appointment of new members of the supervisory board or by refusing to approve the annual statement of accounts[51]. (Voogd, 1989: 249-269; Van der Grinten, 1990).

Two types of companies attempting a takeover and which have obtained 50% or over of a target company's equity capital, are able to render the target company's structural model inoperative. The first is a Dutch takeover company for which the structural model applies. Because the takeover company owns at least 50% of the target's equity capital, the target becomes a subsidiary of the takeover company. The structural model is not mandatory for subsidiaries of a holding that itself is covered by structural model. The second is a foreign takeover company that acquires a majority of the equity capital of a Dutch target company. If a company, where a majority of employees works abroad, owns 50% or over of the equity capital of a Dutch company the mitigated structural model applies (see Section

[50] Since 1992 a comparable law exists in the Netherlands, investors must disclose shareholdings of 5% or over and changes in participations.

[51] After a hostile takeover a majority shareholder may also exert considerable pressure on the management board and the supervisory board by deciding at the general meeting to pay out the difference between the companies stock market value and the nominal value of the stock of shares (Van der Grinten, 1990). Pressure turns into absolute power if as a consequence of that decision the value of the company's equity capital falls below the threshold of 25 million guilders, since this lifts the legal requirement to apply the structural model. The shareholder may also decide to liquidate the company. Upon liquidation management is dismissed and the shareholder receives all assets and liabilities. However these threats can relatively easy be countered by changing the articles of association and transferring the rights to pay out equity or liquidate the company from the general meeting to the management board or the supervisory board. Many structural public companies have introduced these changes.

3.1: 52). Under the mitigated model the supervisory board is still appointed through cooption, but the supervisory board neither appoints nor dismisses management. Therefore, the supervisory board cannot prevent the foreign takeover company to use its voting majority at the general meeting of shareholders to replace management.

Compared to Germany, Dutch companies are also more vulnerable to hostile takeovers. The cases described above show that the structural model offers no absolute defence against hostile takeovers. Furthermore, for a number of Dutch companies the common model is relevant, which offers no defence at all. Finally, holdership of shares is more widely dispersed in the Netherlands. Hence, as additional ways of defence Dutch companies utilize a range of other anti-takeover devices (Cantrijn *et al.*, 1993). Besides voting caps, these devices are not used in Germany.

Table 9 indicates that preference shares are most widely applied as defence mechanisms. Preference shares carry the same voting rights as ordinary shares but in addition give a right to a fixed dividend percentage before ordinary shareholders become entitled to dividend. Issuing preference shares discourages takeovers by reducing the voting power of ordinary shares at the general meeting. Often specific independent foundations, for instance aimed at protection of continuity of the company, own the stock of preference shares. The issue of preference shares can be temporary, after the threat of a hostile takeover has vanished preference shares can be withdrawn.

The second important anti-takeover device in the Netherlands, which also operates by curbing the voting power of ordinary shares, is issuing priority shares. The articles of association of a company can assign special rights to holders of priority shares, like proposing or preventing the appointment of particular new members of the management and supervisory boards, approving the issue of ordinary shares, liquidation of the company or changing the articles of association.

Thirdly, also relatively wide-spread in the Netherlands is the issue of tradable depositary receipts against the stock of shares. The company deposits its share capital at an administrative office, which instead trades depositary receipts on the stock market. Even if a raider obtains the majority of these depositary receipts, voting power at the general meeting still rests with the administrative office. Because the administrative office usually is a business connection of the company, a substantial anti-takeover defence has been raised.

Fourthly, Dutch legislation permits public limited liability companies under the common model to insert the clause in their articles of association that members of the supervisory or management board are to be elected by the general meeting from a binding nomination of at least two persons for every seat. Only a two-third majority at the general meeting can overrule the binding nomination. Because current members of the boards draft the nomination, their control of the composi-

Table 9 Anti-takeover defences of Dutch listed companies

Anti-takeover defences in 1992	*Number of defences*	*Percentage*
Preference shares	*105.*	*32.3*
Priority shares	*79.*	*24.3*
Depositary receipts	*70.*	*21.5*
Binding nomination	*64.*	*19.7*
Voting caps	*7.*	*2.2*
Total	*325.*	*100.*

Number of defences	*Number of companies 1992*	*1995*	*Percentage 1992*	*1995*
Zero	*16.*	*18.*	*9.1*	*11.1*
One	*52.*	*64.*	*29.4*	*39.5*
Two	*62.*	*67.*	*35.0*	*41.4*
Three	*39.*	*13.*	*22.0*	*8.0*
Four	*8.*	*0.*	*4.5*	*0.0*
Total	*177.*	*162.*	*100.*	*100.*

Source: 1992: Cantrijn et al. (1993: 28-29);
1995: van Frederikslust and van Veldhuizen (1996).

tion of the boards is strengthened. For the structural model this anti-takeover device is irrelevant, since members of the supervisory board are elected by cooption and subsequently appoint the management board.

As a fifth option, within certain bounds, voting caps are also allowed in the Netherlands. However, Table 9 shows they are only implemented by 7 out of 177 companies. The relatively modest use of voting caps is in accordance with the German situation. Voting caps have proven to provide insufficient defence because they can be circumvented by using straw-men at the general meeting. Bloemsma (1973) mentions the example of a large Dutch company, which founded 860 small limited liability companies to undermine the voting caps of a company it intended to take over.

Finally, anti-takeover devices like poison pills, crown jewels and greenmail are less common in the Netherlands. These became prevalent in the United States during the 1980s. Poison pills give shareholders certain conditional rights, which become effective in times of a takeover and significantly raise the costs of a takeover. An example is the right of the company to sell additional shares to current shareholders at a low price, which a raider subsequently has to buy against the much higher market price (Jacobs, 1991: 93). A reason why poison pill devices are less known in the Netherlands may be that they are usually kept secret until the threat of a takeover arises. Devices directed at crown jewels aim to cut the chain between the firm and its most valuable business unit, the crown jewel, which often is one of the main targets of a raider. For instance, a crown jewel of a company threatened by a takeover can be sold to a ‘white knight’ or protected by preference shares. Greenmail, *i.e.* sending the raider and envelope filled with dollars, entails the repurchase of the stock of shares already in possession of the raider at a higher price. It is not very effective in the Netherlands because repurchase of shares is only allowed to a maximum of 10% of the share capital.

Comparing the number of anti-takeover defences to the number of companies in Table 9 shows that a considerable number of companies apply several defences. The second part of Table 9 gives some additional information on the cumulation of anti-takeover defences in the Netherlands. About 90% of the companies listed at the stock exchange use at least one means of defence. In 1992 over 25% of the companies have implemented three or four anti-takeover devices. In 1992 the Amsterdam stock exchange sharpened its regulations somewhat and prohibited the cumulation of more than two anti-takeover defences. Table 9 shows that as a consequence the cumulation of defences decreased in the period 1992−1995.

Initiatives to lower Dutch anti-takeover defences

For a long time the wide-spread use of anti-takeover devices in the Netherlands has been in dispute. In the past, EU initiatives emphasized the necessity of increasing shareholder influence. Recently, Dutch shareholders and policy makers contemplate lowering the high defensive walls around Dutch companies.

Former EU initiatives, aimed at enhancing the position of shareholders in takeover cases, have recently been weakened considerably. The Bangemann proposals of May 1990 advocated banning of cooption, preference shares, priority shares and voting caps, and would have made Dutch companies largely defenceless against a contested bid (Coopers & Lybrand, 1990). Germany would be affected to a less extent because proxy voting, the power of the supervisory board to change the management board and stocks of shares owned by companies and banks would remain possible. The proposals faced strong opposition in the Netherlands by both employers’ organizations and unions (Iterson and Olie, 1992: 102), because the revision of EU directives would not reach a level playing field across EU member countries. The Dutch equity market would become very close to the free market in the United Kingdom, whereas in many other countries non-juridical defences would remain effective. In 1992, the EU summit in Edinburgh effectively withdrew the Bangemann proposals. Regulation of takeover activity was considered the responsibility of national governments under the subsidiarity principle. February 1996 proposals for the thirteenth EU directive contain a set of minimum conditions, which provide much room for EU member states to define detailed regulations themselves.

In 1994 the discussion intensified. The Ministry of Finance signalled the parties involved that it would adjust legislation to diminish the use of anti-takeover devices unless the parties would present acceptable alternatives themselves. After lengthy discussions, in February 1996 the Amsterdam Stock Exchange, the Association of listed companies (Vereniging van Effecten Uitgevende Ondernemingen) and the Ministry of Finance agreed on the contents of new regulations that still have to be put forward to Parliament. The agreement opens the possibility that under specific conditions a company's barriers against hostile takeovers can be removed.

Two main features typify this agreement: a substantial waiting period until a takeover procedure starts and an important role for the Chamber of Company Law (Ondernemingskamer), the Dutch court specialized in corporate law. A majority shareholder must own 70% of a firm's equity capital for a successive period of one year before being allowed to start a legal procedure to pull down anti-takeover defences. After that period, the majority shareholder appeals to the Chamber of Company Law. The court tests the shareholder's request both against procedural and intrinsic criteria. Procedural criteria concern the way the shareholder has obtained a majority holding and the integrity of the majority shareholder. Intrinsic criteria relate to the financial, economic and legal consequences of planned policies by the majority shareholder and by current management. The court asks a commission of three experts for advice on all relevant facts and intentions in the fields of business, finance and the social aspects of the takeover. The court will ordain the removal the company's anti-takeover defences if the planned policies of the majority shareholder are not essentially incompatible with the interests of the target company. Important criteria specifying the interests of the target company are the continuity of the company and the position of employees. The court may reject the majority shareholder's request if in the past the shareholder has liquidated a company without an economic justification or if the shareholder plans to reduce employment without an economic justification.

As a response to these initiatives, increasingly Dutch companies pay more attention to investor relations and turn to institutional investors to place blocks of their equity capital. An example is KNP BT, with 29,000 employees the fifth largest manufacturing company in the Netherlands and active in paperware, packaging, and office supplies. KNP BT aims at strengthening the long-term relation with block shareholders. Over 50% of its stock of shares is owned by insurance companies, pension funds and multinational companies (Tamminga, 1995a). In February 1996 Ahold (retailing) and DSM (chemicals) placed blocks of preference shares with several large institutional investors. Other companies led the way; during the preceding years ABN-Amro, Hagemeyer, Hoogovens, ING, NBM-Amstelland took analogous steps.

Investment in block shareholdings indicates that a shift is taking place in the Netherlands towards more concentrated shareholdings. At first sight this seems comparable to the German model, yet a substantial difference remains. Dutch companies issue preference shares, while in Germany banks own ordinary shares. Preference shares are attractive for Dutch banks and insurance companies, because they carry a high and nearly guaranteed dividend, which is free from dividend taxation if the block of shares at least equals 5% of a companies' equity capital[52]. In a sense, investment in preference shares is in between debt financing and pure equity financing. This may be an additional attractive feature for Dutch banks-insurance companies, which emphasize their creditor position in corporate governance. However, some features of these preference share issues seem less attractive. Preference shares of Hoogovens and DSM are not easily transferable on the market. These preference shares carry the condition that if an institutional investor wants to sell them, they have to be offered to the company first. In this way an additional juridical takeover barrier has been raised and block shareholders lack the disciplining instrument of threatening to sell their block of equity on the market. The high dividend is needed to offset this disadvantage from the perspective of the shareholder. Apparently, companies are inclined to pay a mark-up for additional protection. Yet, according to the intentions of the February 1996 procedure to remove anti-takeover barriers, the Chamber of Company Law has to be able to overrule these juridical barriers. Under the agreement only block shareholdings that are freely tradeable on the market can offer protection against hostile takeovers. In that case there always is a final option for institutional investors to sell stock of a company with incompetent management and allow management to be replaced.

3.5 Institutions affecting stock market performance

The two additional corporate governance institutions addressed in this section affect the performance of the stock market. Strong regulations on insider dealing enhance credibility of stock market transactions. Accounting rules and practice affect the possibility for shareholders to derive an accurate view on the financial position of the company from its financial reports.

Insider dealing

In the past, little attention has been paid to insider dealing on the stock market in Germany. Hardly any formal sanctions existed and self-corrective actions only

[52] Preference shares are not particularly attractive for pension funds, because all returns on investment of pension funds are free from taxation.

occurred after a deal had been exposed to publicity in the press. Since August 1994 heavy fines, up to five years of imprisonment, have been put on insider dealing in Germany. These legal reforms aim at enhancing the attractiveness of German stock markets to foreigners and raise their efficiency. A Federal Supervisory Office for Securities Trading (Bundesaufsichtsamt für den Wertpapierhandel) has been founded to monitor share transactions and publication of information by companies relevant to shareholders. If necessary, the Office can demand confidential information from banks or companies to track down insider dealings. Besides the Federal Supervisory Office every German Land with a regional stock market has its own supervisory body for stock market transactions (Börsenaufsichtsbehörde) and every market place its own trade supervisory body (Handelsüberwachungsstelle). This division of authorities on the one hand prevents organizational blindness but on the other hand entails the danger of a lack of coordination (WirtschaftsWoche, 1995). Activities of the Federal Supervisory Office for Securities Trading resulted is some recent convictions for insider dealing in Germany.

A 1989 legal provision in the Dutch criminal code prohibits insider dealing (Amsterdam Stock Exchange, 1994). Since 1992 this provision is part of the more general Act on Supervision of Securities Trading. Implementation of the Act is based on the system of self-regulation. The independent Office on Supervision of Securities Trading monitors transactions on the stock exchange and can commission the Bureau of Control of the stock exchange to investigate specific cases. Yet, in some recent cases prosecution was not very successful. The Dutch government and the Office on Supervision of Securities Trading consider measures to increase the effectiveness of investigation of insider deals. The measures will streamline the investigation procedure and will expand the investigation department at the Ministry of Economic Affairs.

Preventing insider dealing also gains importance because of the increasing use of management stock option plans (compare Section 3.1: 64). In the United States and the United Kingdom managers must disclose their transactions in shares issued by their own company. Such openness does not exist in Germany and the Netherlands. In the Netherlands disclosure of personal transactions does not comply with privacy legislation. Current regulation and increased effectiveness of the investigation procedure are the main instruments applied to tackle insider dealing.

Accounting

Accounting practices are related to corporate governance because differences in accounting rules influence the insight outsiders can obtain in firm performance. German and Dutch accounting practices differ considerably. Nobes (1992) distinguishes two main classes of accounting measurement systems and various subclasses (see Beckman, 1993; Offeren and Wanders, 1993). He categorizes Germany and the Netherlands in different main classes. The Dutch system fits within the class of Anglo-American countries. Accounting is micro-based and commercially driven. The main purpose is to present a ‘true and fair view’ of the financial position of the company and its profits. Within this class a dividing line can be drawn between the United States, where the ‘generally accepted accounting principles’ (US-GAAP) of the Security and Exchange Commission (SEC) comprise a detailed and strict set of regulations, and the United Kingdom and the Netherlands, where regulation only offers a general framework with much room for own interpretations. In particular in the Netherlands the high degree of accounting deregulation leads to a substantial diversity of practice (Beckman, 1993). The class to which Germany belongs is characterized by a macro orientation driven by government rules, in particular related to taxation. The main purpose of accounting is to comply with these rules. In Germany financial and fiscal accounting have to correspond. Fiscal regulations considerably drive accounting practices, which consequently can be typified as adhering to the principle of commercial prudence (Offeren, 1992; Charkham, 1994: 31). Firms create reserves for commercial risks and reduce taxable profits by reducing the value of their assets through quick depreciation or by adding reserve amounts to their balance sheets.

International differences in accounting practice to a large extent blur the information provided by the companies annual report and substantially complicate an international comparison between firms. Wanders (1992) shows depreciation rates for buildings, plant and equipment of Volkswagen (Germany) to be 2−4%, 5−12.5% and 12.5−16%, respectively. For Allied-Lyons (United Kingdom) depreciation rates are much lower (0, 2.5 and 4−8%) and depreciation practice at Akzo (the Netherlands) is in between (3−5, 3−5 and 10%). Offeren and Wanders (1993) present some insight in the large reserves of German companies. Excluding pension provisions reserves of the German firms Veba, Daimler-Benz and BMW comprise respectively 29.7, 26.1 and 20.6 percent of their balance sheet total. For the Dutch firms Philips and Akzo and the Anglo-Dutch Unilever the corresponding figures are 12.5, 8.8 and 5.3%. Charkham (1994: 31) cites an Ernst & Young accountant, who estimates that German accounting rules give rise to 30% lower profits in comparison to United Kingdom accounting regulations. If the information on reserves and rates of depreciation would be entirely transparent to the stock market, relatively high retained profits would manifest themselves completely in high share prices. However, the main difficulty is that it is impossible for outsiders to adjust the figures from companies seated in different countries and bring them on a common base (Offeren and Wanders, 1993). The scant information provided by the companies annual report is insufficient for this purpose. And although by German law shareholders have the right to ask for information at the general meeting, information on reserves and taxation are excluded from this right (WirtschaftsWoche, 1994).

German accounting regulations and practice can be regarded not only to pay attention to shareholders' interest but also to the interest of other stakeholders in the firm. From the perspective of shareholders who are mainly interested in the current stock market value of the firm, lower profits reduce the value of their shareholdings. Insufficient knowledge about the extent of undervaluation of a company because of high reserves and high depreciation rates applied at present and in the past, distorts the information of an outsider and raises the risk of a hostile bid not being in accordance with the real value of the firm. From the perspective of block shareholders and employees who have an insight in the financial position of the company through their representation on the supervisory board, the emphasis on the longer term instead of current profits is a valuable aspect of German accounting practice. However, these advantages heavily depend on the competence of the supervisory board to monitor financial performance, because opaque accounting information strengthens the power of management and raises the risk of late notification of financial distress signals.

Recent shifts in German accounting towards more adequate disclosure of information to shareholders, are driven by the internationalization of German companies and by a reorientation towards the stock market as a source of investment capital. The accounting standards of the United States SEC are extremely rigorous. The accounting practice of ten Dutch companies satisfies the SEC standard (Wall Street Journal, 1995). In contrast, only one German company, Daimler-Benz, has met this standard and has obtained a listing at the New York Stock Exchange. This is not only low compared to the Netherlands but also compared to other European countries[53]. Currently, a number of German companies such as Schering, Bayer, Hoechst, Siemens, Veba, are adjusting their accounting practice towards the international standard, which is less demanding compared to the SEC standard[54], and are trying to convince the SEC to accept this standard for obtaining a listing in the United States. The objective to appeal to the international stock market for the planned privatization of Deutsche Telekom is a further factor and has also contributed to a change in attitude of the German Ministry of Justice towards more shareholder-oriented accounting.

[53] In comparison, the number of SEC registered companies equals 52 in the United Kingdom, eight in France, seven in Italy, and Spain, and six in Ireland an Sweden.

[54] The international standard was devised in London in 1987. In contrast to the German accounting practice it requires disclosure of reserves and pension fund commitments. The SEC standard is still more demanding in requiring a more strict treatment of goodwill and oil and gas reserves.

3.6 Assessment

Table 3 summarizes the main features of corporate governance institutions in Germany and the Netherlands. Table 10 presents an overview of the strong and weak elements of German and Dutch corporate governance institutions. The assessment in this section closely follows the structure of Table 10.

Effectivity of specific governance structures

Concentrated shareholdings in Germany imply that representatives of block shareholders primarily monitor management. Section 2.6: 38, shows that such a shareholder structure is suited for monitoring long-term relationships in well-established industries with incremental technological change. The dispersed holdings of Dutch firms' equity capital offer few incentives to effectively monitor management (see Section 2.2: 16).

The influence of shareholders on Dutch companies is small also because the structural model shields the supervisory board from shareholders, while the supervisory board elects the management board. A system of cooption determines the composition of the supervisory board, *i.e.* current members elect new members of the board. Consequently, the future quality of the supervisory board primarily depends on the quality of the current board and of the management board. Accordingly, shareholders have very little means to change incompetent behaviour of supervisory and management boards.

For a high-quality company with a competent supervisory board the Dutch model may dominate German model. In particular, the presence of employee representatives reduces the effectivity of supervisory board activities in Germany. Companies are inclined to reduce the responsibilities of the board towards the legal minimum to limit the influence of worker representatives. Moreover, shareholder representatives do not like to criticise management in the presence of employee representatives. Furthermore, management fears a loss of confidentiality of information presented to the supervisory board.

The position of German banks in corporate governance fits the concentrated share-ownership structure of German corporations. Banks' concentrated shareholdings add to those of other companies. In contrast, bank share ownership diminishes the efficacy of creditor control (compare Section 2.2: 19). Dutch banks do not own substantial blocks of shares. Instead Dutch banks monitor management from a creditor perspective. Monitoring by creditors mainly is relevant for small and medium-sized firms (see Section 2.2: 17). Large firms can reduce the risks to lenders in alternative ways. Indeed, monitoring by banks is relatively unimportant for large Dutch companies.

Table 10 *Strengths and weaknesses of corporate governance in Germany and the Netherlands*

	Germany	*The Netherlands*
Shareholder control		
Structure of shareholdings	*concentrated holdings promote long-term view*	*dispersed holdings, no monitoring by block shareholders*
Supervisory board	*co-determination reduces effectivity*	*shareholders not able to influence quality*
Managerial shareholdings	*not significant*	*not very effective*
Creditor control		
Creditor position	*constrained by share ownership*	*strong*
Bank shareholder position	*part of monitoring by block shareholders*	*small*
Proxy voting	*enhances monitoring by block shareholders*	*no role aspired*
Governance by pension funds		
Monitoring	*negligible*	*institutions constrain effectivity*
Activism	*negligible*	*active in strengthening shareholder position*
Hostile takeovers		
Anti-takeover defences	*highly effective,* *based on cross holdings,* *no juridical barriers*	*highly effective,* *removal of juridical barriers requires a complex procedure*
Specific regulations		
Insider dealing	*some convictions*	*no convictions since 1989*
Accounting	*blurs shareholder information*	*largely shareholder oriented*
General assessment		
Corporate governance	*maintained by concentrated shareholdings*	*weak shareholder control, strongly dependent on quality supervisory board*
Future developments		
Regulation	*reform proxy voting (?)*	*some improvements by* *− lowering anti-takeover barriers* *− introduction proxy voting*
Enterprises	*supervisory board committees* *improve accounting*	*aim at block holdings*

Dutch pension funds already own relatively large amounts of equity capital in a number of Dutch companies and are enlarging their equity investments. Hence, pension funds' role in corporate governance is expanding in the Netherlands. Evidence from the United States shows that pension fund activism can improve poorly performing management. Dutch pension funds aim at moderate involvement in corporate strategies and specialist monitoring of company performance to strengthen the shareholder position in companies in which they participate.

Anti-takeover barriers take different forms in Germany and the Netherlands. In Germany, concentrated shareholdings constitute an effective anti-takeover barrier. Also in the Netherlands anti-takeover defences are highly effective. However, defences are mainly of the juridical type. Cooption of the supervisory board makes the structural model act as an anti-takeover defence. The structural model is supplemented by various other defences, including preference shares, priority shares and binding nominations. In February 1996, an agreement has been reached between the Ministry of Finance, the stock exchange and the association of listed companies that enables the court to remove anti-takeover barriers if a majority shareholder held 70% of a company's equity capital for at least a year and if the business plan of the majority shareholder is compatible with the interests of the target company. This agreement allows juridical barriers against hostile takeovers to be removed, albeit at considerable effort.

Overall assessment and future developments

In the Netherlands, the position of shareholders is relatively weak, since neither large stakeholders nor the stock market control management. In Germany, representatives on the supervisory board of non-financial firms and banks that own considerable cross-holdings of equity monitor management. Share ownership in the Netherlands is dispersed. Consequently, monitoring by block shareholders is largely absent. In that respect the Netherlands is similar to the United States and the United Kingdom. In contrast to the Anglo-American model, however, also the market for corporate control is absent in the Netherlands. Cooption of members of the supervisory board and extensive use of anti-takeover defences substantially limit the influence of shareholders on management. The exit option, i.e. selling their stock of shares, is the only way shareholders of Dutch companies can oppose company policy.

Hence, the Dutch institutions neither encourage potential stakeholders to engage in active long-term financial relationships with Dutch companies, nor do they strongly enhance a flexible reallocation of financial capital and risk-sharing finance through the stock market. Consequently, Dutch corporate governance institutions do not support incremental technological change in established companies, the main strength of the German model. They also do not strongly promote the financing of innovative emerging technologies, the main strength of the Anglo-American model.

Corporate governance of Dutch enterprises depends primarily on the quality of the supervisory board. The quality of the average Dutch board does not seem to be lower than the average German supervisory board. The variance of the quality distribution in the Netherlands may be larger, because shareholders have little means to change incompetent management and supervisory boards.

Although direct shareholder control is weak in the Netherlands, competition in the product market may serve as an additional disciplinary device. The Dutch economy is very open to foreign competition. Many large listed companies compete on the world market. Thus, competition prevents management from engaging in empire building activities.

The German corporate governance institutions also contain some weak elements. Information flows constitute a weak feature of corporate governance in Germany. Joint representation hampers information flows between management and the supervisory board. Moreover, accounting standards do not adequately present information to shareholders. However, German companies are improving accounting information in response to internationalization of product markets and financial markets. Also the performance of supervisory boards is under discussion. Performance may be improved by installing subcommittees, such as an audit committee, a nominating committee and an investment committee. These subcommittees may resolve some of the problems caused by joint representation of shareholders and employees on German supervisory boards.

Recently proposals have been put forward that will lead to some improvements of corporate governance in the Netherlands. Several large institutional investors demanded adjustment of Dutch legislation to improve shareholder control. Also foreign investors pressed for larger influence of shareholders on company policies. Recently, the Dutch government has reached an agreement with the parties involved on a proposal for new legislation. According to this agreement, juridical anti-takeover defences can be removed by court order, but only after a lengthy and complex procedure. Companies have responded by investing in longer-term relationships with block shareholders. This will remain a viable defence mechanism under the new legislation. However, block equity holdings mainly consist of preference shares, some of which are not freely tradable on the market. Insofar as the latter category of block holdings comprise new anti-takeover defences, they are against the intention of the new regulations.

4 Work governance in Germany and the Netherlands

German workers have a strong voice in managerial decision-making. Workers' representatives have access to firm-specific information, advise employers on business policy and co-decide on personnel matters. German co-determination or 'Mittbestimmung', which is defined here as the institutionalized influence of worker representatives on management, takes place through two different channels. At the enterprise level, worker representatives are present on the supervisory board of most public or private limited liability companies. In addition, workers in many firms are represented at the work-floor level through works councils.

In comparison to the lack of co-determination arrangements in the United States, the Dutch system of co-determination is broadly similar to that in Germany. The interests of American workers at the firm level are, if at all, protected by trade unions. Works councils are not compulsory and direct employee representation on the board of directors does not exist (Hepple, 1993; Biagi, 1993; see also Section 2.6: 42, for a comparison of work governance institutions in Germany and the United States). From a European perspective, Dutch co-determination is relatively close to the German system as well, since co-determination is extensive in both countries (Turner, 1993: 73). However, a closer look reveals that both systems differ. In the Netherlands, workers are not represented on the supervisory board and works councils are not compulsory in small firms (see Table 11 for a summary). On the other hand, Dutch works councils have more influence on managerial financial-economic decisions regarding reorganisations, mergers, etcetera.

The organisation of this section is as follows. Section 4.1 and 4.2 focus on German and Dutch co-determination institutions, respectively. Section 4.3 compares of German and Dutch co-determination institutions, whereas Section 4.4 examines profit-sharing arrangements that can promote the functioning of co-determination. Based on an assessment of worker influence on management and its impact on performance, Section 4.5 draws conclusions and provides mutual lessons to be learned.

Table 11 Indicators of co-determination

	United States	Germany[a]	Netherlands[b]
	in % of workers		
Workers represented on supervisory board	_	26.5	_
Presence of works council is employee right	_	85.2	68

[a] 1980. Streeck (1984: 404), Niedenhoff (1990: 14).
[b] 1995. Statistics Netherlands, rough estimate, private sector workers in firms with 35 workers or more.

4.1 The German system of co-determination

The first and second subsections of this section describe the two types of German co-determination institutions: worker representation on the supervisory board and co-determination at the work-floor level. The third subsection addresses the integrated character of German co-determination and the position of trade unions.

Co-determination at the enterprise level

Co-determination at the enterprise level is closely related to corporate governance, since it takes place through worker representatives on the supervisory board (Aufsichtsrat) who supervise management together with shareholder representatives. The size, sector and legal form of enterprises determines which part of the supervisory board consists of workers' representatives (Table 12). Worker representatives on the supervisory board have two main tasks: they control management together with shareholders, but also promote the interests of the workers they represent (Section 3.1).

Co-determination through workers' representation on supervisory boards was first introduced in 1951 (Co-determination Act of 1951) for the coal, iron and steel industries, where arrangements are still most strict: parity representation is required, which means that half of all board members consist of workers' representatives and the other half of shareholders' representatives. One additional member, the chairman, is co-opted by the entire supervisory board in order to prevent a deadlock of votes (Streeck, 1984: 393). Moreover, the management board needs to contain a worker representative, i.e. the labour director or 'Arbeitsdirektor', whose appointment is approved by the worker representatives on the supervisory board (Streeck, 1984 or Smith, 1994). However, this particular Co-determination Act is now of limited importance because employment in this industry has declined (Jacobi *et al.*, 1992).

Soon after the introduction of co-determination in the coal, iron and steel industries, participatory management was extended to other industries: The Works Constitution Act (WCA of 1952) required worker influence on the supervisory boards. However, requirements were less strict compared to those in the coal, iron and steel industries, as only one third of seats was allocated to worker representatives (Table 12). The main principles of this Act are still valid today (WCA of 1972).

Co-determination rights were further expanded during the 1970s. In particular, near-parity representation on the supervisory board and the presence of a labour director became obligatory for very large firms in all sectors (Co-determination Act of 1976). Small differences to the parity model according to the Co-determination Act of 1951 (which still applies to the coal, iron and steel industries) remained: the

Table 12 Worker representation on the German supervisory board

Legal form	*Firm size (number of workers)*			
	1-500	*501-1000*	*1001-2000*	*2001-*
Public limited liability company	_[a]	*1/3*	*1/3 (1/2)*[b]	*1/2*
Private limited liability company	_	*1/3*	*1/3 (1/2)*[b]	*1/2*
Unlimited liability company	_	_	_	_

Sources: Gurdon and Rai (1990), Streeck (1984), Koene and Slomp (1991), Niedenhoff (1990)
[a] *Founded after August 10, 1994.*
[b] *In brackets: parity applying to coal, iron and steel industry.*

casting vote of the chairman is held by a shareholder representative, which implies near-parity instead of parity. Moreover, the labour director is appointed in the same way as other managers, namely through voting of the entire supervisory board (Streeck, 1984: 401).

The importance of the different co-determination arrangements depends on the number of workers in different types of enterprises. By the end of the 1970s, 26.5% of all workers (or approximately 30% of all private sector workers) was employed by a company that required worker representation at the enterprise-level (Table 11). The one third formula applied to 4.3% of all workers, near-parity representation to 19.6% and parity representation to 2.6% (Streeck, 1984: 404).

Co-determination at the work-floor level

Co-determination at the level of the work-floor involves daily management issues and is therefore considered to be more influential than enterprise-level co-determination (Turner, 1993: 63). Moreover, in contrast to enterprise-level co-determination, the advancement of worker interests is the only objective of worker representatives at the work-floor level. Institutionalized participation at the work floor takes place through works councils. These councils are particularly influential regarding social or personnel policies (with the exception of wage formation), but weaker in relation to business strategies (Jacobi *et al.*, 1992: 243).

Workers in private-sector plants that usually employ six or more workers have the legal right to start a works council. The employer is required to support the establishment of a works council (Jacobs, 1993: 167). This right applies to approximately 85% of the total number of employees[55] (Table 11). The works council is elected by all employees of minimal 18 years old. Only workers who have worked within the firm for a period of at least six months can be elected (Jacobs, 1993: 168).

The regulations on works councils stem from the 1950s (Works Constitution Act of 1952)[56]. During the 1970s, the influence of works councils slightly expanded, for instance through enlargement of the works councils (Works Constitution Act of 1972). Nowadays, works councillors have information, consultation and co-decision rights, but these rights are related to the obligation to work with managers in a way which benefits both the workers and the company. For instance, works councillors are not allowed to organize a strike (Niedenhoff, 1990).

Compared to information or consultation rights, co-decision rights give workers most influence, because management cannot implement particular changes without approval of the works council. Co-decision rights apply to personnel policies related to hiring and firing, transfers, employee training, work environment, working hours, holiday arrangements, performance monitoring and remuneration policies, *e.g.* bonuses, piecework rates (Turner, 1993; Jacobs, 1993: 174). If an agreement cannot be reached, an internal settlement board ('Einigungsstelle') provides binding arbitration. These rights are combined with access of councillors to the relevant firm-specific information.

As regards financial and economic matters (such as re-organisations or the introduction of new technologies) the influence of the works council is confined to information and consultation rights. These rights apply to works councils in firms with 20 or more workers (Koene and Slomp, 1991: 116). Influence of the works council is limited because the worker representatives on the supervisory board are viewed as the main institution for worker influence on financial and economic decisions. Consequently, consultation rights are restricted to the social consequences of managerial decisions (Jacobs, 1993: 173). Management should inform the works council in advance and has to listen to comments and suggestions of works councillors. For instance, in the case of mass lay-offs the works council has to be informed in advance and has the right to give advice about alternative solutions. Once this procedure has been followed, the works council is entitled to negotiate a social plan for redundant workers. These negotiations can be very

[55] This figure includes the public sector, where parallel legislation exists regarding "staff councils" that have somewhat less influence: co-determination over social issues is similar but there is no right to information on business policy (Jacobi *et al.*, 1992).

[56] The first German co-determination laws already existed at the end of the 19th century. In 1933 every form of co-determination was abolished. After the war, arrangements were re-established and further developed (Niedenhoff, 1990).

detailed and often include compensation schemes and retraining measures (Niedenhoff, 1990).

Integration and interaction with trade unions

The two channels of co-determination can be seen as an integrated system of worker representation. Communication between works councillors and worker representatives on the supervisory board is common practice (Streeck, 1984; Koene and Slomp, 1991). Moreover, worker representatives on the supervisory boards are often also members of works councils. The relationships between the supervisory board and the works council improve the access of works councillors to information regarding investment strategies and of the supervisory board to work-floor information.

Co-determination affects worker influence through trade unions and vice versa. Firstly, trade-union power has facilitated the development of co-determination institutions, since trade unions generally favoured worker influence at firm and plant levels. According to Turner (1993), legal co-determination rights cannot easily be developed in countries with little trade-union power. Secondly, the various channels of worker influence are intertwined. Formally, works councils are independent of trade unions, but in practice they are dominated by trade-union members. Consequently, trade unions have an indirect say at the work-floor level. In large firms, one or more worker representatives work full-time for the works council, and these councillors are often trade-union members (Jacobs, 1993: 170). In contrast, the direct representation of trade unions at the work floor is only weak. Trade unions attempted to set up a distinct system of work place representation through local trade-union representatives, but in many cases this was not successful (Smith, 1994: 301). Therefore, a major work-floor task of trade unions is to support the functioning of works councils (Biagi, 1993).

The degree of integration of trade unions and co-determination arrangements poses the question which objectives predominate: general trade-union objectives or the interests of workers in a particular firm. As works councils are dominated by trade-union members, they are often "vehicles for the expression of union interests" (Turner, 1991: 96). However, councillors tend to "identify with their company" and to protect the position of insiders. Therefore, in case of discrepancies between general trade-union objectives and the firm’s direct interests, the latter tend to prevail (Smith, 1994: 302; Streeck, 1984: 398)[57].

[57] For instance, some works councils in the car industry have recently agreed to work on Saturdays, although this contradicted trade-union policy.

4.2 The Dutch system of co-determination

This section compares the Dutch institutions regarding co-determination at enterprise and work-floor level to those in Germany.

Co-determination at the enterprise level

Dutch co-determination at the enterprise level is virtually absent. Members of the supervisory board are elected by the general meeting of shareholders (common model) or appointed through cooption (structural model), but are not elected by workers directly (see Section 3.1: 52). Members of the supervisory board can be shareholders but, in contrast to the German situation, employees of a firm are prohibited to occupy a seat on the firm's supervisory board (Van het Kaar, 1995).

Only in large firms to which the structural model applies[58], employees have an indirect say in the composition of supervisory boards. In particular, works councillors are allowed to advise on the appointment of new members (Van het Kaar, 1995: 16). If the works council in these large firms disagrees with the appointment of a particular supervisory board member, the appointment is cancelled, unless the opinion of the works council is overruled in court at the Chamber of Company Law (Ondernemingskamer), the Dutch court specialized in corporate law. Moreover, it is common practice but no legal right, that at least one member of the supervisory board has somewhat closer connections to the works council because that member is concerned with social aspects or is recommended by the works council (Koene and Slomp, 1991: 48-49; Van het Kaar, 1995).

Co-determination at the work-floor level

Regulations concerning co-determination at the work floor stem from 1950 (Works Council Act or WOR). At that time, works councils became compulsory for firms with 25 workers or more (Vanwersch *et al.*, 1993). They had an advisory task and were directed at the interests of the entire enterprise. In 1979 their influence was strengthened. Works councils became an instrument directed at the protection of workers' interests (WOR 1979). As in Germany, they obtained co-decision rights on social and personnel policies (Albers, 1995; SER, 1991: 106), for instance regarding hiring and firing[59], transfers, employee training, work environment, working hours, holiday arrangements, performance monitoring and remuneration

[58] Section 3.1 describes the specific conditions that pertain to the structural and the common model in the Netherlands.

[59] Co-decision does apply to firing policies in general but not to individual dismissals.

policies (e.g. profit sharing, pension plans). As in Germany, co-decision rights do not apply to wage formation.

The employer has to consult the works council in advance on matters of business policy, such as important organisational changes and investments (SER, 1991: 104), as well as on the appointment and dismissal of directors and higher staff (SER, 1991: 108; Teulings, 1987). The advisory rights of work councils are more extensive than those in Germany. A Dutch employer must consult the works council on any ‘important’ economic decision (Jacobs, 1993; Teulings, 1987: 2; Biagi, 1993; Vanwersch *et al.*, 1993). In contrast to the situation in Germany, the advisory rights not only pertain to the social consequences of a decision but also to the decision itself.

From an international perspective, legal advisory rights are strong. The works council can appeal at the Chamber of Company Law if it is not rightly consulted, presumes that the interests of all stakeholders in the firm are not carefully taken into account, or is convinced that managers should not have disregarded its advice (SER, 1991: 105). If management has neglected advisory rights or if managers did not sufficiently consider the interests of all stakeholders, the Chamber of Company Law often prohibits implementation of a particular management decision. In contrast, if the works council has been consulted but its advice has not been followed, appeals by the works council are hardly ever successful. Accordingly, advisory rights rarely stop an investment plan, although the works council sometimes succeeds in changing business policies, especially in case of reorganisations (Teulings, 1987; Koene and Slomp, 1991).

The reach of works councils has changed over time. Nowadays, all firms in the private sector that usually employ 35 workers or more[60] are obliged to have a works council (SER, 1991: 90). Members of the works council must have been employed by the firm for at least one year, whereas workers with a minimum tenure of half a year are allowed to vote (SER, 1991: 92). The influence of works councils is larger in firms with 100 workers or more. For instance, in firms with 35 to 100 workers consultation rights apply only to matters that affect the labour market position of at least 25% of all employees, whereas this restriction does not apply to large firms (Koene and Slomp, 1991: 35).

The right to start a works council does not apply to very small companies. Workers in small firms, with 10 to 35 workers, merely have limited advisory power via obligatory biannual personnel meetings. According to a rough estimate, approximately 68% of Dutch workers have the right to start a works council, whereas this right applies to approximately 85% of German workers (Table 11).

[60] 35 workers or more who work (on average) more than 1/3 of a full-time work week, or a minimum of 100 workers. The 1/3 criterion will be abolished in the near future.

However, in both countries a considerable number of workers, especially in those in small firms, do not use their co-determination rights because they do not start a works council.

Dutch co-determination is still gaining ground. In the near future some changes in co-determination regulations will take place (Tweede Kamer, 1996a and b). Firstly, the law regarding works councils (WOR) is extended to the public sector, which will strengthen co-determination in this sector after the implementation of the new regulations (Vanwersch et al., 1993). Evidently, government policy will be excluded from co-determination rights. Secondly, the influence of works councils will strengthen in some areas. Co-decision rights will also apply to instruments of performance monitoring and to the registration of personal information of employees. Advisory rights will be extended to technological changes (instead of being limited to new technologies that correspond with important investments), to systems of environmental care as well as to important granting of credit.

Thirdly, firm-level agreements between management and employees will get a more formal status. This change is related to the increasing importance of the works council as a bargaining partner at the firm level. Within the boundaries of the contents of a collective agreement, the works council in many firms negotiates with management over firm level issues, and lays down the outcome in a firm-level agreement. Such an agreement involves not only co-decision rights but often also other issues, since the influence of the works council can be extended through provisions in a collective agreement or by management. The more formal status of these agreements implies that management cannot easily change the contents of this type of firm-level agreements without involving the works council. However, firm-level agreements do not have the same status as collective agreements, as is the case in Germany.

Fourthly, a EU-directive obliges member countries (except the United Kingdom) to implement co-determination requirements for multinationals in their national legislation before september 1996 (Berentsen, 1995). Hence, international co-determination by a European works council or similar committee will become obligatory for multinationals[61]. The influence of this institution will be confined to information and consultation rights related to management decisions at the international level (Sanders, 1995). Of course, this directive will also alter the German legislation. Fifthly, the scope of co-determination will be enhanced in the near future, because part-time workers as well as workers through employment agencies will obtain the same status as full-time workers with respect to co-

[61] The new regulations will apply to multinationals (private or public sector companies) with 1000 employees or more, and at least 150 workers in two or more membership countries.

determination regulations. Nevertheless, the requirement of a minimal tenure, before voting and membership rights become effective, remains intact.

These changes all imply a stronger influence of workers, but do not result in a convergence to the German system on all aspects of co-determination institutions, since the status of firm-level agreements remains different in the Netherlands, Dutch advisory rights of works councils are more extensive, and co-determination through the supervisory board is absent.

4.3 Comparison of institutions and worker influence

This section analyzes the main institutional differences between both countries and their effect on worker influence. Most German co-determination institutions imply similar or stronger worker influence compared to the situation in the Netherlands. Only as regards the advisory power of works councils, legal provisions in the Dutch system are more influential. However, in some firms legal co-determination rights are expanded through collective bargaining agreements or through decisions by management. In other firms, employees do not fully use their legal co-determination rights. Hence, a comparison of Germany and the Netherlands has to take both the strength of legal rights and the actual worker influence into account.

For three reasons, worker influence is relatively strong in Germany. Firstly, the potential influence of works councils is relatively small in the Netherlands, since small firms are not required to have a works council, whereas this is a legal requirement in Germany. However, in practice many small firms do not establish a works council. Table 13 shows that currently German workers are relatively more organized in medium-sized firms, while activity is similar in large firms. This implies that works councils are still more common in Germany (see also Table 11). However, activity rates are likely to converge in the future, since activity in medium-sized Dutch firms is increasing (Van der Burgh and Kriek, 1992).

Secondly, many aspects of German worker influence are more concentrated within the firm. Hence, works councillors do not need to share influence with external institutions. Firing procedures provide an example: a German employer informs the works council in advance in case of an individual dismissal, since works councillors have advisory rights. Moreover, in case of mass lay-offs, the works council negotiates about the contents of a social plan. In contrast, in the Netherlands the regional employment office determines whether individual dismissals are appropriate. In case of mass lay-offs, trade unions negotiate with the employer about a social plan. As another example, internal settlement boards arbitrate if the German works council and management disagree. In contrast, Dutch works councillors can make use of non-binding arbitration by committees in matters related to co-decision rights (Bedrijfscommissies). However, if arbitration is not successful they need to appeal in court. If disagreement is related to advisory

Table 13 Presence of a works council in Germany and the Netherlands

	Germany	*The Netherlands*
	% of firms	
Small firms, 6-10 workers	*10*	_
Medium-sized firms 50 to 100 (Germany), 35 to 100 workers (Netherlands)	*60*	*41*
Large firms, 100 workers or more	*80*	*83*

Source: Koene and Slomp (1991: 234)

rights, the Chamber of Company Law decides.

Thirdly, the legal basis of worker influence is stronger in Germany because some instruments of works councils are formalized in Germany but not in the Netherlands (Jacobi *et al.*, 1992). For instance, works councillors in Germany can conclude formal agreements that have a similar status as collective agreements. As another example, the internal settlement boards that solve disputes between managers and works councillors are required by law (Koene and Slomp, 1991: 250). Legislation is not a sufficient condition for worker influence at the work floor, because the government cannot control work-floor activities. The absence of works councils in smaller firms clearly illustrates this. However, legislation does provide workers with a powerful means to ensure that co-determination is effective in case of disagreements with management.

There is one aspect of Dutch co-determination institutions that is comparatively strong, namely the advisory rights of works councils. Works councillors can advise management to cancel a major investment project. Their advice can be enforced through the Chamber of Company Law, although this rarely happens in practice. Only if management has made procedural mistakes or has not carefully considered the position of all stakeholders, investment plans or re-organisations sometimes have to be cancelled, postponed or amended. Therefore, advisory rights do mainly imply that managers need to operate carefully in case of major investment plans or reorganisations.

The integrated character of German co-determination presents a mixed picture. Worker representation on the supervisory board facilitates access of employee representatives to information on the companies' financial and strategic planning (Turner, 1993: 63). Moreover, compared to the Netherlands, communication between supervisory board members and works councillors is more common in Germany, where members of works councils are often also representatives on the supervisory board (Van het Kaar, 1995 or Koene and Slomp, 1991). In the Netherlands, works councillors, management and supervisory board members are required to organise meetings on a regular basis, but informal contacts between the works council and the supervisory board are much less common (Van het Kaar, 1995; Koene and Slomp, 1991: 26, 48).

However, the German situation shows that enterprise-level co-determination does not constitute the main channel for the advancement of worker interests. Firstly, the objectives of worker representatives on the supervisory board are potentially conflicting. In particular, business policies that are in accordance with the long-run strategy of the firm may not agree with the protection of worker interests. Secondly, many companies have reduced the significance of the supervisory board meetings in order to limit the influence of worker representatives (see Section 3.1: 59). Hence, joint representation improves information flows between the supervisory board and works councils, but at the same time diminishes the efficacy of the board.

These shortcomings are one reason not to introduce directly elected employee representatives in Dutch supervisory boards. A second reason involves the limited influence of shareholders on Dutch companies (see Section 3.6). Increasing the power of employees on supervisory boards entails the risk of generating a bias in board decisions towards employee interests, because the countervailing power by shareholders is more limited in the Netherlands.

Many other aspects of institutional co-determination are similar in both countries. Co-decision rights are alike, since they apply to many matters of personnel policy except to wage bargaining. Moreover, in both countries the works council mainly has a passive role; initiatives are exceptional. In Germany, the right of initiative is somewhat stronger because internal arbitration is required. In the Netherlands, a more limited form of arbitration will probably be implemented in the near future, but it is not expected that this will make the position of the Dutch works council regarding initiatives much more stronger. Another similarity is that both systems enhance the influence of core workers, as opposed to that of peripheral workers. A minimum duration of tenure is required before a worker can be elected for the works council. In this respect, regulations with respect to tenure are more strict in the Netherlands.

In summary, based on an analysis of the stronger, weaker and similar aspects of legal co-determination arrangements the conclusion can be drawn that some aspects of legal provisions result in a stronger potential influence of workers in Germany. In addition, Dutch workers are still less active compared to their German counterparts in fully using their co-determination rights. In contrast, the advisory rights of works councils are stronger in the Netherlands. Furthermore, the integrated German system enhances information flows to employees but reduces the effectiveness of the supervisory board. Nevertheless, in some firms works councillors exert more influence than is required by law. For instance, in some multinationals legal institutional arrangements are so broadly interpreted that actual worker influence between German and Dutch subsidiaries has converged.

4.4 Profit sharing

Section 2.4: 26, concluded that profit sharing enhances the effectiveness of co-determination. Moreover, empirical evidence suggests that the introduction of profit sharing raises the level of productivity in a firm (see also Section 2.4). To analyze these issues this section briefly reviews profit-sharing arrangements in Germany and the Netherlands.

Together with Canada, France, Italy, Japan, Mexico, the United Kingdom, and the United States, Germany and the Netherlands are among the countries where profit sharing covers at least 5% of the employees (OECD, 1995b). In particular, cash-based informal schemes are wide-spread in the Netherlands. These schemes involve a direct cash payment related to current profits. They may be part of a collective labour agreement or of a voluntary agreement between a specific company and its employees. In the early 1990s, on average 4% of total gross earnings of 10 to 20% of business sector employees consisted of a cash-based payment out of companies' profits. In Germany the coverage of cash-based schemes is less extensive, since only 6% of the total number of employees is covered. Yet, the average payment equals 5 to 10% of gross wages and thus exceeds that in the Netherlands. Neither in Germany nor in the Netherlands does legislation substantially encourage cash-based profit sharing.

Legal support for employee share ownership is more elaborate in Germany. According to one type of legislation, an employee is allowed to receive annually up to DM 936 in company shares tax-free (Seeger, 1995). Yet, only few companies use this way of profit-sharing, because the associated regulation and administration is expensive and burdensome. Companies and employees use the second alternative more extensively. According to this arrangement companies are allowed to offer their shares to their employees at a price that is 50% below the market price at the maximum. The price discount is free from taxes and social security contributions up to a ceiling of DM 300. Recently, this ceiling has been lowered from DM 500 to DM 300. Hence, the fiscal stimulus is relatively modest. In both schemes shares can be only sold after a period of six years. The number of employees that make use of the price discount scheme has doubled since 1985 to approximately 5% of total employment in 1995 and covers some 200 out of 650 listed German companies. Rising equity value of these shares due to higher share prices is not subject to capital gains taxes in Germany, which increase the attractiveness of employee share ownership.

In the Netherlands, tax concessions pertain to employee share-ownership schemes that are open to 75% of a company's workforce and that are approved by the works council (IDS, 1995). When the stock option is granted 7.5% of the equity value of the option right is liable to income taxes. Recall from Section 2.2: 17 that a stock option entails a right to buy the company's shares at a given price at a future date. Hence, the option valued by the price given at the moment the option is granted is completely subject to income taxes and social security contributions. The attractiveness to an employee stems from the fact that the option rises in value if share prices increase. Because 7.5% of the option right is liable to income taxes, employees with a 50% marginal tax rate benefit from the stock option if the share price rises by more than 3.75%. Any further increase of share prices is exempt from taxation because in the Netherlands capital gains from rising share prices are not subject to taxation.

Income taxes on an option right are due only above an allowance of about *ƒ*1500, if the shares are not sold for a period of four years. Hence, under the four year constraint, stock option rights up to *ƒ*20 000 (*ƒ*1500 / 0.075) are exempt from taxation and the option becomes attractive to employees if the share price does not fall. As yet, no data on coverage of these tax provisions are available because the complete legislation only exist since 1994 and detailed information on stock option arrangements does not have to be published.

In comparison, the coverage of cash-based profit-sharing arrangements in the Netherlands exceeds that in Germany. The extent of tax provisions on employee share ownership is difficult to compare because these differ considerably and data on the use of employee stock options are lacking for the Netherlands. The absence of capital gains taxes makes both German and Dutch tax incentives relatively large from an international perspective. By consequence these institutions which, according to the theoretical arguments and empirical studies cited in Section 2.4, enhance the effectiveness of employee participation and the level of productivity are present in both countries, although their effect is not expected to be large.

4.5 Assessment

The analytical framework (Section 2.4: 26) shows that co-determination can be viewed as an employee control mechanism restricting managerial opportunism, and guarding the way in which management handles employees' residual claims on the company. Co-determination enforces the realization of implicit agreements in relational contracts, because it precludes unilateral decisions by managers to renege implicit agreements. In other words, stronger mutual commitment of workers and managers alleviates the hold-up problem. In this way, co-determination encourages workers to invest relationship-specific assets.

The comparison of the Anglo-American and German models in Section 2.6: 42 provided several additional arguments to assess the impact of co-determination on firm performance. Co-determination enhances employment stability, which strengthens long-term relationships between management and employees and as such supports reputation and mutual commitment to reduce the hold-up problem. The semi-fixed character of core-employment forces enterprises to invest in the quality and internal flexibility of workers. Works councillors are inclined to accept the demand by employers for recurrent investments in the quality and internal flexibility of the workers they represent, because they recognise the need for a high quality and flexible labour force in order to maintain the employment level of the firm. Accordingly, the works council often supports management decisions regarding rationalisation and modernization, as long as the employment level remains unaffected (Jacobi *et al.*, 1992). Moreover, besides supporting managerial decisions that increase worker quality and internal flexibility, the works council can also strengthen the quality of managerial decision-making by providing management with work-floor information.

However, co-determination rights suffer also from disadvantages. In particular, if worker representatives become too influential, workers may pursue opportunistic objectives as well. Co-determination may slow down decision-making within established firms by requiring extensively lengthy procedures before decisions can be taken. In extreme cases, conflicts between management and works councils may result in a deadlock. Moreover, co-determination may reduce the flexibility of employment adjustments across firms and industries. By succeeding in maintaining the current level of employment within the firm, co-determination may hamper the re-allocation of labour towards newly emerging sectors with strong growth perspectives (see also Section 2.6). Through strong insider protection, new hirings may be hampered as well (Streeck, 1984).

Quantitative empirical evidence on the effects of co-determination in Germany on firm performance and employment adjustments is scarce. Regarding firm performance, it is difficult to disentangle the effects of co-determination from other factors, such as the quality of the schooling system or of other business strategies. Moreover, empirical studies suffer from methodological problems, such as measuring long-run firm performance, and from data problems (Nickell, 1995; Smith, 1994: 307). Hence, it is not surprising that empirical findings are mixed. To illustrate, Gurdon and Rai (1990) find a positive influence of co-determination on firm performance (profitability), whereas FitzRoy and Kraft (1993) find that co-determination increases private costs, but recognize that it is hard to quantify potential benefits[62]. As to the effects on employment adjustments across firms and industries, empirical evidence generally confirms that co-determination reduces external labour market flexibility. Fitzroy and Kraft (1993) relate increased private costs to labour hoarding during periods of economic downturn. Houseman (1991)

[62] Empirical evidence on the effects of co-determination (defined as joint decision making) in the United States is also mixed. Miller and Monge (1986) and Wagner and Gooding (1987), performing a meta-analysis on a large number of empirical studies, conclude that results strongly depend on the methodology adopted.

finds that down-ward adjustments of employment in the European steel industry took place comparatively slow in Germany. However, the contribution of co-determination is difficult to separate from that of other institutions, notably short-time working arrangements and work-sharing.

Qualitatively-oriented studies have reached more consensus, by emphasizing the beneficial effects of worker participation on firm performance in many German industries (for example Biagi, 1993; Jacobi *et al.*, 1992; Turner, 1991; Nickell, 1995). As an example, during the 1980s West-German firms in the car industry were able to recover from intensified international competition with the United States and Japan without mass lay-offs. Hence, "the stability of workers' interest representation in the industry has been consistent with successful industrial adjustment" (Turner, 1991: 152).

In conclusion, theoretical arguments and case-studies support the view that co-determination can improve firm performance in the long run, whereas mixed empirical information neither supports nor contradicts this view. This suggests that the future extensions of Dutch co-determination, which imply partial convergence to the German system, will probably not hamper but support the performance of established firms. The German evidence contradicts the view that the present degree of worker influence leads to internal inflexibility within firms because of sluggish decision-making. However, the reallocation of labour through the external labour market may slow down, because co-determination reduces external flexibility by protecting the position of insiders within a firm. In this way, co-determination hampers efficiency of reallocation of labour between firms or industries. The scarce empirical evidence for Germany confirms the theoretical argument that co-determination delays the adaptation of employment.

The analysis of differences between the German and Dutch co-determination institutions leads to the conclusion that is not advisable to introduce the integrated German system, which combines works councils with formalized supervisory board representation of employees, in the Netherlands. The German experience shows that such a system may promote more efficient information flows from management to employees, but reduces the overall effectiveness of the supervisory board. Moreover, the Dutch system lacks a countervailing shareholder power to balance the increased representation of workers on the supervisory board. Furthermore, introduction of joint supervisory board representation is also less needed as a way to strengthen worker influence in the Netherlands, because the advisory rights of Dutch works councils exceed those of German works councils. In contrast to their German counterparts, Dutch employers must consult the works council not only on the social consequences of important economic decisions, but on the economic and financial consequences as well.

No univocal assessment can be made on the efficiency of work-floor co-determination procedures in Germany and the Netherlands. On the one hand

German worker influence is more concentrated within enterprises, which can enhance the efficiency of procedures. Yet, on the other hand, German co-determination regulations are more detailed, which requires more effort from participants to comply with the regulations.

5 Governance of stakeholder relationships: summary and lessons

Institutions affect investments in relationship-specific assets

Shareholders, creditors, managers, employees, suppliers, competing firms and consumers can all have a stakeholder relationship with a firm. The distinctive feature of a stakeholder relationship, in contrast with a market transaction, is the existence of investments in relationship-specific assets by stakeholders. These investments can be hampered by partly diverging interests or conflicting objectives of stakeholders. Comprehensive contracts cannot align conflicting interests because economic agents are boundedly rational, which implies that contracts are always incomplete. Incomplete contracts and opportunism of economic agents give rise to the hold-up problem, which states that it is not possible to commit agents to keep to an agreement. Agents have the possibility to renege on an agreement and opportunistically pursue their own goals. In this way the hold-up problem curbs relationship-specific investments. The function of governance institutions is to reduce the hold-up problem by strengthening the commitment of parties not to renege on an initial agreement. To enhance commitment, governance institutions promote monitoring capabilities of parties, reallocate revenues so as to align differing incentives, increase co-decision powers, or support long-term relationships between economic agents.

Countries differ in the way in which their governance institutions succeed in supporting investments in relationship-specific assets. Although managers in different countries aim at maximization of the equity value of the company, their behaviour is not identical. Institutional differences between countries imply that managers to various degrees take the interests of other stakeholders into account. Therefore, governance institutions have a crucial impact on the extent of a nation's investments in relationship-specific assets.

The Anglo-American and German models of stakeholder relationships

Two stylized models of stakeholder relationships can be distinguished, the Anglo-American model and the German model. Market orientation and competition characterize the Anglo-American model. The stock market is well-developed so that changes in share prices and takeover threats can discipline managers. Management stock ownership is an additional governance institution that aligns interests of managers and shareholders. Relationships between companies are governed by relatively extensive vertical integration and formal contracts. The labour market is competitive, labour contracts are formal to a considerable extent. Profit sharing acts as an incentive for workers. Workers largely bear the risk of relationship-specific human-capital losses, since long-run stable worker relationships are not common.

Long-term relationships and cooperation are distinctive features of the German model. Block shareholdings and cross-representation of companies on supervisory boards support long-term relationships between companies as well as between companies and banks. Personal reputation strengthens the ties between companies in industrial groups. Co-determination enables employees to monitor management and supports relationship-specific investments of workers.

Institutions associated with the German model to a larger extent support the commitment of managers and other stakeholders to invest in relationship-specific assets compared to institutions in the Anglo-American model. Hence, the Anglo-American model has many characteristics of a 'shareholder society', whereas the German model corresponds with a 'stakeholder society'. Strong elements of the Anglo-American model are fast reallocation of financial, physical and human capital through the market. Short-run flexibility facilitates a shift of resources towards innovative emerging technologies, in particular towards start-up firms. The German model is strong on the development of long-term commitment, investments in relationship-specific physical and human capital, cooperation between companies. This model promotes technological progress and re-allocation of resources within established enterprises. Superiority of one of the two stylized models of stakeholder relationships cannot easily be established. The models are valuable as a point of reference for the comparison of the German and Dutch governance structures regarding corporate governance and work governance.

Corporate governance in Germany and the Netherlands

Corporate governance institutions, which pertain to governance of relationships between financiers and managers, differ between both countries. In Germany representatives of non-financial firms and banks in the supervisory board monitor management. Supervisory board representation by banks and firms is related to the considerable cross-holdings of equity among companies. In addition, cross-holdings function as a protection against hostile take-overs. In the Netherlands, share ownership is dispersed, so that monitoring by block shareholders is largely absent. In this respect the situation in the Netherlands is comparable to that in the United States and the United Kingdom. However, in contrast to the Anglo-American model the market for corporate control is virtually absent in the Netherlands. Cooption of members of the supervisory board and extensive use of juridical anti-takeover defence mechanisms substantially restrict the influence of shareholders on management. The only alternative available to shareholders of Dutch companies is the exit option, *i.e.* selling their stock of shares if they oppose company policy. In conclusion, the position of shareholders in the Dutch model is weak since neither large shareholders nor the stock market control management.

Being shielded from direct shareholder influence, corporate governance of Dutch enterprises primarily depends on the quality of the supervisory board. There are no reasons to assert that the quality of the average Dutch board is lower than the average German supervisory board. However, the variance of the quality distribution in the Netherlands is expected to be larger, since shareholders have little means to change the composition of incompetent supervisory boards once management and the supervisory board conspire.

The main types of shareholders also differ, which intensifies the differences between the German system of cross-holdings and the Dutch system of weak shareholder influence. The position of German banks in corporate governance corresponds with the concentrated share-ownership structure of corporate Germany. In contrast, bank share ownership diminishes the efficacy of creditor control. Dutch banks do not own substantial blocks of shares. Instead Dutch banks monitor management from a creditor perspective. Large firms have several ways to reduce the risks to lenders. Hence, monitoring by banks is relatively unimportant for large listed and unlisted companies in the Netherlands. In contrast to Dutch banks, pension funds in the Netherlands own relatively large amounts of equity capital in a number of Dutch companies and are enlarging their equity investments. Combined with their rising shareholder activism, pension funds' role in corporate governance is expanding in the Netherlands. Evidence from the United States shows that pension fund activism can be effective to improve poorly performing management. The aim of Dutch pension funds is to strengthen the shareholder position in companies.

Work governance in Germany and the Netherlands

Work governance, which concerns the governance of relationships between management and employees, also features different characteristics in both countries. Co-determination is the main work governance institution in Germany and the Netherlands, although it is supported by institutional arrangements such as dismissal protection or profit-sharing. German co-determination operates through two different channels. At the enterprise level, worker representatives are present on the supervisory board of most public or private limited liability companies. In addition, workers in many firms are represented at the work-floor level through works councils. In the Netherlands, workers are not represented on the supervisory board and works councils are not obligatory in small firms. On the other hand, Dutch works councils have more influence on managerial financial-economic decisions regarding reorganisations, mergers, etcetera.

Lessons and future changes

Regarding corporate governance institutions, it can be concluded that Dutch institutional characteristics of corporate governance do not encourage potential stakeholders to engage in long-term financial relationships with Dutch companies, since potential stakeholders have no strong means to govern the long-term relationship. In this respect the German system performs better. Moreover, Dutch corporate governance institutions do not enhance flexible re-allocation of capital or risk-sharing finance through the stock market to innovative start-up firms because of an extensive use of anti-takeover defence mechanisms. In this respect the Anglo-American model performs better.

Policy changes in the near future will lead to some improvements of the Dutch system of corporate governance. Recently the Dutch government has reached an agreement with the parties involved on a proposal for new legislation that will strengthen the influence of shareholders. According to this agreement, which still has to be put forward to Parliament, juridical anti-takeover defence can be removed by court order, although this is only possible after a lengthy and complex procedure. Moreover, the introduction of a system of proxy voting is currently put forward in the discussion on Dutch corporate governance institutions.

Dutch companies anticipate these changes by investing in longer-term relationships with block shareholders, which will remain a viable defence mechanism under the new legislation. Enactment of the new proposals will strengthen the position of institutional investors and may enhance long-term financial investment relations in the Netherlands. Hence, lowering anti-takeover defence mechanisms will sooner lead to a shift towards the German model than to the Anglo-American model, with the qualification that institutional investors instead of banks will have a stronger position in the Netherlands.

In contrast, German governance institutions to a larger extent support long-term financial relationships. However, information flows constitute a weak feature of the German system of corporate governance compared to the Dutch system. Accounting standards do not adequately present information to shareholders to develop a detailed view on the financial position of the firm. In addition, the joint representation of shareholders' representatives and workers' representatives on the supervisory board hampers information flows between management and the supervisory board. However, German companies are reacting to internationalization of product markets and financial markets by improving accounting information. Installing supervisory board subcommittees might resolve some of the problems caused by joint representation on German supervisory boards.

With respect to work governance institutions, theoretical arguments and case-studies support the view that co-determination can improve firm performance in the long run. Therefore the lesson can be drawn for the Dutch situation that some future extensions of co-determination will not hamper but support the performance of established firms. Yet, the improved internal performance of established firms corresponds with slower reallocation of labour through the external labour market, because co-determination reduces external flexibility by protecting the position of insiders within a firm. In this way co-determination hampers efficiency of reallocation of labour between firms or industries, compared to the Anglo-American work governance institutions.

For the Netherlands it is not advisable to introduce the integrated German system, which combines works councils with formalized supervisory board representation of employees. The German experience teaches that such a system may promote more efficient information flows from management to employees, but at the same time reduces the overall effectiveness of the supervisory board. Moreover, the Dutch practice lacks a countervailing shareholder power to balance increased representation of workers on the supervisory board. Introduction of joint supervisory board representation is also less needed as a way to strengthen worker influence in the Netherlands, because advisory rights of Dutch works councils exceed those of German works councils.

No univocal assessment can be made on the efficiency of co-determination procedures in Germany and the Netherlands. On the one hand German worker influence is more concentrated within enterprises, which can enhance the efficiency of procedures. Yet on the other hand German co-determination regulations are more detailed, which requires more effort from participants to comply with the regulations.

A recapitulation of the main findings on the position of Dutch governance institutions yields the following main conclusions. Dutch corporate governance institutions have a particular position compared to both the German and the Anglo-American models of stakeholder relationships between financiers and management. This position does not stand out as favourable compared to the German and the Anglo-American model. Dutch corporate governance institutions neither strongly encourage investments in relationship-specific assets, nor strongly enhance flexible reallocation of capital or risk-sharing finance. Recent policy changes will probably lead to a moderate shift to the German model.

In contrast, work governance institutions more closely resemble those in Germany, whereas they differ strongly from the Anglo-American institutions. This implies that the performance within large established firms is enhanced through worker influence, but external allocation through the labour market is less efficient compared to the functioning of markets in the Anglo-American model. Future policy changes that strengthen Dutch worker influence will be beneficial for performance in established firms, and are in accordance with the gradual shift towards German governance structures.

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Abstract

Countries' governance institutions to a varying degree support investments in relationship-specific assets by stakeholders. The function of governance institutions is to strengthen the commitment of parties not to keep to an initial agreement. Thus, interbational differences in governance institutions affect relationship-specific investments.

Two stylized models of stakeholder relationships can be distinguished, the Anglo-American model and the German model. Market orientation and competition characterize the Anglo-American model. Long-term relationships and cooperation are distinctive features of the German model. Strong elements of the Anglo-American model are fast reallocation of financial, physical and human capital through the market. Short-run flexibility facilitates a shift of resources towards innovative emerging technologies, in particular towards start-up firms. The German model is strong with respect to the development of long-term commitment, investments in relationship-specific physical and human capital, cooperation between companies. This model promotes technological progress and re-allocation of resources within established enterprises.

The position of Dutch corporate governance institutions, which govern the relationships between management and financiers, does not stand out as favourable compared to both the German and the Anglo-American models of corporate governance. In the Netherlands, share ownership is dispersed, so that monitoring by block shareholders is largely absent. In this respect the situation in the Netherlands is comparable to that in the United States and the United Kingdom. However, in contrast to the Anglo-American model the market for corporate control is virtually absent in the Netherlands. Cooption of members of the supervisory board and extensive use of juridical anti-takeover defence mechanisms substantially restrict the influence of shareholders on management. Therefore, Dutch corporate governance institutions neither strongly encourage investments in relationship-specific assets, nor strongly enhance flexible reallocation of capital or risk-sharing finance. Recent policy changes will probably lead to a moderate shift to the German model.

Dutch work governance institutions, which concern the governance of relationships between management and employees, more closely resemble those in Germany. This implies that the performance within large established firms is enhanced through worker influence, but external allocation through the labour market is less efficient compared to the functioning of markets in the Anglo-American model. Future policy changes that strengthen Dutch worker influence will be beneficial for performance in established firms, and are in accordance with the gradual shift towards German governance structures.